

**CSA Notice of Amendments to
National Instrument 81-105 *Mutual Fund Sales Practices*
and
Related Consequential Amendments**

**Prohibition of Mutual Fund Trailing Commissions
Where No Suitability Determination Was Required**

September 17, 2020

Introduction

The Canadian Securities Administrators (the **CSA** or **we**), are adopting amendments to National Instrument 81-105 *Mutual Fund Sales Practices* (**NI 81-105**), changes to Companion Policy 81-105CP *Mutual Fund Sales Practices* (**81-105CP**) and related consequential amendments to National Instrument 41-101 *General Prospectus Requirements* (**NI 41-101**) and National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (**NI 81-101**) (collectively, the **Amendments**).

The Amendments

- prohibit the payment of trailing commissions by members of the organization of publicly-offered mutual funds (**fund organizations**) to participating dealers who were not required to make a suitability determination in connection with a client's purchase and ongoing ownership of prospectus qualified mutual fund securities, and
- prohibit the solicitation or acceptance of trailing commissions by participating dealers from fund organizations, in connection with securities of the mutual fund held in an account of a client of the participating dealer if the participating dealer was not required to make a suitability determination in respect of the client in connection with those securities.

The Amendments will effectively prohibit the payment of mutual fund trailing commissions to dealers who are not subject to the obligation to make a suitability determination under section 13.3 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) or under the corresponding rules and policies of the Investment Industry Regulatory Organization of Canada (**IIROC**) and the Mutual Fund Dealers Association of Canada (**MFDA**) (together, the **SROs**). Such dealers would include, among

others, order-execution only (**OEO**) dealers and dealers acting on behalf of a “permitted client”¹ that has waived the suitability requirements.

In some jurisdictions, ministerial approvals are required for the implementation of the Amendments. Provided all ministerial approvals are obtained, the Amendments to NI 81-101 and NI 41-101, which provide certain exemptions from the delivery requirements for fund facts documents (**Fund Facts**) and ETF facts documents (**ETF Facts**), respectively, for all switches from a trailing commission paying series or class of a mutual fund to a no trailing commission series or class of the same mutual fund, will come into force on December 31, 2020, and the Amendments to NI 81-105 will come into force on June 1, 2022.²

The text of the Amendments is contained in Annexes B through E of this notice and will also be available on websites of the following jurisdictions:

www.bcsc.bc.ca

www.asc.ca

www.fcaa.gov.sk.ca

www.mbsecurities.ca

www.osc.gov.on.ca

www.lautorite.qc.ca

www.fcnb.ca

nssc.novascotia.ca

Substance and Purpose

The Amendments, together with the enhanced conflict of interest mitigation framework for dealers and representatives under detailed reforms to NI 31-103 (the **Client Focused Reforms**) published on October 3, 2019, comprise the CSA’s policy response to the investor protection and market efficiency issues we have identified with the payment and acceptance of trailing commissions where no suitability determination was required. The Amendments restrict the compensation that fund organizations may pay to participating dealers who were not required to make a suitability determination in connection with a client’s purchase and ongoing ownership of prospectus qualified mutual fund securities.

Background

The Amendments were developed over the course of an extensive consultation process.

CSA Consultation Paper 81-408

On January 10, 2017, the CSA published for comment CSA Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions* (the **Consultation Paper**),

¹“Permitted client” as defined in section 1.1 of NI 31-103.

²The Amendments to NI 81-105 will take effect on June 1, 2022 with the exception of the “suitability determination” definition, which will take effect on December 31, 2020. Please see the explanation provided under “Effective Date”.

which identified and discussed key investor protection and market efficiency issues arising from mutual fund embedded commissions.³ The Consultation Paper sought specific feedback, including evidence-based and data-driven analysis and perspectives, on the option of discontinuing embedded commissions as a regulatory response to the identified issues and on the potential impacts to both market participants and investors of such a change, to enable the CSA to make an informed policy decision on whether to pursue this option or consider alternative policy changes.

CSA Staff Notice 81-330

On June 21, 2018, the CSA published CSA Staff Notice 81-330 *Status Report on Consultation on Embedded Commissions and Next Steps (CSN 81-330)* which proposed the following policy changes:

- (a) implement enhanced conflict of interest mitigation rules and guidance for dealers and representatives requiring that all existing and reasonably foreseeable conflicts of interest, including conflicts arising from the payment of embedded commissions, be addressed in the best interests of clients or avoided,
- (b) prohibit all forms of the DSC option (as defined below) and their associated upfront commissions in respect of the purchase of securities of a prospectus qualified mutual fund, and
- (c) prohibit the payment of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who were not required to make a suitability determination in connection with the distribution of securities of a prospectus qualified mutual fund.

In addition to announcing the CSA's policy decision and providing a summary of the consultation process and the feedback received, CSN 81-330 provided an overview of the regulatory concerns that the proposed policy changes aimed to address, and also discussed why CSA members were not proposing to ban all forms of embedded commissions.

The Proposed Amendments

On September 13, 2018, the CSA published proposed amendments (the **Proposed Amendments**) to

- (a) prohibit fund organizations from paying upfront commissions to dealers, which will result in the discontinuation of all forms of the deferred sales charge option⁴

³ The Consultation Paper followed the CSA's initial consultation on mutual fund fees under CSA Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees* published on December 13, 2012, which was followed by in-person consultations in several CSA jurisdictions in 2013. The CSA published an overview of the key themes that emerged from this consultation process in CSA Staff Notice 81-323 *Status Report on Consultation under CSA Discussion Paper and Request for Comment 81-407 Mutual Fund fees*.

⁴ Under the traditional deferred sales charge option, the investor does not pay an initial sales charge for fund securities purchased but may have to pay a redemption fee to the investment fund manager (i.e., a deferred sales

including low-load options⁵ (collectively, the **DSC option**), and

- (b) prohibit the payment of trailing commissions to dealers who were not subject to a suitability requirement, such as dealers who were not required to provide investment recommendations in connection with the distribution of prospectus qualified mutual fund securities.

The 90-day comment period ended on December 13, 2018.

CSA Staff Notice 81-332

On December 19, 2019, the CSA published CSA Staff Notice 81-332 *Next Steps on Proposals to Prohibit Certain Investment Fund Embedded Commissions (CSN 81-332)* to announce that the CSA, with the exception of the Ontario Securities Commission,⁶ would publish for adoption final amendments in early 2020 to prohibit the DSC option (the **DSC Ban**).⁷

CSN 81-332 also announced that all members of the CSA would publish for adoption final amendments later in 2020 to prohibit payments of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who are not required to make a suitability determination.

Summary of Written Comments Received by the CSA

The CSA received 55 comment letters on the Proposed Amendments. We thank everyone who provided comments. A summary of the comments together with our responses are set out in Annex A. The names of the commenters are also set out in Annex A.

charge) if the securities are sold before a predetermined period of typically 5 to 7 years from the date of purchase. Redemption fees decline according to a redemption fee schedule that is based on the length of time the investor holds the securities. While the investor does not pay a sales charge to the dealer, the investment fund manager pays the dealer an upfront commission (typically equivalent to 5% of the purchase amount). The investment fund manager may finance the payment of the upfront commission and accordingly incur financing costs that are included in the ongoing management fees charged to the fund.

⁵ The low-load purchase option is a type of deferred sales charge option but has a shorter redemption fee schedule (usually 2 to 4 years). The upfront commission paid by the investment fund manager and redemption fees paid by investors are correspondingly lower than the traditional deferred sales charge option.

⁶ Ontario Securities Commission Notice and Request for Comment – Proposed Ontario Securities Commission Rule 81-502 *Restrictions on the Use of the Deferred Sales Charge Option for Mutual Funds* and Proposed Companion Policy 81-502 to Ontario Securities Commission Rule 81-502 *Restrictions on the Use of the Deferred Sales Charge Option for Mutual Funds and Related Consequential Amendments* was published on February 20, 2020 by the Ontario Securities Commission.

⁷ Multilateral CSA Notice of Amendments to National Instrument 81-105 *Mutual Fund Sales Practices*, Changes to Companion Policy 81-105CP to National Instrument 81-105 *Mutual Fund Sales Practices* and Changes to Companion Policy 81-101CP to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* relating to Prohibition of Deferred Sales Charges for Investment Funds was published on February 20, 2020 by the CSA, except the Ontario Securities Commission.

Copies of the comment letters are posted on the websites of the Alberta Securities Commission at www.asc.ca, the Ontario Securities Commission at www.osc.gov.on.ca, and the Autorité des marchés financiers at www.lautorite.qc.ca.

Summary of Changes to the Proposed Amendments

After considering the comments received, we have made some non-material changes to the Proposed Amendments. These changes are reflected in the Amendments that we are publishing as Annexes to this notice. As these changes are not material, we are not republishing the Amendments for a further comment period.

The following is a summary of the key changes made to the Proposed Amendments:

(a) Definition of “suitability determination” in section 1.1 of NI 81-105

We added a definition of “suitability determination” in section 1.1 of NI 81-105 to specify where a suitability determination is required under securities legislation and SRO rules and policies. The definition of suitability determination references section 13.3 of NI 31-103 and the corresponding rules and policies of IIROC and MFDA named in Appendix G and Appendix H, respectively, of NI 31-103, as applicable.

(b) Clarification of the prohibition on participating dealers in subsection 2.2(3) of NI 81-105

We added subsection 2.2(3) to NI 81-105 to provide clarification that a participating dealer may not solicit or accept a payment of a trailing commission from a member of a fund organization in connection with mutual fund securities held in a client account if the participating dealer was not required to make a suitability determination under securities legislation or SRO rules and policies.

(c) Knowledge qualifier in subsection 3.2(4) of NI 81-105

We received comments from fund organizations indicating that they may not know whether a suitability determination was required to be made in connection with a mutual fund purchase. For example, some participating dealers use separate dealer codes for their full-service dealer and their OEO dealer, and in those circumstances, fund organizations should be able to determine whether mutual fund purchase orders are from the OEO dealer, who was not required to make a suitability determination. However, other participating dealers use a single dealer code for multiple affiliated dealers, including their full-service dealer and their OEO dealer and, as a result, the mutual fund purchase orders for their full-service dealer and their OEO dealer are aggregated with the same dealer code. In those circumstances, fund organizations may not be able to distinguish whether the mutual fund purchase orders are from the full-service dealer, who was required to make a suitability determination, or from the OEO dealer, who was not required to make a suitability determination.

For circumstances where fund organizations do not know, or would not reasonably be expected to know, whether a suitability determination was required to be made in connection with a mutual fund purchase, we added a knowledge qualifier to clarify that subsection 3.2(4) applies only if the fund organization knows, or ought reasonably to know, that the participating dealer was not required to make a suitability determination.

We added corresponding guidance in section 5.4 of 81-105CP, as discussed in (e) below.

(d) Exemptions from the Fund Facts and ETF Facts Delivery Requirements in section 3.2.04.1 of NI 81-101 and section 3C.2.1 of NI 41-101, respectively

We added section 3.2.04.1 to NI 81-101 and section 3C.2.1 to NI 41-101 to provide exemptions from the Fund Facts delivery requirement⁸ and the ETF Facts delivery requirement,⁹ respectively, for all switches from a trailing commission paying series or class of a mutual fund to a no-trailing commission series or class of the same mutual fund in client accounts administered by dealers who are not required to make a suitability determination. The exemptions can be relied upon for switches of existing mutual fund holdings, transfers and pre-authorized purchase plans.

(e) Changes to section 5.4 of 81-105CP

We revised section 5.4 of 81-105CP to reference section 2.2(3) of NI 81-105 which sets out the restriction on the payment and acceptance of trailing commissions where no suitability determination was required to be made.

Section 5.4 was also revised to remind members of the organization of a mutual fund and participating dealers of their duty under section 11.1 of NI 31-103 to establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, including the prohibitions in subsections 2.2(3) and 3.2(4) of NI 81-105.

We also revised section 5.4 to indicate that we expect members of the organization of a mutual fund and participating dealers to be diligent in complying with subsections 2.2(3) and 3.2(4) of NI 81-105. Participating dealers should be operating in a manner that enables members of the organization of a mutual fund to ascertain whether a suitability determination was required to be made in connection with the securities of the mutual fund held in an account of the dealers' clients and members of the organization of a mutual fund should be aware of the information that a participating dealer makes available to them regarding whether a suitability determination was required to be made.

Effective Date

⁸ Section 3.2.01 of NI 81-101.

⁹ Section 3C.2 of NI 41-101.

With the exception of the “suitability determination” definition, the Amendments to NI 81-105 will take effect on June 1, 2022 (the **Effective Date**). Compliance with the Amendments to NI 81-105 will therefore be required approximately 20 months after the publication of this notice. The “suitability determination” definition is cross-referenced in the Fund Facts and ETF Facts delivery exemptions set out in the NI 81-101 and NI 41-101 Amendments and will therefore come into effect on December 31, 2020 in order to match up with the effective dates of those amendments.

The CSA anticipate that the extended period between the publication of this notice and the Effective Date will provide sufficient time for participating dealer firms and representatives who currently are not required to make a suitability determination in connection with mutual fund purchases and holdings to transition their practices, operational systems and processes to comply with the Amendments to NI 81-105. For some dealer firms, this may also require a reassessment of their internal compensation arrangements and implementation of new direct-fee charging systems and processes to enable them to collect fees for their services directly from mutual fund investors as of the Effective Date.

Fund organizations who wish to offer their mutual fund securities to investors with OEO accounts after the Effective Date should make available a no-trailing commission series or class of their mutual funds to participating dealers. The extended period should also provide fund organizations with sufficient time to amend their prospectuses, Fund Facts and ETF Facts, if necessary.

Transition

As of the Effective Date, mutual funds securities that are subject to a trailing commission will no longer be permitted to be held in the account of a client for whom a dealer was not required to make a suitability determination. This will have the following transitional impacts:

(a) Existing holdings of trailing commission paying mutual funds securities, except those purchased under the DSC option

As of the Effective Date, mutual fund securities not purchased under the DSC option and subject to a trailing commission must be switched to a no-trailing commission series or class of the same mutual fund if the dealer who administers the client account was not required to make a suitability determination. However, if a no-trailing commission series or class of the same mutual fund does not exist, those holdings may be subject to other alternatives, such as being transferred to a dealer who is required to make a suitability determination.

(b) Mutual fund securities purchased under the DSC option

As of the Effective Date, dealers who are not required to make a suitability determination will no longer be allowed to accept trailing commissions in respect of mutual fund securities purchased under the DSC option (**DSC holdings**).¹⁰

For current DSC holdings in accounts administered by dealers who were not required to make a suitability determination, we expect fund organizations and dealers to comply with the Amendments using a range of options available that will ensure the best outcome for investors with DSC holdings. Specifically, our expectation is that fund organizations and dealers will take any necessary measures to ensure that investors with DSC holdings will not be required to pay redemption fees as a result of the implementation of the Amendments by a fund organization or a dealer.

One option would be to allow investors to continue holding their DSC holdings after the Effective Date. In respect of these DSC holdings, fund organizations would suspend the payment of trailing commissions to dealers and dealers would not solicit or accept the payment of trailing commissions in respect of such holdings in compliance with the Amendments.

Another option would be for fund organizations to waive the redemption fees payable by investors for switches or redemptions of their DSC holdings, if applicable, in situations where such fee is triggered as a result of an action taken to comply with the Amendments.

We expect fund organizations and dealers to clearly communicate their implementation plans and expected outcomes to investors with DSC holdings in accounts administered by dealers who are not required to make a suitability determination. We also expect fund organizations and dealers to collaborate and facilitate client communications, as necessary.

For investors who would prefer to transfer their DSC holdings to a dealer who is required to make a suitability determination, we expect that dealers will help facilitate such transfers.

We also remind dealers of their obligation to deal fairly, honestly, and in good faith with their clients, in accordance with applicable securities legislation.

(c) Pre-authorized purchase plans

Prior to the Effective Date, fund organizations and dealers should give consideration of how to deal with pre-authorized purchase plans that provide for the periodic purchase of mutual fund securities that are subject to a trailing commission. In order to comply with the Amendments, these plans will need to be amended to switch over to the purchase of a no-trailing commission series or class of the same mutual fund if the dealer was not required

¹⁰ See footnote 7. Following the effective date of the DSC Ban on June 1, 2022, dealers will not be allowed to sell mutual funds with the DSC option. However, the redemption fee schedules on existing DSC holdings will be allowed to run their course.

to make a suitability determination. Alternatively, if a no-trailing commission series or class of the same mutual fund does not exist, the pre-authorized purchase plan would need to be terminated or potentially amended in consultation with the client to allow for periodic purchases of another mutual fund that is available on a no-trailing commission basis.

(d) Transfers from full-service accounts to OEO accounts

Similar to existing holdings of trailer commission paying mutual fund securities, as of the Effective Date, when investors transfer their accounts from a full-service dealer to an OEO dealer, any mutual funds that are subject to a trailing commission must be switched to a no-trailing commission series or class of the same mutual fund at or before the time of transfer.

We expect that OEO dealers will inform investors at, or before, the time of a proposed transfer of accounts that they are unable to accept transfers of trailing commission paying mutual fund securities, including DSC holdings, into OEO accounts.

Given that DSC holdings pay trailing commissions and trigger a redemption fee upon early redemption, DSC holdings should not be transferred to OEO dealers after the Effective Date.

(e) Exemptions from the Fund Facts Delivery Requirement and ETF Facts Delivery Requirement

The Amendments to NI 81-101 and NI 41-101 provide exemptions from the Fund Facts delivery requirement and the ETF Facts delivery requirement, respectively, for all switches from a trailing commission series or class of a mutual fund to a no-trailing commission series or class of the same mutual fund for existing holdings, transfers and pre-authorized purchase plans.

The exemptions from the Fund Facts and ETF Facts delivery requirements have an effective date of December 31, 2020, which is 17 months prior to the Effective Date. This 17-month period provides considerable time for fund organizations and dealers to facilitate switches of trailing commission paying mutual fund securities to no-trailing commission series or class of the same mutual fund held in client accounts administered by dealers who are not required to make a suitability determination, on or before the Effective Date.

Local Matters

Annex F is being published in any local jurisdiction that is making related changes to local securities laws, including local notices or other policy instruments in that jurisdiction. It also includes any additional information that is relevant to that jurisdiction only.

Contents of Annexes

The text of the Amendments is contained in the following annexes to this notice and is available on the websites of members of the CSA:

- Annex A:** Summary of Comments on the Proposed Amendments and Responses
Annex B: Amendments to National Instrument 81-105 *Mutual Fund Sales Practices*
Annex C: Changes to Companion Policy 81-105CP *Mutual Fund Sales Practices*
Annex D: Amendments to National Instrument 41-101 *General Prospectus Requirements*
Annex E: Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*
Annex F: Local Matters

Questions

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