Annex I

DIFFERENCES IN MUTUAL FUND FEE STRUCTURE BETWEEN CANADIAN MUTUAL FUNDS AND MUTUAL FUNDS IN OTHER JURISDICTIONS

The recent research studies and media articles which compare mutual fund costs between jurisdictions have generally focused on MER levels. When comparing average MERs of mutual funds across countries, these studies consistently conclude that mutual fund fees in Canada are among the highest in the world. These conclusions, however, sometimes fail to recognize the unique features of each market and how these features are likely to affect respective mutual fund fee levels in those jurisdictions.

The average mutual fund MER in a country is influenced, in large part, by that country's distinct capital market structure, including the competitive pressures in which mutual fund manufacturers operate and compete, as well as the regulatory framework in which the mutual funds function. Therefore, before a comparison of mutual fund fees can occur, it is important to understand the distinctions between the Canadian market and the markets of major regulatory jurisdictions.

Factors that may influence average fund costs in a jurisdiction include:

- *Fund investment objective/asset class:* Fixed income and money market funds tend to have lower MERs than equity funds. Among equity funds, MERs tend to be higher for funds that specialize in particular industry sectors or those that invest in international equities, because such funds tend to be more costly to manage. Accordingly, a jurisdiction whose mutual fund assets under management tend to be more heavily weighted in equity or other higher MER funds will exhibit a higher overall MER. Conversely, a jurisdiction whose mutual fund assets under management include a significant weighting in money market funds will exhibit a lower overall MER.

  Similarly, whether a mutual fund is passively or actively managed can impact MER. Typically, passively managed funds (such as index funds) have lower MERs. Accordingly, a jurisdiction whose mutual fund assets under management include a significant weighting in index funds will exhibit a lower MER;

- *Average fund size and average individual securityholder account size:* Larger mutual funds generally tend to exhibit economies of scale and consequently tend to have lower MERs. In addition, mutual funds with higher average securityholder account balances, such as funds that focus on institutional or higher net worth investors, also tend to have lower MERs than other funds. This reflects the fact that each securityholder account, regardless of its size, requires certain basic services (such as record keeping, account mailings, call centre support, etc.), and the cost of those services tends to be the same per account. Consequently, a fund that primarily serves retail investors, and that therefore has a large number of securityholder accounts with lower average account balances, will typically incur more of these basic costs and therefore have a relatively higher MER than a fund that primarily serves institutional and/or higher net worth investors;

- *Fund distribution channels:* The nature of the distribution channels used to sell mutual fund securities to investors in a jurisdiction can greatly influence MER levels in that jurisdiction. For example:

    - a jurisdiction whose mutual fund manufacturers are largely reliant on advised distribution channels to sell mutual funds will typically have higher MER funds on account of the cost associated with compensating advisors for their services, particularly if these costs are embedded in the funds' MER;
    - a jurisdiction that has a higher incidence of fee-based advisors (which are compensated separately for their services directly by investors rather than through fees embedded in the funds' MER) and thus a lower incidence of embedded fund costs, will tend to have lower MER levels;
    - a jurisdiction that has a developed and unsegregated (in terms of price and product competition) occupational retirement plan market through which mutual funds are distributed to investors will tend to have lower MER levels.

- *Taxation:* Sales taxes may apply to mutual fund management fees and/or expenses in certain jurisdictions (e.g. Canada and Australia) which may inflate overall MERs in those jurisdictions.

- *Regulation:* The regulatory framework in which mutual funds operate in a jurisdiction may have an impact on the overall MER in that jurisdiction. This may be the case where, for example, the legislation imposes specific caps on various fund fees (such as in the U.S.);

- *Competition:* The relative size of the fund industry, the number of mutual fund manufacturers and their respective market share, and the size and number of integrated relative to independent mutual fund manufacturers and dealers, may impact the competitive dynamics in each jurisdiction, which in turn may influence overall MER levels. In addition, whether or not the market in question is open to foreign funds may also enhance competition. Generally, the greater the competition and the greater the choice for the investor, the better the mutual fund fee proposition may be for the investor.

At the end of this Annex, we include a table which provides a snapshot of the respective fund industry in which mutual funds operate and compete in Canada, the U.S., the U.K. and Australia. It highlights some of the factors discussed above, including differences in the regulatory framework, which potentially impact the overall MER level in each jurisdiction. Some of these country-specific factors, as well as other relevant factors that may impact overall MER levels in each jurisdiction, are set out below:

Canada:

- Canada has the smallest mutual fund industry out of the four countries. It has the least number of mutual fund manufacturers, of which the 10 largest hold 75% of all Canadian mutual fund assets under management;
- The average Canadian mutual fund is almost 7 times smaller than the average U.S. fund;
- Distribution of mutual funds in Canada is almost always made through the intermediation of an advisor. At the end of 2011, 91% of investment fund assets were acquired and held by investors through distribution channels involving the intermediation of an advisor, and over 80% of mutual fund investors said their last purchase was made through an advisor;[1]
- Canada's mutual fund industry is primarily focused on the retail investor, with only 7.5% of mutual fund assets sitting in institutional accounts as at the end of 2011;[2]
- The fund industry exhibits a greater reliance on trailing commissions relative to other jurisdictions. Canada's mutual funds carry the highest trailing commission rates of all four countries featured in the table;
- At the end of 2011, equity funds and balanced funds (which have higher MERs than fixed income and money market funds) accounted for 68% of the mutual fund industry's asset base and money market funds (which have the lowest MERs) accounted for approximately 5% of the mutual fund industry's asset base;[3]
- Index mutual funds (which tend to have lower MERs) account for a small portion of assets under management, making up only 1.5% of mutual fund assets under management as at June 2012;[4]
- Relative to other countries, Canada's defined contribution occupational plan market is very small, and consequently does not figure significantly in the distribution of mutual funds to investors.[5] At the end of June 2011, an estimated $49 billion was invested in group RRSPs and $46 billion was invested in defined contribution plans.[6] Collectively, this potential market for fund manufacturers[7] would equal about 10.2% of assets under management in the investment funds industry.[8]

U.S.:

- The U.S. mutual fund market, with $12.8 trillion (CAD) in assets under management at year-end 2011, remains the largest in the world, accounting for 49% of mutual fund assets worldwide;[9]

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[1] See notes 4 and 5 in the Discussion Paper.
[2] Source: Investor Economics. Investment by mutual fund-of-funds, segregated funds, insurance company pools and private investment counsel into mutual funds has been removed.
[3] Source: Investor Economics.
[4] Source: Investor Economics, *ETF and Index Funds Report*, Q2, 2012.
[5] According to the Organization for Economic Co-operation and Development (OECD) Global Pension Statistics, defined contribution plans made up only 3% of total pension plan assets in Canada in 2011. By contrast, defined contribution plans in the U.S. and Australia made up 39.4% and 89.1%, respectively, of total pension plan assets in those countries.
[6] Source: Benefits Canada 2011 CAP Suppliers Directory. Private sector defined contribution plan assets reported.
[7] Not all of the assets in group RRSPs and defined contribution plans would be invested in investment funds though the majority would be.
[8] Source: OSC calculations based on data from Benefits Canada *2011 CAP Supplier Directory* and Investor Economics *2012 Household Balance Sheet*.
[9] Investment Company Institute, *2012 Investment Company Fact Book*, 52nd Edition.

- It has the largest number of mutual fund manufacturers, of which the 10 largest hold 53% of all U.S. mutual fund assets under management;
- U.S. mutual funds are on average very large (average size is $1.58 billion CAD);
- Distribution of U.S. mutual funds is less reliant on advisors than in Canada:
    - Employer-sponsored retirement plans (401(k) plans/defined contribution plans) figure significantly in the distribution of mutual funds to investors. Mutual funds distributed through this channel are typically no-load mutual funds.[10] As at the end of 2011, 21% of U.S. mutual fund assets were held by investors through defined contribution plans;[11]
    - In 2011, of the U.S. households owning mutual funds outside employer-sponsored retirement plans, 54% owned mutual funds purchased through an advisor, and 32% owned mutual funds purchased through the direct market channel (i.e. from the mutual fund manufacturer directly or through a discount broker);[12]
- Outside of employer-sponsored retirement plans, 11% of mutual fund assets as at year-end 2011 were held by institutional investors;[13]
- Trailing commissions (12b-1 fees) on U.S. funds are capped by law to no more than 1% per annum and trailing commissions on no-load funds are capped by law to no more than 0.25% per annum;[14]
- Money market funds (which have low MERs) weigh considerably into the overall asset mix of U.S. mutual funds, accounting for 23% of mutual fund assets under management as at the end of 2011. Equity funds and balanced funds (which have higher MERs) accounted for 54% of mutual fund assets under management at the end of 2011;[15]
- Index funds (which tend to have lower MERs than actively managed funds) accounted for approximately 9% of mutual fund assets under management.[16]

U.K.:

- The U.K has 241 mutual fund manufacturers, of which the 10 largest hold 45% of all U.K. mutual fund assets under management;
- The U.K. fund market is open to UCITS qualified funds.[17] At December 2011, there was €5.6 trillion invested in UCITS qualified funds.[18]
- Distribution of U.K. mutual funds is less reliant on advisors than in Canada:

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[10] No-load mutual funds in the U.S. are typically less expensive than no-load mutual funds in Canada as their trailing commissions (12b-1 fees) are capped by law to no more than 0.25% per annum (see note 155 in the Discussion Paper), whereas Canadian no-load funds may pay trailing commissions of up to 1.50%,
[11] Investment Company Institute, *supra*, note 9.
[12] Investment Company Institute, *Profile of Mutual Fund Shareholders*, *2011* (February 2012). Note that mutual funds acquired directly from the mutual fund manufacturer or through a discount broker are typically no-load funds whose trailing commissions (12b-1 fees) are capped by law to no more than 0.25%.
[13] Investment Company Institute, *supra*, note 9.
[14] See notes 153 and 154 in the Discussion Paper.
[15] Investment Company Institute, *supra*, note 9. Note that in the U.S., balanced funds are called hybrid funds.
[16] *Ibid.*
[17] The U.K. fund market is open to foreign domiciled UCITS funds subject to compliance with UCITS regulation. UCITS funds can be marketed to retail investors within any European Union member state.
[18] European Fund and Asset Management Association (EFAMA), Investment Fund Industry Fact Sheet, December 2011.

- Fund platforms[19] accounted for 41% of gross retail fund sales in 2011.[20]
- Direct distributions to investors by mutual fund manufacturers accounted for 13% of gross retail fund sales in 2010.[21]

- Pension funds are the largest U.K. institutional client category, accounting for 50.3% (£1.2 trillion) of U.K. institutional client assets. Defined contribution plans account for approximately 36% of those pension fund assets, and play a role in the distribution of mutual funds;[22]
- Trailing commissions on U.K. mutual funds (pre-RDR reforms) typically don't exceed 1% per annum;[23]
- While equity funds accounted for 53% of U.K. mutual fund assets under management as at the end of 2011, approximately 11% of those equity fund assets (or 6% of all U.K. mutual fund assets under management) were held by passively managed index funds (which tend to have lower MERs).[24]

Australia:

- Australian employers are required to contribute, at least quarterly, 9% of each employee's earnings to a designated superannuation fund.[25]
- Australia has no government sponsored, earnings related, social insurance program equivalent to the Canada Pension Plan. Instead, it relies entirely on superannuation for its funded retirement system, which is why its mutual fund industry is quite large, ranking 3rd in the world by mutual fund assets under management;[26]
- Superannuation funds drive growth in the Australian fund management industry, accounting for approximately 70% of mutual fund assets under management;[27]
- The fund market in Australia is open to foreign-domiciled funds.[28]

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[19] Fund platforms in the U.K. are somewhat akin to discount brokerages in Canada. They typically let you invest online in various products, including mutual funds, normally at a discount. A portion of the trailing commissions that is normally paid out to advisors on mutual funds is paid to the platform which often rebates it back to the customer.

[20] Investment Management Association, *Asset Management in the UK 2011-2012, The IMA Annual Survey* (September 2012)

[21] Investment Management Association, *Asset Management in the UK 2010-2011, The IMA Annual Survey* (July 2011)

[22] See Investment Management Association, *supra*, note 20. We note that the U.K. Government introduced regulatory reforms in 2012, to be implemented in stages over the next 4 years, that will require employees not currently covered by employer pension plans to make statutory minimum contributions of 8% of gross qualifying earnings. Given the decline in defined benefit plan provision in the U.K. over the past decade, it is expected that the majority of employees being automatically enrolled will become members of defined contribution plans. For those employers who do not wish to use an existing private sector provider, the Government has created a quasi-state universal service provider, the National Employment Savings Trust (NEST). Given these reforms, the role of defined contribution plans in the distribution of mutual funds to U.K. investors is likely to increase in the coming years.

[23] This data is based on information provided by staff of the Financial Services Authority. They advise that trailing commissions typically range from 0.50% to 1% per annum.

[24] See Investment Management Association, *supra*, note 20.

[25] This compulsory contribution rate is expected to increase in steps over the next 8 years, reaching 12% in 2020.

[26] Source: International Investment Funds Association, Q2:2012.

[27] Source: Australian Bureau of Statistics, as at December 2011.

- More than half of Australian funds are classified as no-load funds (which generally have lower MERs than load funds);[29]
- Trailing commissions on Australian funds (pre-FoFA reforms) typically don't exceed 0.50% per annum[30], and are the lowest of the four countries featured in the table.

[28] The fund market in Australia is open to foreign domiciled funds that comply with ASIC's Regulatory Guide 178 – Foreign collective investment schemes.
[29] B.N. Alpert, J. Rekenthaler, *Morningstar Global Fund Investor Experience 2011* (March 2011).
[30] This data is based on information provided by staff of the Australian Securities and Investments Commission. They advise that the trailing commission is typically around 0.50% per annum. The Australian Investors Association also states this. See their website at: http://www.investors.asn.au/education/other-investments/managed-funds/.

PROFILE		CANADA	U.S.	U.K.	AUSTRALIA
Market structure					
Total fund AUM ($billion CAD)		762[1]	12,814.2[3]	902.8[5]	1,585[7]
Number of mutual fund manufacturers		103[1]	713[3]	241[2]	159[2]
Average (median) AUM per mutual fund manufacturer ($million CAD)		7,822 (439)[2]	16,802 (211)[2]	3,499 (208)[2]	4,347 (525)[8]
Share of total AUM held by top 10 firms (%)		75%[4]	53%[3]	45%[5]	56%[2]
Number of mutual funds		2,667[2]	7,637[3]	2,572[6]	3,726[2]
Average (median) fund size ($million CAD)		242 (52)[2]	1,580 (233)[2]	375 (84)[2]	210 (25)[8]
Market open or closed to foreign funds		Closed	Closed	Open	Open
Fund ownership costs					
Asset-weighted average MER (%)		**1.93[9]**	**0.79[3]**	**1.14[10]**	**1.13[11]**
Components of MER		• Management fees (with embedded trailing commissions) • Operating expenses • HST /GST	• Management fees • 12b-1 fees (trailing commissions) • Operating expenses	• Management fees (with embedded trailing commissions pre-RDR) • Operating expenses	• Management fees (with embedded trailing commissions pre-FoFA) • operating expenses • GST (10%)
Typical max. trailer fee rate		1.50%	1.00%	1.00% (pre-RDR reforms)	0.60% (pre-FoFA reforms)
Sales charges	Front-end load	Front-end load: • up to 5%, but often less than 1%, payable by the investor to the advisor • negotiable with the advisor	Front-end load (Class A): • up to 5.75% of purchase amount payable by the investor to the mutual fund manufacturer, who in turn pays all or a portion to the advisor • <u>not</u> negotiable with advisor, but eligible for load reductions in breakpoints	Front-end load: • up to 5% of purchase amount payable by the investor to the mutual fund manufacturer, who in turn pays all or a portion to the advisor • negotiable with the advisor	Front-end load: • up to 6% of purchase amount payable by the investor to the mutual fund manufacturer, who in turn pays all or a portion to the advisor • negotiable with the advisor
	Deferred sales charge	Deferred sales charge: • up to 6% (decreasing by approx. 1% each year) payable by investor to mutual fund manufacturer if redeem within 7 years	Deferred sales charge (Class B): • up to 6% (decreasing by approx. 1% each year) payable by investor to mutual fund manufacturer if redeem within 6 years	Deferred sales charge option rarely offered.	Deferred sales charge: • up to 4% (decreasing by approx. 1% each year) payable by investor to mutual fund manufacturer if redeem within 5 years • 3% paid upfront by the mutual

		• up to 5% paid upfront by the mutual fund manufacturer to the advisor.	• up to 5% paid upfront by the mutual fund manufacturer to the advisor.		fund manufacturer to the advisor.
	Low-load/Level-load	Low-load: • 2% or 3% (decreasing by approx. 1% each year) payable by investor to mutual fund manufacturer if redeem within 3 years • 2% to 3% paid upfront by the mutual fund manufacturer to the advisor	Level-load (Class C): • 1% payable by investor to mutual fund manufacturer if redeem within first year • 1% paid upfront by the mutual fund manufacturer to the advisor	Low-load not available	Low-load not available
	No-Load	No-load: • No front-end load or deferred sales charges	No-load: • No front-end load or deferred sales charges	No-load not available	No-load: • No front-end load or deferred sales charges
Fund Fees Regulation					
Caps on fund fees		None	Yes – under NASD/FINRA Conduct Rule 2830(d) which imposes caps on sales charges and 12b-1 fees (i.e. trailing commissions).	None	None
Other		• ***Disclosure:*** NI 81-101 - requires disclosure of all sales charges and ongoing asset-based fees, including trailing commissions, in simplified prospectus and Fund Facts; • ***Payment of sales and trailing commissions out of management fees:*** NI 81-105 generally permits mutual fund manufacturers to pay commissions, including trailing commissions, to advisors for the distribution of mutual fund securities; • ***Securityholder approval for fee increases:*** NI 81-102 requires securityholder approval of proposed increase in fees or	• ***Disclosure:*** Form N-1A (Registration form for open-end management investment companies) requires disclosure of all sales charges and ongoing asset-based fees, including 12b-1 fees (trailing commissions), in Registration Statement; • ***Rule on multiple classes of shares:*** Rule 18f-3 under the *Investment Company Act of 1940* (ICA) requires the following: o separate classes of shares for each available purchase option; and o automatic conversion of Class B (DSC) shares to shares of lower cost class (Class A) at end of redemption schedule;	• ***Disclosure:*** The Collective Investment Scheme Sourcebook (COLL) requires disclosure in a fund prospectus of all payments made out of the fund's assets and details of applicable front-end sales charges and redemption charges (see COLL 4.2.5). In addition, where the fund is a UCITS fund, a KIID must be prepared which discloses all charges, including ongoing charges, associated with the fund (see COLL 4.7.2 and KII Regulation for form and content of KIID) in COLL Appendix 1EU). • ***Regulation of payments made out of fund assets:*** A mutual fund manufacturer may make	• ***Disclosure:*** Corporations Regulations 2001 (Div 4C and Schedule 10) and Corporations Act 2001 (Part 7.9 (especially section 1017D)) require disclosure of sales charges and ongoing asset-based fees in a mutual fund's Product Disclosure Statement (i.e. prospectus) and in periodic statements to investors; • ***Best interest duty:*** Corporations Act 2001, section 601FC requires the mutual fund manufacturer to act in the best interests of fund securityholders and, if there is a conflict between the securityholders' interests and its own interests, give priority to the securityholders' interests; and treat the securityholders who hold

	expenses charged to the mutual fund or directly to securityholders; • ***Best interest duty:*** NI 81-107 requires investment fund manufacturers to act honestly and in good faith, with a view to the best interests of the investment fund.	• ***Payment of 12b-1 fees:*** Rule 12b-1 under the ICA requires the following: o establishment of 12b-1 plan describing financing of distribution (i.e. trailing commissions); o Annual approval of 12b-1 plan by the fund's board of directors; o Approval of any increase in 12b-1 fees by the fund's board and the fund's securityholders; • ***Board review and re-approval of investment advisory contracts:*** Section 15 of the ICA requires investment company boards to review and re-approve investment advisory contracts annually. The board's basis for approving, or recommending the approval of an investment advisory contract and the associated fees must be disclosed in the investment company's Statement of Additional Information; • ***Best interest duty specific to receipt of fees:*** Section 36(b) of the ICA provides that the investment adviser of a registered investment company is deemed to have a fiduciary duty with respect to the receipt of compensation for services paid by the investment company. This section gives investors ability to bring "excessive fee" claims against investment companies.	payments out of fund assets for the following purposes: (a) to remunerate the parties operating the fund, (b) to cover the administration of the fund and (c) to invest or safekeep the fund's property (see COLL 6.7.4R(1)). No payment under this rule can be made from the fund's assets if it is unfair to (or materially prejudices the interests of) any class of securityholders or potential securityholders (see COLL 6.7.4R(2)); • ***Securityholder approval for new fee paid out of fund assets and securityholder notice requirement for increase in existing fee paid out of fund assets:*** The mutual fund manufacturer must obtain the prior approval from the securityholders for the introduction of any new type of payment out of fund assets and give at least 60-days prior notice of material increases to existing payments out of fund assets (see COLL 4.3.4 and 4.3.5); • ***Regulation of sales charges:*** Under COLL 6.7.7R, the mutual fund manufacturer may impose charges on securityholders or potential securityholders when they buy or sell units which may be (a) a front-end sales charge which must be either a fixed amount or calculated as a percentage of the price of a unit; (b) a redemption charge made in accordance with the prospectus. COLL 6.7.8G provides that the	interests of the same class equally and securityholders who hold interests of different classes fairly.

			redemption charge may be expressed in terms of amount or percentage, and also expressed as diminishing over the time during which the securityholder has held the units or be calculated on the basis of the performance of the units. However, any redemption charge should not be such that it could be reasonably regarded as restricting any right of redemption; • ***Best interest duty:*** The mutual fund manufacturer of a UCITS fund must ensure that the securityholders of any such fund it manages are treated fairly, refrain from placing the interests of any group of securityholders above the interests of any other group of securityholders and, act in such a way as to prevent undue costs being charged to any such fund it manages and its securityholders. (See COLL 6.6A.2).	

Notes:

1. Investor Economics Insight Report (January 2012).
2. OSC calculations based on data from Morningstar Direct at December 31, 2011.
3. Investment Company Institute, *2012 Investment Company Fact Book*, 52nd Edition. Asset values converted to Canadian dollars using U.S./CAD exchange rate from the Bank of Canada at December 2011.
4. OSC calculations based on data from Investor Economics Insight Report and individual fund company annual reports.
5. U.K. Investment Management Association (IMA) website. Asset values converted to Canadian dollars using U.K./CAD exchange rate from the Bank of Canada at December 31, 2011.
6. Number of funds reported in Morningstar Direct at April 30, 2012.
7. Australian Bureau of Statistics. Assets under management of superannuation funds and public offer (retail) unit trusts at December 31, 2011. Asset values converted to Canadian dollars using CAD/U.S. exchange rate from Bank of Canada at December 31, 2011.
8. OSC calculations based on data from Morningstar Direct at December 31, 2011 for superannuation funds and unit trusts only.
9. Investor Economics Insight Report (January 2012).
10. OSC calculations based on MER and share class net assets data (where available) from Morningstar Direct at December 31, 2011.
11. OSC calculations based on MER and share class net assets data (where available) for superannuation and unit trusts from Morningstar Direct at December 31, 2011.