CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Notice and Request for Comment

Proposed Amendments to National Instrument 81-105 *Mutual Fund Sales Practices* and Related Consequential Amendments

September 6, 2018

Introduction

The Canadian Securities Administrators (the **CSA** or **we**) are publishing for a **90-day** comment period

- proposed amendments to National Instrument 81-105 Mutual Fund Sales Practices (**NI 81-105**),
- proposed changes to Companion Policy 81-105CP *To National Instrument 81-105 Mutual Fund Sales Practices* (**81-105CP**), and
- proposed consequential amendments to:
  - National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (**NI 81-101**), including Form 81-101F1 *Contents of Simplified Prospectus* (**Form 81-101F1**) and Form 81-101F3 *Contents of Fund Facts Document* (**Form 81-101F3**), and
  - National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**),

(collectively, the **Proposed Amendments**).

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

www.bcsc.bc.ca
www.albertasecurities.com
www.fcaa.gov.sk.ca
www.mbsecurities.ca
www.osc.gov.on.ca
www.lautorite.qc.ca
www.fcnb.ca
https://nssc.novascotia.ca

Substance and Purpose

The purpose of the Proposed Amendments is to implement the CSA's policy response to the investor protection and market efficiency issues arising from the prevailing practice of investment fund managers remunerating dealers and their representatives for mutual fund sales through commissions, including sales and trailing commissions (**embedded commissions**).

The Proposed Amendments, together with the enhanced conflict of interest mitigation framework for dealers and representatives proposed under detailed reforms to NI 31-103 (the **Client Focused Reforms**) on June 21, 2018[1], comprise the CSA's policy response to each of the investor protection and market efficiency issues we have identified. The Proposed Amendments, if adopted, would restrict the compensation that members of the organization of publicly-offered mutual funds (**fund organizations**) may currently pay to participating dealers, and that participating dealers may currently solicit and accept, under NI 81-105 in connection with the distribution of mutual fund securities.

Specifically, the objectives of the Proposed Amendments are to prohibit:

- the payment of upfront sales commissions by fund organizations to dealers, and in so doing, discontinue sales charge options that involve such payments, such as all forms of the deferred sales charge option[2], including low-load options[3] (collectively, the **DSC option**), and

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[1] On June 21, 2018, we published a CSA Notice and Request for Comment seeking feedback on detailed reforms to registrant obligations that focus on the client's interests in the client-registrant relationship. These reforms, referred to as the Client Focused Reforms, propose changes to NI 31-103 that would, among other things, require registrants to:

- address conflicts of interest in the best interest of the client;
- put the client's interests first when making a suitability determination; and
- provide clients with greater clarity on what they should expect from their registrants.

The 120-day comment period on the Client Focused Reforms ends October 19, 2018.

[2] 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 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 sales commission (typically equivalent to 5% of the purchase amount). The investment fund manager may finance the payment of the upfront sales commission and accordingly incur financing costs that are included in the ongoing management fees charged to the fund.

[3] 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 sales commission paid by the investment fund manager and the redemption fees paid by investors are correspondingly lower than those of the traditional deferred sales charge option.

- trailing commission payments by fund organizations to dealers who do not make a suitability determination, such as order-execution-only (**OEO**) dealers.

The discontinuation of the DSC option would render obsolete certain disclosure requirements specific to that sales charge option under Form 81-101F1, Form 81-101F3 and NI 31-103. The consequential amendments propose to eliminate those disclosure requirements.

Background

On January 10, 2017, we published for comment CSA Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions* (the **Consultation Paper**), in which we identified and discussed key investor protection and market efficiency issues arising from mutual fund embedded commissions.[4] 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.

Further to our evaluation of all the feedback received throughout the consultation process, including written submissions and in-person consultations, the CSA decided on a policy response which we announced in CSA Staff Notice 81-330 *Status report on Consultation on Embedded Commissions and Next Steps* (**CSN 81-330**) published on June 21, 2018. The CSA proposed the following policy changes:

1. to 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;

2. to prohibit all forms of the DSC option and their associated upfront commissions in respect of the purchase of securities of a prospectus qualified mutual fund; and

3. 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 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

[4] 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. We 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*.

regulatory concerns that our proposed policy changes aim to address, and also discussed why we are not banning all forms of embedded commissions.

Concurrently with CSN 81-330, we published a CSA Notice and Request for Comment[5] seeking comment on the Client Focused Reforms proposing to implement the enhanced conflict of interest mitigation framework for dealers and representatives contemplated in component #1 of our policy response, together with other important changes aimed at better aligning the interests of registrants with the interests of their clients and improving investor outcomes. The Proposed Amendments are focused on the specific prohibitions proposed in components #2 and #3 of our policy response, thus completing the implementation of a package of reforms that we expect will respond to the issues arising from mutual fund embedded commissions.

Summary of the Proposed Amendments

1. Substantive amendments:

As discussed above, the Proposed Amendments are intended to prohibit the following payments by fund organizations in connection with the distribution of prospectus qualified mutual fund securities:

- upfront sales commissions to dealers – which prohibition we expect will eliminate the DSC option, and
- trailing commissions to dealers who are not subject to a suitability requirement, such as OEO dealers.

The Proposed Amendments include the following amendments to NI 81-105, which is the instrument that sets minimum standards of conduct to be followed by industry participants in their activities in distributing prospectus qualified mutual fund securities:

a. Definition of "member of the organization"

We propose to expand the definition of "member of the organization" in section 1.1 of NI 81-105 to include an "associate"[6] of the investment fund manager, of the principal distributor or of the portfolio adviser of the mutual fund. This would expand the group of persons or companies that are prohibited from making payments or providing benefits to participating dealers under NI 81-105 to also include any partners of the investment fund manager, principal distributor or

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[5] See note 1.

[6] Under securities legislation, the term "associate", where used to indicate a relationship with any person or company, includes among others,

(a) any company of which such person or company beneficially owns, directly or indirectly, voting securities carrying more than 10 per cent of the voting rights attached to all outstanding voting securities of the company,

(b) any partner of that person or company, and

(c) any trust or estate in which such person or company has a substantial beneficial interest or as to which such person or company serves as trustee or in a similar capacity.

portfolio adviser of the mutual fund, as well as any companies in which the investment fund manager, principal distributor or portfolio adviser of the mutual fund may have a 10% voting interest.

b. Definition of "trailing commission"

While section 3.2 of NI 81-105 currently permits a fund organization to pay a "trailing commission" to a participating dealer, the instrument currently does not define what comprises such payment. We accordingly propose to include a definition of "trailing commission" in section 1.1 in order to lend greater clarity to the existing permissive provision in subsection 3.2(1) and our new proposed rule regarding the payment of trailing commissions to dealers who do not make a suitability determination in subsection 3.2(4), discussed further below.

Consistent with the definition of "trailing commission" in NI 31-103, we broadly define "trailing commission" to mean any payment that is part of a continuing series of payments related to the ownership of securities of a mutual fund by a client of a participating dealer. This definition is accordingly not restricted to payments intended to compensate dealers and their representatives for advice afforded to clients, but rather captures payments for all services of any kind to the client in connection with their ownership of mutual fund securities.

c. Prohibition of sales commission payments by fund organizations

In connection with the CSA's decision to discontinue the DSC option and its associated upfront commissions, we propose to repeal section 3.1 of NI 81-105 which currently permits fund organizations to pay sales commissions to dealers for the distribution of mutual fund securities.

Subject to specified conditions, section 3.1 currently permits fund organizations to pay:

- upfront sales commissions out of their general revenue, and
- upfront sales commissions for sales made under the front-end load option that are deducted by the participating dealer from the investment amount at the time of the purchase.[7]

We expect that the repeal of section 3.1 and the resulting prohibition on fund organizations paying sales commissions to participating dealers[8] will have the following effects:

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[7] See CSA Notice of Proposed National Instrument 81-105 and Companion Policy 81-105CP *Mutual Fund Sales Practices* dated July 25, 1997, which describes the purpose of section 3.1 as follows:

> Section 3.1 permits the payment of a commission in money if the obligation to pay the commission arises at the time of the sale of the mutual fund on the conditions indicated. Commissions permitted by section 3.1 include upfront sales commissions paid by fund organizations and those paid under arrangements where the principal distributor of a mutual fund permits a participating dealer to retain the whole or a portion of commissions paid by those investors purchasing securities on a "front end load" basis. The primary conditions to such payments include requirements for prospectus disclosure as to the range of commissions that may be paid and the method of calculation used in determining the amounts of those commissions.

i. ***Discontinue all forms of the DSC option:***

The upfront sales commission payable by fund organizations to dealers for mutual fund sales made under the DSC option is a key feature of that sales charge option that gives rise to a conflict of interest that can incentivize dealers and their representatives to make self-interested investment recommendations to the detriment of investor interests. We refer you to CSN 81-330 for an overview of the problematic registrant practices and investor harms we have identified in connection with the use of the DSC option and that underlie our proposal to eliminate that option.

By prohibiting fund organizations from paying upfront sales commissions to participating dealers, we will correspondingly eliminate the need for fund organizations to finance the cost of these commissions, which we expect will in turn eliminate the need for the following two features of the DSC option:

a. the redemption fee schedule, representing the period of time the fund organization requires the investor to remain invested in the mutual fund in order to recoup its financing costs (through management fees charged to the fund), and
b. the redemption fee, which essentially functions as a default penalty allowing the investment fund manager to recoup its financing costs in the event the investor redeems from the mutual fund prior to the end of the redemption fee schedule.

Consequently, we expect the prohibition on fund organizations paying upfront sales commissions to dealers will result in the discontinuation of the DSC option and its various features, including the redemption fee schedule and the related redemption fee. While we do not propose to specifically prohibit redemption fee schedules and redemption fees, we expect their use in this context will cease further to the implementation of this policy change. In our view, the continued use of these individual features of the DSC option in connection with new mutual fund investments made after the repeal of section 3.1 would promote the commercial interests of fund organizations ahead of the interests of mutual fund investors, which we would consider to be inconsistent with registrant conduct standards, including the investment fund manager's fiduciary duty under the legislation. However, we expect that the use of redemption fees by mutual funds for other specific purposes, such as for the purpose of deterring excessive or short-term trading and offsetting the associated costs, will continue.

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[8] Section 3.1 of NI 81-105 is a permissive provision that permits fund organizations to pay sales commissions to dealers as an exception to the general prohibition on the payment of money in section 2.1 of NI 81-105. Further to the repeal of section 3.1 of NI 81-105, fund organizations will be prohibited from paying sales commissions under the general prohibition on the payment of money in section 2.1 of NI 81-105. Similarly, dealers will be prohibited from soliciting and accepting sales commissions from fund organizations under the general prohibition on the solicitation and acceptance of the payment of money in section 2.2 of NI 81-105.

We further expect that, since fund organizations will no longer incur the cost of financing upfront sales commissions to dealers on DSC mutual fund sales, the management fees charged to the mutual funds who previously offered the DSC option will be correspondingly reduced.

We do not expect that the repeal of section 3.1 will have any impact on the availability and use of other sales charge options, including the front-end load option as it currently exists today. We understand that, under that option, the dealer retains the sales commission agreed to by the investor from the investment proceeds that the investor submits for the mutual fund purchase, and remits the net proceeds to the fund organization for investment in the fund. In this case, we consider that the sales commission is paid directly by the investor and not by the fund organization, and thus is not within the scope of NI 81-105.

ii. ***Shift sales compensation matters to the dealer-client relationship:***

The inability of participating dealers to receive upfront sales commissions from fund organizations for the distribution of mutual fund securities will require them to find alternative ways of maintaining their revenue stream which will likely require them to turn directly to their clients for such compensation. We therefore expect that this will cause dealers to shift to alternative, more salient forms of compensation for mutual fund purchases, such as front-end commissions under the front-end load option, transaction fees, or other type of compensation, that they may negotiate with, and charge directly to, the client. Fund organizations would accordingly no longer play a role in setting sales commission rates for the sale of their mutual funds as this would be a matter left to be negotiated and settled exclusively within the dealer-client relationship.

In proposed new sections 4.1.1 and 4.1.2 of 81-105CP, we clarify that, while fund organizations would, further to the repeal of section 3.1 of NI 81-105, be prohibited under the existing general prohibition in section 2.1 of the instrument from paying sales commissions to participating dealers, this would not preclude them from facilitating the payment of a sales commission negotiated and agreed to exclusively between the dealer and the mutual fund investor. For example, we would not consider the prohibition in section 2.1 of the instrument to be breached where a participating dealer remits to a fund organization the gross proceeds of an investor's purchase of mutual fund securities from which the fund organization then deducts and remits the sales commission to the participating dealer on the investor's behalf pursuant to instructions received from the dealer.

We note that the Client Focused Reforms published for comment on June 21, 2018[9], propose certain changes that support and complement this proposed shift of sales compensation matters to the dealer-client relationship. Specifically, proposed

[9] See note 1.

amendments to the relationship disclosure obligations propose to require dealer firms to make publicly available information that a reasonable investor would consider important in deciding whether to become a client of the firm, including the account types, products and services that the firm offers, the charges and other costs to clients, including any fee schedule in effect, as well as any third-party compensation associated with its products, services and accounts.[10] We anticipate that these changes will give investors ready access to basic information about competing firms' products and services including the costs associated with those products and services, and thus enable investors to comparison shop and select a firm that best meets their needs and expectations.

d. Restriction on payment and acceptance of trailing commissions where no suitability determination made

In new subsection 3.2(4) of NI 81-105, we propose to prohibit fund organizations from paying trailing commissions where the participating dealer is not required to make a suitability determination in connection with a client's purchase and ongoing ownership of prospectus qualified mutual fund securities. This would 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 NI 31-103 or under the corresponding rules of the self-regulatory organizations (**SROs**). Such dealers would include, among others, OEO dealers and dealers acting on behalf of a 'permitted client' that has waived the suitability requirements.

Accordingly, new subsection 3.2(4) of NI 81-105 is intended to require dealers to provide investors with advice arising from the suitability requirements in order to qualify for the receipt of trailing commission payments. OEO dealers and other dealers who are not required to make suitability determinations will be expected to charge investors directly for the services they provide. We expect this will lead to an increased use of more transparent and salient fees (such as trading commissions, transaction fees, or other directly-charged fees) for the purchase and holding of mutual fund securities through OEO dealers that may better align with the cost of the services such dealers provide.

In proposed new section 5.4 of 81-105CP, we clarify our expectations with respect to this new restriction on the payment of trailing commissions by fund organizations to dealers who do not make suitability determinations. The section reminds that subsection 2.2(2) of NI 81-105 imposes a corresponding restriction on participating dealers from soliciting and accepting from fund organizations any payment that fund organizations are not expressly permitted to make under Parts 3 and 5 of the instrument. Accordingly, the new restriction on fund organizations in subsection 3.2(4) of NI 81-105 gives rise to a corresponding restriction on dealers who do not make suitability determinations from soliciting or accepting trailing commission payments from fund organizations. We also state our view in section 5.4 of 81-105CP that fund organizations should make available to participating dealers who do not make suitability determinations in respect of a client, a class or series of securities of a mutual fund that does not pay trailing

[10] See proposed section 14.1.2 of NI 31-103 of the amendments published for comment June 21, 2018.

commissions[11], which the dealer should offer to the client. We expect that the rate of the management fee charged on that class or series of securities of a mutual fund would reflect the absence of trailing commission costs and thus be correspondingly reduced.

Finally, we propose a housekeeping amendment to subsection 3.2(1) of NI 81-105 which consists of moving the lead-in language in that subsection stating that trailing commissions are based on the value of securities of the mutual fund held in accounts of clients of the participating dealer, and making this a specific condition to the payment of trailing commissions under new proposed paragraph 3.2(1)(a.1).

2. Consequential amendments:

We propose certain consequential amendments to the simplified prospectus form under Form 81-101F1 and the Fund Facts document under Form 81-101F3, as well as to dealer disclosure obligations under NI 31-103, to reflect the expected discontinuation of the DSC option and the shift of sales compensation matters to the dealer-client relationship, as discussed above. Specifically, we propose:

- under Item 8.1 of Part A of Form 81-101F1, to replace the requirement to disclose in the "Fees and Expenses" table the percentage rate of the sales charge with a general statement that the dealer may charge the investor a sales charge or transaction fee which the investor may negotiate with the dealer;
- under Item 8.2 of Part A of Form 81-101F1, to repeal the requirement to illustrate the impact of sales charges associated with the different purchase options;
- under Item 9 of Part A of Form 81-101F1, to delete instructions pertaining to disclosure of the payment of sales commissions by the investment fund manager to the dealer;
- under Item 1.2 of Part II of Form 81-101F3, to replace the table requiring illustrations of different sales charge options with the requirement to provide an overview of any sales charges that investors may have to pay when they purchase securities of the mutual fund, including whether the amount is negotiable, whether it may be paid directly by the investor or deducted from the amount paid at the time of purchase, who pays (in the case of a payment on behalf on an investor) and who receives the amount payable;
- under Item 1.3 of Part II of Form 81-101F3, to remove the requirement to state that the rate of the trailing commission depends on the sales charge option chosen by the investor, and replace the requirement to disclose the range of the rates of the trailing commission for each sales charge option with the requirement to disclose the range of the rate of the trailing commission;
- in paragraph 8.7(4)(a) of NI 31-103, to repeal the requirement for an investment fund to set out in its prospectus, as a condition to the exemption from the dealer registration requirement provided for investment fund reinvestments, the details of any deferred or contingent sales charge or redemption fee that may be payable; and

[11] For example, an existing class or series of mutual fund securities generally denoted as class or series "F" (typically intended for fee-based clients) could potentially be used for this purpose. Alternatively, another class or series that similarly does not pay any trailing commissions could be used.

- in paragraph 14.2.1(1)(b) of NI 31-103, to repeal the requirement for a registered firm to provide pre-trade disclosure of any deferred sales charges applicable to the subsequent sale of the security and the redemption fee schedule that will apply.

Alternatives Considered to the Proposed Amendments

The CSA previously considered various alternatives to the Proposed Amendments. The CSA initially examined under the Consultation Paper the option of discontinuing all forms of embedded commissions and, in subsequent in-person consultations with stakeholders, explored the viability of various alternatives, including: (i) standardizing or capping trailing commissions, (ii) implementing additional standards for the use of the DSC option, (iii) enhancing fee disclosure requirements, and (iv) requiring dealers and representatives to offer all clients the option of a direct-pay arrangement alongside an embedded commission option. We concluded that these alternatives would not adequately address the investor protection and market efficiency issues arising from the use of embedded commissions. Given the importance of the identified issues, the CSA did not consider maintaining the status quo to be an option.

The CSA also considered other ways of improving fee disclosure. In this regard, as mentioned in CSN 81-330, the CSA are supportive of the Mutual Fund Dealers Association's (**MFDA**) proposal to expand cost reporting for investment funds to allow investors to better understand the ongoing costs of each investment fund they own and their total costs of investing.[12] We expect to engage more closely with the MFDA and the Investment Industry Regulatory Organization of Canada to advance this important initiative.

The CSA believe that the Proposed Amendments, together with the enhanced conflict of interest mitigation framework proposed under the Client Focused Reforms, appropriately respond to the issues we identified, and at the same time respond to stakeholders' concerns about the potential adverse consequences to investors and market participants of discontinuing all forms of embedded commissions. Importantly, this package of reforms is designed to address not only conflicts arising from embedded commissions, but rather all types of conflicts that can incentivize poor registrant behaviour and subvert investor interests, and thus provides a holistic approach to the treatment of all conflicts in the registrant-client relationship.

Anticipated Costs and Benefits of the Proposed Amendments

In Annex F, we provide an overview of the anticipated costs and benefits of our proposed package of reforms to address concerns related to the payment of embedded commissions, which reforms include the Proposed Amendments together with the changes proposed under the Client Focused Reforms.

[12] On April 19, 2018, the MFDA published a discussion paper to solicit feedback from stakeholders on the potential expansion of cost reporting for investment funds. This discussion paper outlines a number of different approaches that can be integrated into existing reporting requirements. See MFDA Bulletin #0748-P.

Transition

We expect that registrants will require some time to operationalize the Proposed Amendments. At this time, we anticipate providing a transition period of 365 days from the date of final publication of the amendments, at the end of which the changes would become effective (**effective date**).

Discontinuation of DSC option:

We anticipate that the proposed transition period will provide sufficient time for dealer firms and representatives who currently make substantial use of the DSC option to transition their practices and operational systems and processes to the use of other sales charge options. We expect they will increase their use of the front-end load option or other direct-pay arrangements with their clients. Some dealer firms may also have to reassess their internal compensation arrangements. We believe the proposed transition period should also give investment fund managers enough time to revise their mutual funds' simplified prospectuses and Fund Facts documents to reflect the discontinuation of the DSC option.

We would not expect existing mutual fund investments held under the DSC option as at the effective date to have to be converted to the front-end load option or other sales charge option. Accordingly, the redemption schedules on those existing DSC holdings as at the effective date would be allowed to run their course until their scheduled expiry, and fund organizations would continue to be allowed to charge redemption fees on those existing holdings that are redeemed prior to the expiry of the applicable redemption schedule. However, any new mutual fund purchases made on or after the effective date will need to comply with the new rules.

While dealer firms will continue to be allowed to sell mutual fund securities under the DSC option during the transition period, we caution that we will closely examine such sales that are made up to the effective date to ensure that those recommendations are fully compliant with securities legislation, in particular the suitability requirements of NI 31-103. The SROs are also expected to closely examine such sales under their conflict of interest rules.

Discontinuation of trailing commission payments to dealers who do not make suitability determinations:

We anticipate that the proposed transition period will provide sufficient time for OEO dealers and other dealers who do not make suitability determinations to implement new direct-fee charging systems and processes to enable them to collect their fees for their services directly from mutual fund investors as at the effective date. As of that date, dealers who are not subject to the suitability requirement and who administer client accounts that have existing holdings of publicly-offered mutual funds would no longer be allowed to accept trailing commission payments from fund organizations on those holdings. We expect that the dealers concerned would move those mutual fund holdings to a trailing commission-free class or series of the relevant mutual funds, which class or series we would expect fund organizations to correspondingly make available for use on OEO dealer platforms.

In Annex A of this Notice, we invite comments on specific questions to help inform and determine transition needs.

Local Matters

An additional annex 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.

Unpublished Materials

In developing the Proposed Amendments, we have not relied on any significant unpublished study, report or other written materials.

Request for Comments

We welcome your comments on the Proposed Amendments, and also invite comments on the specific questions set out in Annex A of this Notice. Some CSA jurisdictions will hold in-person consultations to further discuss the Proposed Amendments and the questions in Annex A. The details of any in-person consultations will be announced by the CSA jurisdiction.

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. All comments will be posted on the websites of each of the Ontario Securities Commission at www.osc.gov.on.ca, the Alberta Securities Commission at www.albertasecurities.com and the Autorité des marchés financiers at www.lautorite.qc.ca. Therefore, you should not include personal information directly in comments to be published. It is important you state on whose behalf you are making the submissions.

Deadline for Comments

Please submit your comments in writing on or before **December 6, 2018**. If you are not sending your comments by email, please send a USB flash drive containing the submissions (in Microsoft Word format).

Where to Send Your Comments

Address your submission to all of the CSA as follows:

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission of New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory

Superintendent of Securities, Nunavut

Deliver your comments only to the addresses below. Your comments will be distributed to the other participating CSA.

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Contents of Annexes

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

Annex A: Specific Questions of the CSA Relating to the Proposed Amendments

Annex B: Proposed Amendments to National Instrument 81-105 *Mutual Fund Sales Practices*

Annex C: Proposed Changes to Companion Policy 81-105CP To National Instrument 81-105 *Mutual Fund Sales Practices*

Annex D: Proposed Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*

Annex E: Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*

Annex F: Regulatory Impact Analysis of the Proposed Reforms to Address Concerns Related to the Payment of Embedded Commissions

Questions

Please refer your questions to any of the following:

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ANNEX A

SPECIFIC QUESTIONS OF THE CSA RELATING TO THE PROPOSED AMENDMENTS

Definition of "member of the organization"

1. Under the Proposed Amendments, we propose to expand the definition of "member of the organization" in NI 81-105 to capture an "associate", as defined under securities law, of the investment fund manager, of the principal distributor or the portfolio adviser of the mutual fund. Aside from potential future modernization amendments contemplated further below, are there additional immediate changes or updates we should consider making to the definition in connection with the implementation of the Proposed Amendments? For example, would paragraph (e) of the definition still be relevant further to the elimination of the DSC option?

Repeal of section 3.1 of NI 81-105

The proposed repeal of section 3.1 of NI 81-105 would prohibit fund organizations from paying any sales commissions to participating dealers. We expect the prohibition on fund organizations from paying upfront sales commissions to dealers for mutual fund sales made under the DSC option would effectively eliminate the DSC option, including its individual features, such as the redemption fee schedule and the related redemption fee.

2. Would the proposed repeal of section 3.1 of NI 81-105 have the expected effect of eliminating all forms of the DSC option? If not, what other measures should be taken to ensure that all forms of the DSC option are eliminated?

3. Would there be any sales practices and/or compensation arrangements with a redemption fee schedule and redemption fee that could exist despite the repeal of section 3.1 of NI 81-105? If so, are rule changes required to specifically prohibit redemption fees that are charged for purposes other than to deter excessive or short-term trading in funds?

4. We do not expect that the repeal of section 3.1 of NI 81-105 will have any impact on the availability and use of other sales charge options, including the front-end load option as it currently exists today.

    (a) Are there any unintended consequences on the front-end load option with the repeal of section 3.1 that we should consider?

    (b) Are there any other types of sales charge options that will be impacted by repealing section 3.1?

Amendment of section 3.2 of NI 81-105

Proposed subsection 3.2(4) of NI 81-105 would prohibit fund organizations from paying trailing commissions where the participating dealer is not required to make a suitability determination in connection with a client's purchase and ongoing ownership of prospectus qualified mutual fund securities.

5. We expect that fund organizations will make available a trailing commission-free class or series of securities of a mutual fund to participating dealers who do not make suitability determinations. Would fund organizations have any issues with making available a class or series of securities of a mutual fund without trailing commissions to such dealers?

6. Would fund organizations encounter any issues, including any operational challenges, in confirming whether a participating dealer has made a suitability determination, and is thus eligible to be paid a trailing commission in compliance with subsection 3.2(4) of NI 81-105? If so, please explain.

Transition Period

We anticipate that a transition period of 1 year from the date of publication of the final amendments is sufficient time for registrants to operationalize the Proposed Amendments.

7. Are there any transitional issues for fund organizations and participating dealers with implementing the Proposed Amendments within the proposed 1-year transition period? If so, please provide details of the relevant operational, technological, systems, compensation arrangements or other significant business changes required, and the minimum amount of time reasonably required to operationalize those changes and comply with the Proposed Amendments.

8. With the implementation of the Proposed Amendments, would the required changes to the disclosure in the simplified prospectus and fund facts documents within the proposed 1-year transition period necessitate amendments outside of a mutual fund's prospectus renewal period? Would these changes be considered to be material changes under NI 81-106?

9. By the effective date of the Proposed Amendments, the CSA expect that those dealers who do not make suitability determinations in respect of a client will have switched any existing mutual fund holdings of such client to a trailing commission-free class or series of the relevant mutual fund.

   (a) Switching a client from a class or series of securities of a mutual fund that pays a trailing commission to one that does not pay a trailing commission would trigger the delivery requirement for the fund facts document. As a transitional measure, should there be an exemption from the fund facts document delivery requirement for such switches? Such an exemption would mean that the investor would not have the right of withdrawal from the purchase, however, the investor would

continue to have a right of action for rescission or for damages if there is a misrepresentation in the prospectus of the mutual fund, including any documents incorporated by reference into the prospectus, such as the fund facts document. In some jurisdictions, investors have a right of rescission with delivery of the trade confirmation for the purchase of mutual fund securities and this right would remain unchanged with such an exemption.

(b) Are there any other types of exemptions from CSA or SRO rules that we should consider to facilitate switches to trailing commission-free classes or series of mutual funds? If so, please describe.

10. At this time, the CSA is allowing redemption schedules on existing DSC holdings as of the effective date of the Proposed Amendments to run their course until their scheduled expiry, and fund organizations to continue charging redemption fees on those existing holdings that are redeemed prior to the expiry of the applicable redemption schedule. Should the CSA propose amendments to require existing DSC holdings as of the effective date of the Proposed Amendments to be converted to the front-end load option or other sales charge option? If so, are there any transitional issues for fund organizations and participating dealers with converting existing DSC holdings to another sales charge option? What would be an appropriate transition period?

Regulatory arbitrage

11. We understand that the elimination of the DSC option may give rise to the risk of regulatory arbitrage to similar non-securities financial products, such as segregated funds, where such purchase option and its associated dealer compensation are still available. Please provide your thoughts on controls and processes that registrants may consider using, and on specific measures or initiatives that the relevant regulators should undertake, to mitigate this risk.

Modernization of NI 81-105

After the implementation of the Proposed Amendments, the CSA may consider future amendments to modernize NI 81-105, an instrument that has been in place since May 1998. The following questions will help inform the CSA's initiative to modernize NI 81-105.

12. Given that NI 81-105 aims to restrict compensation arrangements that can conflict with registrants' fundamental obligations to their investor clients, and given that the proposed Client Focused Reforms introduce the requirement for registrants to address conflicts of interests, including conflicts arising from third-party compensation, in the best interests of clients or avoid them, should the modernization of NI 81-105 entail a consolidation of its requirements into the registrant conduct obligations of NI 31-103?

13. NI 81-105 currently applies only to the distribution of prospectus qualified mutual funds. In our view, the conflicts arising from sales practices and compensation arrangements that are addressed by the provisions in NI 81-105 are not unique to the distribution of

prospectus qualified mutual funds and also arise in the distribution of other investment products, either sold under a prospectus or a prospectus exemption. Are there other types of investment products that are not currently subject to NI 81-105, such as non-redeemable investment funds, certain labour-sponsored investment funds, structured notes and pooled funds that should also be subject to NI 81-105? If not, why should these investment products, their investment fund managers and the dealers that distribute them, remain outside the scope of NI 81-105?

14. We seek feedback on whether we should change the term "trailing commission" to a plain language term that investors would better understand and would better describe what a trailing commission is. If so, what are some suggested terms?

15. The definition of "participating dealer" in NI 81-102 carves out a principal distributor. As a result, principal distributors are not subject to the provisions of NI 81-105 that apply to participating dealers. Should the modernization of NI 81-105 contemplate the inclusion of principal distributors in the application of all the provisions of NI 81-105? Alternatively, are there specific provisions in NI 81-105 that should also apply to principal distributors? Please explain.

ANNEX B

PROPOSED AMENDMENTS TO
NATIONAL INSTRUMENT 81-105 *MUTUAL FUND SALES PRACTICES*

1. ***National Instrument 81-105 Mutual Fund Sales Practices is amended by this Instrument.***

2. ***Section 1.1 is amended***

   (a) ***in paragraph (d) of the definition of "*member of the organization*" by adding "*associate or*" before "*affiliate*",***

   (b) ***in the definition of "*mutual fund family*", by deleting "*and*" at the end of paragraph (b),***

   (c) ***in the definition of "*representative*", by replacing "*dealer.*" with "*dealer;*" at the end of paragraph (c), and***

   (d) ***by adding the following definition:***

   "trailing commission" means a payment of money that is part of a continuing series of payments related to the ownership of securities of a mutual fund by a client of a participating dealer.**.**

3. ***Section 3.1 is repealed.***

4. ***Section 3.2 is amended***

   (a) ***in subsection (1) by deleting "*in money that is based upon the aggregate value of securities of the mutual fund held in accounts of clients of the participating dealer as at a particular time or during a particular period,***",***

   (b) ***by adding "*in securities of the mutual fund by the client of the participating dealer*" at the end of paragraph 3.2(1)(a),***

   (c) ***by adding the following paragraph to subsection (1):***

   (a.1) the amount of the trailing commission is based on the value of securities of the mutual fund held in an account of the client of the participating dealer as at a particular time or during a particular period; ***and***

   (d) ***by adding the following subsection:***

(4) Despite subsection (1), no member of the organization of a mutual fund may pay a trailing commission to a participating dealer in connection with securities of the mutual fund held in an account of a client of the participating dealer if the participating dealer is not required by securities legislation or rules of an SRO applicable to the dealer to make a suitability determination in respect of the client in connection with those securities.

5. This Instrument comes into force [*365 days from the date of final publication*].

ANNEX C

PROPOSED CHANGES TO
COMPANION POLICY 81-105CP TO NATIONAL INSTRUMENT 81-105 *MUTUAL FUND SALES PRACTICES*

1. ***Companion Policy 81-105CP to National Instrument 81-105 Mutual Fund Sales Practices is changed by this Document.***

2. ***Part 4 of the Companion Policy is changed by adding the following sections:***

   4.1.1 Payment of money – Except for payments specifically permitted under Parts 3 and 5 of the Instrument, section 2.1 of the Instrument prohibits members of the organization of a mutual fund from making payments of money to participating dealers or their representatives in connection with the distribution of securities of the mutual fund.

   4.1.2 Means of payment – The Canadian securities regulatory authorities are of the view that the Instrument does not preclude members of the organization of a mutual fund from facilitating the payment by a mutual fund investor to a participating dealer of a sales commission in connection with the purchase of mutual fund securities that is negotiated and agreed to exclusively between those two parties. For example, the participating dealer may remit to the member the gross proceeds of an investor's purchase of mutual fund securities from which the member may then deduct and remit the sales commission to the participating dealer on the investor's behalf pursuant to instructions received from the dealer.

3. ***Section 5.1 is changed by replacing "***Paragraphs 3.1(b) and 3.2(b) of the Instrument require the disclosure of the method of calculation used in determining the amount of sales commissions and***" with "***Paragraph 3.2(1)(b) of the Instrument requires the disclosure of the method of calculation used in determining the amount of***".***

4. ***Section 5.2 is changed by replacing "***Subparagraphs 3.1(c)(iii) and 3.2(1)(d)(iii) of the Instrument prevent***" with "***Subparagraph 3.2(1)(d)(iii) of the Instrument prevents***".***

5. ***Part 5 of the Companion Policy is changed by adding the following section:***

   5.4 Restriction on payment and acceptance of trailing commissions where no suitability determination made – Subsection 3.2(4) prohibits members of the organization of a mutual fund from paying trailing commissions to participating dealers who do not make a suitability determination for a client in connection with securities of the mutual fund held in an account of the client. Correspondingly, subsection 2.2(2) of the Instrument permits participating dealers to solicit and accept only those payments that members are permitted to make under Parts 3 and 5. Consequently, participating dealers who are not subject to the obligation to make a suitability determination under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* or corresponding SRO rules may not solicit or accept trailing commission

payments from members of the organization of a mutual fund. Consistent with this restriction, participating dealers and members of the organization of a mutual fund should establish a process under which a participating dealer is required to confirm to the member that it has made a suitability determination for a client as a prerequisite to the receipt of trailing commission payments. In addition, members of the organization of a mutual fund should make available to participating dealers not making a suitability determination in respect of a client, a class or series of securities of a mutual fund that does not pay trailing commissions, which the dealer should offer to the client.

6. These changes become effective [*365 days from the date of final publication*].

ANNEX D

PROPOSED AMENDMENTS TO
NATIONAL INSTRUMENT 81-101 *MUTUAL FUND PROSPECTUS DISCLOSURE*

1. National Instrument 81-101 Mutual Fund Prospectus Disclosure is amended by this Instrument.

2. Subsection 6.1(3) is amended by adding "Alberta and***" before "***Ontario***".***

3. Form 81-101F1 Contents of Simplified Prospectus is amended

(a) in Item 8.1 of Part A by replacing "*[specify percentage, as a percentage of ………]****" in the table opposite "***Sales Charges***" with "****[See Instruction (6)]****",***

(b) by adding the following subsection to the Instructions under Item 8.1 of Part A:

*(6) Under "Sales Charges", state that the dealer may, in connection with the investor's purchase of securities of the mutual fund, charge the investor a sales charge or transaction fee which the investor may negotiate with the dealer.****,***

(c) by repealing Item 8.2 of Part A,

(d) in subsection (2) of the Instructions under Item 9.1 of Part A by deleting the following:

*For example, if the manager of the mutual fund pays an up-front sales commission to participating dealers, so state and include the range of commissions paid. If the manager permits participating dealers to retain the sales commissions paid by investors as compensation, so state and include the range of commissions that can be retained.****,***

(e) in subsection (2) of the Instructions under Item 9.2 of Part A by deleting "*sales and****", and***

(f) by repealing subsection (3) of the Instructions under Item 9.2 of Part A.

4. Form 81-101F3 Contents of Fund Facts Document is amended

(a) by replacing Item 1.2 of Part II with the following:

1.2 – Sales Charges

(1) Under the sub-heading "Sales charges", provide a brief overview of any sales charges that investors may have to pay when they purchase securities of the mutual fund and how the sales charges work including:

- whether the amount payable is negotiable;
- whether the amount payable is to be paid directly by the investor or deducted from the amount paid at the time of purchase;
- who pays and who receives the amount payable.

(2) If no sales charges apply to purchases of securities of the mutual fund, state that no sales charges apply.***,***

(b) ***in Item 1.3(6) of Part II by deleting "***The rate depends on the sales charge option you choose.***",***

(c) ***by replacing Item 1.3(7) of Part II with:***

(7) If applicable, disclose the range of the rate of the trailing commission.***, and***

(d) ***in subsection (8) of the Instructions under Item 1.3 of Part II by replacing "****rates of trailing commissions for each sales charge option****" with "****the rate of the trailing commission****".***

5. (1) Subject to subsection (2), this Instrument comes into force [*365 days from the date of final publication*].

(2) Sections 1 and 2 of this Instrument come into force [*90 days from the date of final publication*].

ANNEX E

PROPOSED AMENDMENTS TO
NATIONAL INSTRUMENT 31-103 *REGISTRATION REQUIREMENTS, EXEMPTIONS AND ONGOING REGISTRANT OBLIGATIONS*

1. National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations is amended by this Instrument.

2. Paragraph 8.7(4)(a) is amended by deleting "deferred or contingent sales charge or***".***

3. Subsection 14.2.1(1) is amended by

(a) adding "and***" at the end of paragraph (a), and***

(b) repealing paragraph (b).

4. This Instrument comes into force [*365 days from the date of final publication*].

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[13], 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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[13] 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). 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[14] and dealers and representatives[15] 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.[16]

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

[14] Embedded commissions can reduce IFMs' focus on fund performance, which can lead to underperformance.

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

[16] 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)

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:[17]

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[18];
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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[17] 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.

[18] 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.[19] 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

[19] 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.[20]

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.[21] 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.[22]

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[20] 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.

[21] 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.

[22] 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.[23] 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.[24] 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 the that option will cease to be incurred by the mutual fund and passed on to investors.[25]

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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[23] 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.

[24] Based on OSC review of FundSERV codes and Fund Facts documents.

[25] 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[26], 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.[27] In particular, non-deposit taker dealers,[28]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.[29] 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.

[26] 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.

[27] 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).

[28] 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).

[29] 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.[30] 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.[31]

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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[30] 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.

[31] 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.[32]

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.

[32] 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.