

## ANNEX F

### REGULATORY IMPACT ANALYSIS OF THE PROPOSED REFORMS TO ADDRESS CONCERNS RELATED TO THE PAYMENT OF EMBEDDED COMMISSIONS

In this section, we provide an overview of the anticipated costs and benefits of the proposed package of reforms to address concerns related to the payment of mutual fund embedded commissions. These reforms include:

1. the Client Focused Reforms to NI 31-103 which were previously released by the CSA on June 21, 2018<sup>13</sup>, and;
2. the Proposed Amendments to NI 81-105 and related consequential amendments as outlined in the CSA Notice and Request for Comment (together with the Client Focused Reforms, the **Proposed Reforms**).

Overall, we anticipate that the Proposed Reforms, if implemented, will be significant in addressing the three key investor protection and market efficiency issues originally highlighted by the CSA in Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions (CP 81-408)*. In particular, we anticipate that the Proposed Reforms will:

1. significantly reduce the conflicts of interest associated with the payment of mutual fund trailing commissions to registrants;
2. eliminate the conflicts of interest associated with certain mutual fund purchase options and certain mutual fund distribution practices;
3. improve mutual fund investor outcomes through the use of better quality mutual funds;
4. increase engagement between mutual fund investors and the registrants that serve them;
5. increase investors' awareness and control of the fees associated with mutual fund investing.

In CP 81-408, the CSA identified and discussed the following three key investor protection and market efficiency issues arising from the prevailing practice of investment fund managers

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<sup>13</sup> The regulatory impact analysis of the proposed Client Focused Reforms to NI 31-103 is provided in Annex E - Ontario Local Matters to the CSA Notice and Request for Comment published on June 21, 2018 (see [http://www.osc.gov.on.ca/en/SecuritiesLaw\\_rule\\_20180621\\_31-103\\_client-focused-reforms.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20180621_31-103_client-focused-reforms.htm)). Our focus throughout this discussion of the proposed amendments to NI 31-103 is on the anticipated specific impacts of these amendments on embedded commissions.

(IFMs) remunerating dealers and their representatives for mutual fund sales through the use of embedded commissions (the **Key Issues**):

- Issue 1: Embedded commissions raise conflicts of interest that misalign the interests of IFMs<sup>14</sup> and dealers and representatives<sup>15</sup> with those of investors, which can impair investor outcomes (**conflicts of interest**);
- Issue 2: Embedded commissions limit investor awareness, understanding and control of dealer compensation costs (**awareness and control of costs**); and
- Issue 3: Embedded commissions paid generally do not align with the services provided to investors (**cost and service alignment**).

These Key Issues form the basis for the evaluation of the impacts of the Proposed Reforms.<sup>16</sup>

### **The Client Focused Reforms to NI 31-103**

#### **i) Suitability determination**

The proposed amendments to the suitability requirement impact, either directly or indirectly, all three Key Issues. The proposed changes to subsection 13.3 (1) and the introduction of subsection 13.3 (2), if implemented, would directly address Issue 1 – *conflicts of interest*.

Under the Client Focused Reforms, registrants would be required to consider all relevant factors when making a suitability determination, including the cost of the security and its impact on client returns, the features and costs of the account type offered, as well as the overall liquidity and concentration of the client's portfolio. Registrants would also be required to put the client's interest first when making a suitability determination. At its core, the requirement to put the client's interest first means that the registrant must consider the client's situation from the client's point of view and recommend the actions that would be best if they were in the client's position. To do this, we would expect that registrants would need to control for real and potential conflicts when assessing suitability.

We anticipate that these actions would also indirectly address Issue 2 – *awareness and control of costs* – as we expect that when the client's interests are put first, the outcome that results would

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<sup>14</sup> Embedded commissions can reduce IFMs' focus on fund performance, which can lead to underperformance.

<sup>15</sup> Embedded commissions can incent dealers and representatives to make biased investment recommendations that favour their compensation at the expense of investor outcomes.

<sup>16</sup> We note that *any* rule amendments that touch the mutual fund industry are likely to be impactful as mutual funds are by far the most popular investment held by Canadians that own securities. Mutual funds and ETFs respectively are held by 69% and 19% of Canadians that hold securities. Overall, 74% of Canadians that hold securities own a mutual fund, ETF or both. Source: 2017 CSA Investor Index, Innovative Research Group ([https://www.securities-administrators.ca/uploadedFiles/Investor\\_Tools/CSA07%20Investor%20Index%20Deck%20-%20Full%20Report%20-%2020171128.pdf](https://www.securities-administrators.ca/uploadedFiles/Investor_Tools/CSA07%20Investor%20Index%20Deck%20-%20Full%20Report%20-%2020171128.pdf))

be in line with the outcome that would result if the client were as aware and as in control of costs as the registrant. In addition to this indirect impact, Issue 2 is also directly addressed by the proposed requirement for the registrant to consider costs and account type as part of their suitability determination.

Finally, the anticipated impacts of the proposed amendments to the suitability requirements on Issue 1 and Issue 2 are likely to have knock-on effects on Issue 3 – *cost and service alignment*. As the registrant puts the client’s interests first, and as costs and their impacts on client returns are considered and controlled, we anticipate that the costs paid (including the embedded commissions) will be more aligned with the services received.

We anticipate that, if implemented, the proposed amendments to the suitability requirements will result in improved risk-adjusted returns and better investing outcomes over time no matter the types or combination of securities used and no matter whether those securities include embedded commissions or not. We also anticipate that these changes, together with other factors such as competition in the fund industry, may generate downward pressure on overall portfolio costs.

We also anticipate that, if implemented, the proposed changes to the suitability requirements, in terms of their impact on the use of embedded commissions will be most impactful to clients in the MFDA and IIROC channels, where these commissions are most prevalent in terms of size and scope.

We anticipate that the cost of transitioning to an approach to suitability that puts the client’s interest first and takes into account new factors such as cost and account type will be significant for most firms in these distribution channels. We anticipate that these costs will likely include the building and implementation of new compliance systems and oversight processes as well as new training for registrants. However, we anticipate that these costs would largely be one-time in nature and once new suitability processes are in place, we do not anticipate that ongoing compliance costs will be materially higher than they are today.

## **ii) Conflicts of interest**

The proposed amendments to the conflicts of interest rules provide a core response to the Key Issues. In particular, the proposed requirements for registered firms and registered individuals to identify and address all conflicts in the best interest of the client and avoid any conflict that cannot be addressed in the best interest of the client (proposed sections 13.4.1, 13.4.2, and 13.4.3 of NI 31-103) directly address Issue 1 – *conflicts of interest*.

In addition to the proposed amendments, there is proposed guidance pertaining to the acceptance by the registrant of third-party compensation, including trailing commissions received from IFMs. The proposed guidance expressly identifies that the acceptance by a registrant of third party compensation is a conflict of interest that must be resolved in the best interest of the client. It also highlights the CSA’s expectation that registrants should be able to demonstrate that both product shelf development and client recommendations are based on the quality of the security without influence from any third-party compensation associated with the security, which also addresses Issue 1.

We anticipate that the proposed amendments and accompanying guidance to the conflict of interest rules will help indirectly address Issue 2 – *awareness and control of costs* - in a manner similar to the proposed amendments to the suitability requirements. Registrants would be required to identify and control the conflict of interest posed by the acceptance of compensation from third parties, potentially resulting in product choices that are equivalent to those that would result if the client were well informed of this conflict and able to independently control it.

The anticipated impacts of the proposed amendments to the conflict of interest rules on Issue 1 and Issue 2 are likely to have knock-on effects on Issue 3 – *cost and service alignment*. Registrants that can demonstrate that the payment of embedded commissions did not influence their product shelf development and recommendations to clients, and whose clients are making investment decisions that demonstrate awareness and control of costs, are more likely to have greater alignment between the amount of embedded commissions they receive and the services they provide to clients than may be the case today.

The CSA expect that the proposed amendments to the conflicts of interest rule and related guidance is likely to encourage the following changes in product shelf development and registrant recommendations over time:<sup>17</sup>

1. for firms that offer both third-party and proprietary mutual funds, a more merit-based balance between these two fund types;
2. an increase in the use of lower-cost mutual funds, including passively managed index tracking mutual funds<sup>18</sup>;
3. an increase in the use of mutual funds with better risk-adjusted outperformance potential;
4. an increase in the use of mutual funds that do not pay third-party compensation;
5. an increase in the use of direct pay arrangements with mutual fund investors;
6. a movement towards internal incentive structures that better align with the interests of mutual fund investors.

We anticipate that these changes will have the greatest impact on those dealers in the MFDA and IIROC channels whose use of embedded commissions and reliance on proprietary products is highest.

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<sup>17</sup> The anticipated impacts discussed in this section (particularly impacts 1 through 5) are based on analyses of the risk-adjusted, peer group and excess return performance of fee-based and other non-trailing commission paying mutual fund and ETF series. These impacts resulted no matter which evaluation process was applied (e.g. risk-adjusted comparisons, peer group, excess return comparisons over various time periods). We evaluated the universe of funds using their non-trailing commission paying series versions to ensure that we were evaluating the product before additional costs related to services and advice provided by the dealer were applied. We anticipate that many registrants will follow a similar approach if the proposed changes to the conflict of interest rules and related guidance are implemented.

<sup>18</sup> In Canada, investments in passively managed index mutual funds are significantly lower than in other markets, such as in the United States and the United Kingdom markets. At June 2015, passively managed index mutual funds (excluding ETFs) amounted to only 1.5% of total mutual fund assets under management in Canada – a level that has remained essentially unchanged over the last 10 years.

We anticipate that while there are likely to be one-time costs incurred by registrants in order to introduce new compliance processes and build new compliance systems, these are likely to significantly overlap with those introduced for the new suitability requirements and other proposed requirements of the Client Focused Reforms.<sup>19</sup> We do not anticipate that ongoing compliance costs will be materially higher than they are today.

### iii) Publicly Available Information

The proposed amendment to require the registered firm to make publicly available information that an investor would consider important in deciding whether to become a client, including information on the products and services offered (and any limitations on those offerings), fee schedules, account minimums and account types available (proposed subsection 14.1.2(1) of NI 31-103), is likely to have a significant impact on the market and significant benefits for investors.

We anticipate that the proposed amendment will primarily help address Issue 2 – *awareness and control of costs* and Issue 3 – *cost and service alignment*. Investors will have a better sense of the types and range of costs, including the front-end commissions and ongoing embedded fees, including mutual fund trailing commissions, which they are likely to incur if they decide to become a client of a registrant.

In addition, the public posting of this information would allow analysts, journalists and other interested parties to view and evaluate the information provided by registrants, potentially leading to the production of dealer guides of the sort we already see for online advisors and discount brokerages. It may also incentivize dealer firms to streamline and simplify their fee and commission schedules. We anticipate that these enhancements will increase investor awareness and control of fees, including mutual fund trailing commissions, over time.

The proposed publicly posted document will also highlight not just the cost but also the services that investors can expect from registrants, thus allowing investors to more easily match the services they are seeking with the registrants most likely to provide them, and increasing the likelihood of better alignment between the costs paid, including mutual fund trailing commission costs, and the services received.

The proposed amendment will likely also help to address Issue 1 – *conflicts of interest* – because it requires a registrant to identify any material limitations to the products and services offered (including a focus on proprietary mutual funds), any restrictions on the clients to whom it makes products, services or accounts available, and any third-party compensation it is likely to receive.

In terms of the cost to registrants, we do not anticipate that either the transition costs or the ongoing costs of providing this document will be material. In all cases, dealers have an internal document that already includes most of the required information. The transition costs would accordingly be focused on making those internal documents suitable for potential clients and the

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<sup>19</sup> This includes the proposed introduction of new know-your-product (KYP) requirements.

public generally. Likewise, the ongoing costs of providing this document amount to the cost of updating it in response to a change in business practices and fee schedules and the cost of public provision which in most cases will be posting the document to the firm's website.

## **Proposed Amendments to National Instrument 81-105**

### **i) Repeal of section 3.1**

The proposed repeal of section 3.1 of NI 81-105 is a prohibition of the payment of any upfront sales commission by an IFM to a registrant in connection with the distribution of mutual fund securities.<sup>20</sup>

The intention of this proposed repeal is to prohibit the use of the DSC option and all its variants by prohibiting the upfront sales commission component of the DSC option. We expect that this prohibition will correspondingly discontinue the redemption fee schedule and the redemption fees components of the DSC option, which are designed to help finance the cost of the upfront sales commission. The proposed repeal would also eliminate the role IFMs have traditionally played in setting the range of front-end commissions that registrants may charge to their clients on their mutual fund purchases.

We anticipate that the proposed repeal would help to address all three Key Issues.

For Issue 1 – *conflicts of interest* – The conflict of interest inherent to the DSC option gives rise to a number of specific problematic practices and investor harms. Compliance sweeps and enforcement files reveal that, among other things, the higher upfront and third-party nature of the dealer compensation on the DSC option encourages poor suitability assessments and increases the risk of mis-selling.<sup>21</sup> We anticipate that the proposed repeal, if implemented, will eliminate the conflict of interest associated with the DSC option and encourage suitability assessments that meet investors' needs and objectives. It will also reduce the promotion of unsuitable leverage strategies by registrants, as well as investor complaints, compliance deficiencies and enforcement actions arising from the use of the DSC option.<sup>22</sup>

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<sup>20</sup> We note here that NI 81-105 only applies to the sales practices associated with the distribution of securities of a "mutual fund" offered under a prospectus. The sales practices associated with other types of investment funds, offered with and without a prospectus, are not addressed by this rule.

<sup>21</sup> A 2015 targeted sweep of MFDA Members' DSC option trading activity showed that, among other things, clients were sold funds with DSC option redemption fee schedules that were longer than their investment time horizon, and showed that clients over the age of 70 were sold funds under the DSC option. See MFDA Bulletin #0670-C, 2015 *DSC Sweep Report*, December 18, 2015. See also MFDA Bulletin #0705-C, *Review of Compensation, Incentives and Conflicts of Interest*, December 15, 2016, in which the MFDA identifies compensation and incentive practices that increased the risk of mis-selling under the DSC option.

<sup>22</sup> For further discussion of these issues, please see CSA Staff Notice 81-330 *Status Report on Consultation on Embedded Commissions and Next Steps* and CSA Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions*.

We anticipate that the proposed repeal will also change how certain dealer firms recruit and train new staff. Currently, some firms rely on the upfront sales commissions received on sales made under the DSC option to fund the on-boarding and turnover costs of staff recruitment. Thus, clients of these firms who hold mutual funds under the DSC option pay for or assume some part of the firm's risk in taking on new staff, through the redemption fee schedule and the applicable redemption fees. If the proposed repeal is implemented, registered firms will have to internalize these costs and risks directly.

The proposed repeal is also anticipated to directly address Issue 2 – *awareness and control of costs* – as it will eliminate the purchase option that has tended to be the most difficult for investors to understand and to have the most negative impact on subsequent investor behaviour.<sup>23</sup> More specifically, the proposed repeal will eliminate the penalizing “lock-in” effect of the redemption fee schedule and the applicable redemption fees, and no longer deter investors from redeeming an investment or changing their asset allocation in the face of poor fund performance, unforeseen liquidity events, or a change in their financial circumstances.

Were the DSC option and all its variants to be discontinued today, we would expect to see a 30% decline in the number of FundSERV codes for mutual funds as well as a 25% to 40% reduction in the length of a Fund Facts document for the typical retail trailing commission-paying mutual fund series.<sup>24</sup> We expect this streamlining of the Fund Facts document would reduce the complexity of the disclosure pertaining to sales charge options and related fees, and would help improve investor awareness, understanding and control of dealer compensation costs.

In addition, overall fund costs are likely to fall modestly with the discontinuation of the DSC option as the higher costs associated with that option will cease to be incurred by the mutual fund and passed on to investors.<sup>25</sup>

Finally, we anticipate that the proposed repeal will directly address Issue 3 – *cost and service alignment* – as the upfront sales commissions dealers receive today for sales made under the DSC option may not always align with the services provided to investors. We expect that the discontinuation of the DSC option will encourage dealers and their representatives to adopt more transparent compensation arrangements which will require them to better demonstrate and justify their value proposition, and thus improve the alignment between the services provided and their cost to investors.

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<sup>23</sup> Empirical mutual fund fee research commissioned by the CSA demonstrates the effect the redemption fee penalty may have on an investor, as it indicates that investments made under the DSC option show the lowest sensitivity to past performance out of all available purchase options analyzed. See Douglas Cumming, Sofia Johan and Yelin Zhang, “A Dissection of Mutual Fund Fees and Performance”, Feb. 8, 2016, [http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp\\_20160209\\_81-407\\_dissection-mutual-fund-fees.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20160209_81-407_dissection-mutual-fund-fees.pdf).

<sup>24</sup> Based on OSC review of FundSERV codes and Fund Facts documents.

<sup>25</sup> See CP 81-408 discussion at page 120. For IFMs that segregate DSC and front-end purchase options into different fund series, the MER cost difference is on average between 20 and 30 bps depending on the asset class of the fund.

As mutual fund assets held under the DSC option make up a significant portion of Canadian mutual fund assets under management<sup>26</sup>, we expect the discontinuation of that option will have an impact on the fund industry. We anticipate that the impact will be primarily felt by IFMs and those registrants in the MFDA and IIROC channels that make significant use of the DSC option.<sup>27</sup> In particular, non-deposit taker dealers,<sup>28</sup> who have historically been much more reliant on the DSC option, will likely be required to ask their clients for a front-end sales commission or move to a fee-based or other direct pay arrangement in order to maintain current revenues.<sup>29</sup> For certain dealers, shifting to the use of the front-end sales charge option or other form of direct pay arrangement to maintain their current revenue may necessitate certain operational, systems, compensation arrangements or other business changes. We anticipate these changes may be more significant for small to medium-sized independent mutual fund dealers (not affiliated with an IFM) that are more reliant on the DSC option and that have less scale than integrated financial service providers.

We accordingly anticipate that the proposed repeal of section 3.1 may result in one-time and ongoing costs for certain dealers, in particular those that opt to switch to alternative compensation arrangements, such as fee-based compensation. Finally, we anticipate that ongoing compliance costs are likely to fall further to the discontinuation of the DSC option as this purchase option generates compliance costs to supervise and assess the suitability of the use of the DSC option and to manage the conflict of interest inherent in this option.

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<sup>26</sup> As at the end of December 2016, a total of 18% of Canadian mutual fund assets was held under the traditional DSC option (13%) and low-load option (5%). While the market share of mutual fund assets held under the DSC option has steadily declined over the last 10 years, assets held in these options increased by 64% or \$222 billion over the period. Assets held in the traditional DSC option decreased by 16% (\$32 billion) while assets in low-load purchase options increased by 332% (\$47 billion) between 2006 and 2016. There was, at least until 2015, a gradual shift in assets from the traditional DSC model to the low-load model (See Figures 6 and 7 on pages 45 and 46 of CP 81-408 for further information on mutual fund assets and mutual fund market share by purchase option). We note that several IFMs have recently discontinued, or have announced that they will discontinue, the traditional DSC option.

<sup>27</sup> Across registrants in these two distribution channels and across IFMs, reliance on the DSC option varies widely. While the use of the DSC option and its variants has been falling in terms of market share, non-deposit taker dealer firms and non-deposit-taker IFMs have a much higher reliance on the DSC option. At the end of 2016, 31% of non-deposit taker IFM assets were held under the DSC option compared to 2% for deposit taker IFMs (Source: Strategic Insight). In the MFDA channel, 48% of mutual fund assets under administration by non-deposit taker dealers were held under the DSC option, whereas 2% of mutual fund assets under administration by deposit taker dealers were held under the DSC option (Source: Strategic Insight and MFDA).

<sup>28</sup> These include dealers belonging to an insurance company-owned IFM or other IFM, as well as dealers with no affiliation to an IFM (independent dealers).

<sup>29</sup> For a typical equity fund earning a 5% return per annum, a registrant would require a 3.1% front-end commission with a 1% ongoing trailing commission or an annual fee of 1.8% to generate the same revenue as that obtained over the life of a mutual fund investment under the traditional DSC option with a six year redemption fee schedule.



For IFMs, we also anticipate minimal one-time and ongoing costs stemming from the proposed repeal. IFMs will need to adjust their fund disclosure documents to remove references to DSC options and front-end commission rates. IFMs will also be able to simplify their information technology systems and reduce their transfer agent expenses over time as the DSC option and its variants disappear from the market.

The elimination of the DSC option may also give rise to the risk of regulatory arbitrage to similar non-securities financial products where such purchase option and its associated dealer compensation are still available.

## ii) **Amendment of section 3.2**

The proposed amendment to section 3.2 of NI 81-105 to prohibit the payment of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who do not make a suitability determination is intended to primarily address Issue 3 - *cost and service alignment* – particularly for do-it-yourself (**DIY**) mutual fund investors, but also indirectly for mutual fund investors in the full service channels as well.

For DIY mutual fund investors, we anticipate that the proposed amendment will lead to fees, paid directly, that better align with the more limited services provided by registrants that are not providing suitability determinations. Likewise, we anticipate that the management fees of those fund series that are distributed in the online/discount brokerage channel are likely to fall by the total amount of trailing commissions embedded today.<sup>30</sup> We note that these investors are already more accustomed to paying fees directly, particularly if they are investing in a mix of mutual funds and other securities where commissions are more commonly charged, such as most ETFs.<sup>31</sup>

We anticipate that the proposed amendment may have an indirect effect on full-service dealers servicing mutual fund investors as it may increase their incentive to demonstrate their value to these clients in order to discourage a potential move of their accounts to the online/discount brokerage channel.

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<sup>30</sup> We note that IFMs may choose to allow online/discount brokerage clients to access their current fee-based fund series (“series F”) after the proposed amendments are implemented. If so, the fund management costs would likely drop by the amount of trailing commissions embedded in the fund series distributed in the online/discount brokerage channel today. This is because the management fees of fee-based fund series are often less than net of trailing commission management fees of the fund series typically distributed in the online/discount brokerage and full service channels today. The IFM may also opt to create a new series instead (for example, by removing the embedded trailing commissions and lowering the management fees on existing discount brokerage focused fund series (“series D”) sold in the online/discount brokerage channel today). If so, we would expect the management fee costs to decline by exactly the amount of the embedded trailing commission.

<sup>31</sup> While the online/discount brokerage channel is typically depicted as an online only channel, there are still many trades, including mutual fund trades that occur over the phone with a representative. The commission on these trades can be as high as \$65 per trade although some discount brokerages do not charge commissions on these trades. Over the 12 months ending 2017, a total of 4.1 million online/discount brokerage trades of all securities were made over the phone through a representative (Source: Strategic Insight).

We anticipate that the use of direct forms of payment in the online/discount brokerage channel will also help increase investors' awareness, understanding and control of fees associated with mutual fund investing in this channel, thus helping to address Issue 2 – *awareness and control of costs*.

Finally, we anticipate that the proposed amendment would also address Issue 1 – *conflicts of interest* by removing a longstanding conflict between IFMs (who have been reluctant to offer non trailing commission-paying fund series in this channel), online/discount brokerages (who have been satisfied to accept full trailing commission-paying funds), and DIY investors.

In terms of the impact to the industry, we anticipate significant one-time costs if the proposed amendment is implemented. Online/discount brokerages will need to adjust their business models to bring mutual fund sales in-line with their commission practices for every other security currently offered on their platforms. Any cross-subsidization stemming from the revenues generated by mutual fund trailing commissions that may exist today (e.g. the use of mutual fund revenues to lower the commissions charged on other securities) would also be expected to be curtailed if the proposed amendment is implemented. Ongoing costs are likely to be less significant once the changes have been implemented.

This change may also require mutual fund investors in the online/discount brokerage channel to consider, as they would today for stock and ETF trades, such factors as the timing and investment amount size in order to minimize costs and increase likely portfolio returns.<sup>32</sup>

And finally, this change will require IFMs to decide what mutual fund series they want to make available in the online/discount brokerage channel. We note that one option would be for IFMs to make available those non trailing commission-paying mutual fund series that already exist and that they already make available today in the fee-based channel.

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<sup>32</sup> We note that some mutual fund investors in the online/discount brokerage channel have mutual fund investments under the DSC option which were transferred in from a full-service brokerage. As a result, these mutual fund investors do not trade frequently as they are often waiting for their redemption fee schedules to expire before making changes to their investments.