Canadian Securities Administrators   Autorités canadiennes en valeurs mobilières

CANADIAN SECURITIES ADMINISTRATORS DISCUSSION PAPER AND REQUEST FOR COMMENT 81-407 *MUTUAL FUND FEES*

December 13, 2012

Administering the Canadian Securities Regulatory System
Les autorités qui réglementent le marché des valeurs mobilières au Canada

Table of Contents

I. INTRODUCTION 3

II. BACKGROUND 4

III. CANADIAN MUTUAL FUND INDUSTRY PARTICIPANTS 6

IV. MUTUAL FUND FEE STRUCTURE IN CANADA 12

V. CURRENT ISSUES ARISING FROM THE MUTUAL FUND FEE STRUCTURE IN CANADA 28

VI. GLOBAL REGULATORY REFORMS 44

VII. CURRENT REGULATORY INITIATIVES AND TOPICS FOR CONSIDERATION..50

VIII. COMMENT PROCESS 58

Annex I..62

I. INTRODUCTION

The Canadian Securities Administrators (CSA or we) are examining the mutual fund fee structure in Canada in order to see whether there are investor protection or fairness issues, and to determine whether any regulatory responses are needed to address any issues we find. This paper is intended to be a platform to begin a discussion on the current mutual fund fee structure in Canada.

This discussion paper is the first step in the CSA's public consultations about this project. It:

- provides an overview of the roles of the market participants in the mutual fund industry (mutual fund manufacturers and advisors who distribute the funds)
- provides an overview of the current mutual fund fee structure
- identifies some investor protection and fairness issues we think arise from the current fee structure
- provides an overview of global regulatory reforms
- describes some regulatory options the CSA could potentially consider, either alone or in combination.

Some of the options would impact mutual funds or mutual fund manufacturers directly, and others would impact those who sell the product.

While the focus of this paper is on mutual funds, we recognize that there are other investment fund products whose fee structure may raise similar investor protection and fairness issues for investors. Accordingly, we anticipate that any regulatory initiative we might ultimately undertake would assess whether the same initiative should also apply to other investment funds and comparable securities products.

Before considering any of these regulatory options further, we intend to consult extensively with investors and industry participants, and will continue to closely monitor and assess the effects of related regulatory reforms in Canada and around the world. In particular, the CSA recognize this paper raises some novel and difficult issues. It will be important for the CSA to consider the unique features of the Canadian market as we examine what, if any, changes could or should be made.

We welcome comments from investors, participants in the mutual fund and financial services industries, and all other interested parties on the issues raised and regulatory options set out in this paper. We also invite suggestions for other possible regulatory responses to these issues. The comments will help inform a roundtable the CSA plans to hold with investors and industry participants in 2013. The comments and roundtable discussions will help the CSA determine what, if any, regulatory responses might be appropriate.

Please see Part VIII for information on how to submit comments. The comment period closes on April 12, 2013.

II. BACKGROUND

Mutual funds are a cornerstone investment for many Canadian investors. At the end of 2011, the mutual fund industry managed $762 billion in assets on behalf of Canadians. Those assets accounted for 73.8% of all Canadian investment fund industry assets under management.[1]

Mutual funds are the most commonly held investment product, with 62% of Canadians with savings or investments set aside holding this product in their investment portfolios.[2] In addition, mutual funds make up the largest share of investable assets for the typical Canadian household. At June 2011, the average Canadian household held 36.1% of its investable assets in mutual funds.[3]

In Canada, most mutual funds are purchased through an advisor. At the end of 2011, 91% of investment fund assets were acquired and held by investors through distribution channels involving the intermediation of an advisor,[4] and over 80% of mutual fund investors said their last purchase was made through an advisor.[5]

Mutual fund investors in Canada primarily incur two kinds of fees and expenses to invest in and own mutual funds: sales charges and ongoing fund fees. Sales charges are transaction-based fees that investors pay directly either when they buy the fund or when they sell or redeem from the fund. Ongoing fund fees, which include the management fees and fund expenses (expressed together as the management expense ratio or MER), are paid from fund assets, which means that investors pay these fees indirectly. Embedded within the management fees of most Canadian mutual funds are ongoing trailing commissions paid to advisors.

A number of published research studies have compared mutual fund ownership costs globally, each concluding that Canadian mutual fund fees are among the highest in the world.[6] Some

[1] The remaining 26.2% of Canadian investment fund industry assets under management is made up of the following investment fund assets: hedge funds (1.7%), closed-end funds (3.1%), segregated funds (3.5%), exchange-traded funds (4.2%), pooled funds (4.6%) and insurance company pools (9.1%). The source for this data is Investor Economics at December 2011. 'Wrapped assets' have been removed to control for double-counting.
[2] See Innovative Research Group, Inc., *2012 CSA Investor Index* (October 2012), prepared for the CSA. That survey finds that the three most commonly held investment products are mutual funds (62% of those with savings or investments set aside), term deposits or GICs (45%) and individually held stocks (33%).
[3] Source: Ipsos Reid Canadian Financial Monitor. For advised Canadian households, this figure increases to 41.7%. Ipsos Reid defines investable assets as including chequing and savings accounts, GICs, stocks, bonds and mutual funds.
[4] Investor Economics, *Household Balance Sheet (update and rebased forecast)* (June 2012), pages 156, 160 and 161. This total includes the Branch Direct, Branch Advice, Financial Advisors, Full-service Brokers and Private Investment Counsel distribution channels, each of which provide varying forms of advice and services through the intermediation of advisors. See "**2. The advisors**" in Part III for a description of the various distribution channels.
[5] POLLARA, *Canadian Investors' Perceptions of Mutual Funds and The Mutual Fund Industry – 2011*, Report prepared for the Investment Funds Institute of Canada (IFIC). The percentage of investors using an advisor for their last purchase has varied between 81% and 85% since IFIC began conducting this survey in 2006.
[6] Examples of such studies include: B.N. Alpert, J. Rekenthaler, *Morningstar Global Fund Investor Experience 2011* (March 2011); J. Rekenthaler, M. Swartzentruber, C. Tsai, *Morningstar Global Fund Investor Experience 2009* (May 2009); and A. Khorana, H. Servaes, P. Tufano, *Mutual Fund Fees Around the World* (July 23, 2007); and K. Ruckman, *Expense ratios of North American mutual funds*, Canadian Journal of Economics (February 2003) p. 192-223.

members of the Canadian mutual fund industry and other commentators[7] have challenged these studies, saying that they provide inaccurate comparisons or do not consider the value to investors of the advice that advisors provide.[8]

Over the last few years, there has been a wave of regulatory reforms and proposals in other major international jurisdictions that fundamentally change the way retail investors buy investment funds and other financial products, as well as how they pay for financial advice. These include:

- the ban in the United Kingdom (U.K.) and Australia of advisor commissions set by financial product providers or embedded in financial products,
- the imposition in Australia of a statutory best interest duty on advisors who sell financial products, and
- the consideration of similar reforms by regulators in Europe and the United States (U.S.).

These global regulatory changes, together with the comparative studies on fund fees, have prompted calls for greater scrutiny of fund fees in Canada.

The CSA have to date focused their regulatory efforts on enhancing transparency of fund fees for investors, including the cost of embedded trailing commissions, through such initiatives as the Point of Sale disclosure project and Client Relationship Model project (each discussed later in this paper). While we continue to move forward to implement these initiatives to help investors make more informed investment decisions, we are now examining whether the current mutual fund fee structure raises investor protection concerns that require additional regulatory action. As such, the CSA are looking at all aspects of the current mutual fund fee structure and regulatory framework to determine what changes could or should be made, to enhance investor protection and to foster confidence in our market.

In Annex I to this paper, we include an overview of the mutual fund fee structures that exist in other major jurisdictions, namely the U.S., the U.K. and Australia, and highlight certain aspects of their fund industries including differences in their mutual fund regulatory framework that could influence average fund fees in those jurisdictions. The data we set out and the observations we make in Annex I are intended to provide context for our examination of Canada's mutual fund fee structure and current regulatory framework.

Defined terms

In this paper:

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[7] Mackenzie Financial, *Canadian Mutual Fund Ownership Costs: Competitive Relative to the U.S.* (September 2010); D. Yanchus, *A cross-border perspective on MERs* (May 18, 2011) available at: http://cawidgets.morningstar.ca/ArticleTemplate/ArticleGL.aspx?id=381595; and Investor Economics, *Attribution analysis of MERs explains cross-border gap*, Investor Economics Insight Monthly Update (July 1996).

[8] The Canadian mutual fund industry has commissioned several reports supporting the value of advice and what a relationship with an advisor can mean to Canadians' wealth accumulation and overall financial health. These reports include: IFIC, *The Value of Advice: Report* (July 2010); IFIC, *The Value of Advice: Report* (November 2011); C. Montmarquette, N. Viennot-Briot, *Econometric Models on the Value of Advice of a Financial Adviser*, (Montreal: the Centre for Interuniversity Research and Analysis on Organizations (CIRANO)) (July 2012).

- The term "advisor" is a plain language term that is used in the same way that mutual fund industry participants and members of the public commonly use this term to refer to a mutual fund salesperson. The term "advisor" is not indicative of a mutual fund salesperson's category of registration with Canadian securities regulators. Mutual fund salespersons that are registered with Canadian securities regulators to trade in mutual fund securities are, in most cases, registered as dealing representatives of mutual fund dealers or investment dealers. Unless otherwise specifically indicated in this paper, the term "advisor" should not be taken to imply registration as an advising representative of a portfolio manager firm with authority to trade for clients on a discretionary basis.

- The term "mutual fund manufacturer" means the entity that produces and promotes the mutual fund and that is also the registered investment fund manager responsible for directing the business, operations and affairs of the mutual funds.

III. CANADIAN MUTUAL FUND INDUSTRY PARTICIPANTS

The participants in the Canadian mutual fund industry include the mutual fund manufacturers who produce and promote mutual fund products and advisors who distribute those products to investors.

1. The mutual fund manufacturers[9]

There are currently 103 mutual fund manufacturers in Canada. They fall into the following four categories:

i. Canadian banks/deposit-takers

The fund management arms of 7 Canadian chartered banks together with the Mouvement Desjardins in Québec currently account for 43% of mutual fund assets under management. These manufacturers largely distribute their mutual funds through their branch networks, full-service and discount brokerage networks. Most of them also distribute a separate series of securities of their mutual funds, known as the *Advisor* series, through third party advisors.

These manufacturers typically offer their mutual funds on a no-load basis (i.e. without a sales commission) when sold through their bank branches. Their *Advisor* fund series, distributed through third party advisors and through their own full-service brokerage networks, is sold on a load basis (i.e. subject to a sales commission) under various purchase options.[10]

ii. Life insurers

While Canadian life insurance companies primarily produce and promote segregated fund

[9] The source for the data on mutual fund manufacturers provided in this section is Investor Economics. The data is as of December 2011. See Figure 1.
[10] In Part IV under "**1. Current mutual fund fees**", we describe the various purchase options under which mutual fund manufacturers sell their funds.

products, they are also involved in manufacturing mutual funds. These manufacturers currently represent 4.6% of mutual fund assets under management. Their mutual funds are largely sold on a load basis under various purchase options through their own licensed insurance agents who are typically dually licensed to sell both segregated funds and mutual funds.

iii. Independents

Independent mutual fund manufacturers are those that are not a subsidiary of one of the large deposit-taker institutions. These independents manage the largest share of industry assets and currently represent 49.4% of mutual fund assets under management. Their mutual funds are typically sold on a load basis through third party advisor distribution networks that include the registered distribution arms of deposit-takers, life insurers and independent dealers. Some independents also have their own dealer network that typically focuses on their own funds.

A very small subset of the independent mutual fund manufacturers category consists of "direct sellers" who typically make their mutual funds available for sale on a no-load basis directly to the investor, without using a third party advisor. In this case, the direct seller or a related entity will be a registered dealer firm through which the direct seller may sell securities of its mutual funds to investors.[11] Direct sellers typically maintain websites and telephone service centres for their direct investors. Independent direct sellers currently account for 1.2% of mutual fund assets under management.

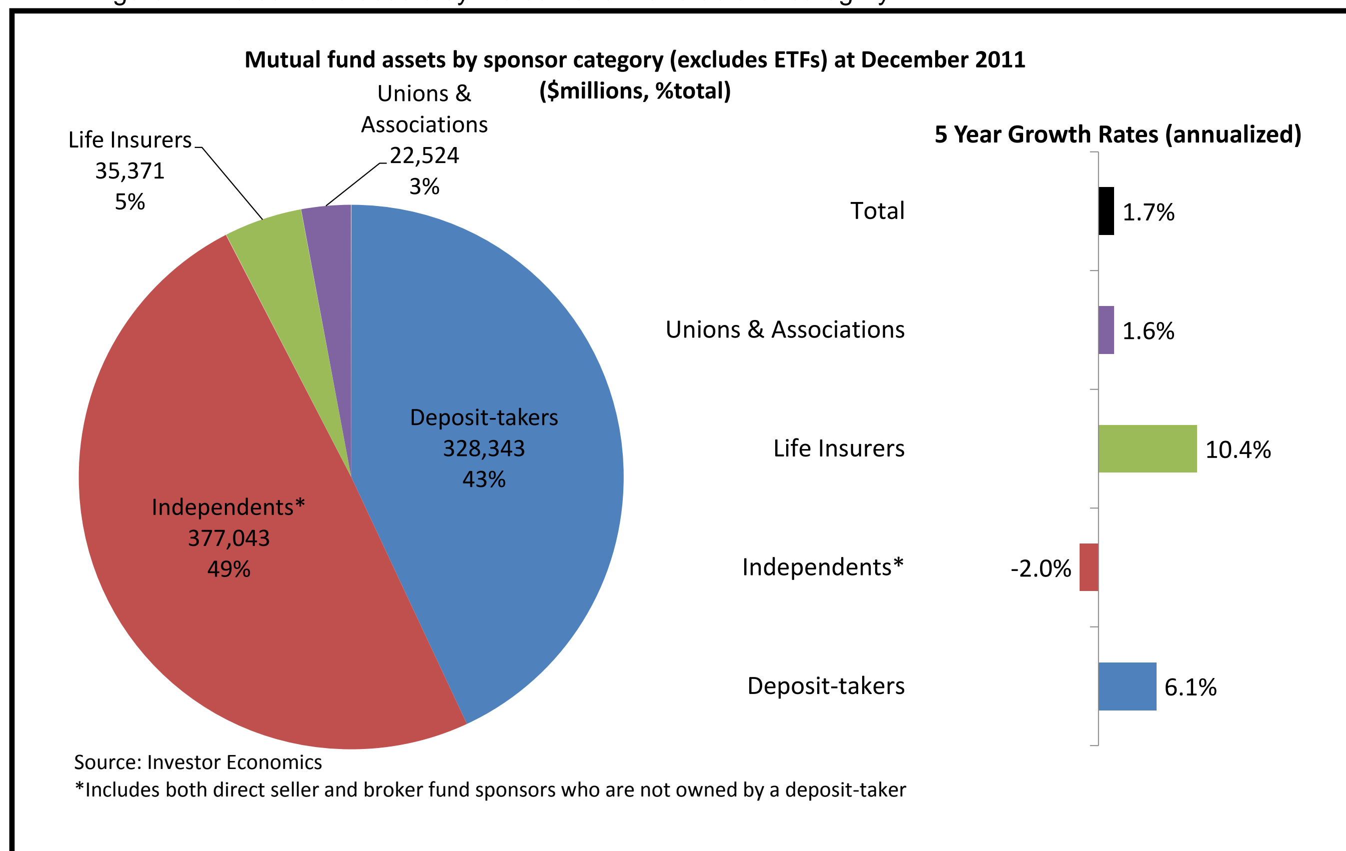
iv. Unions and Associations

The remaining 3% of mutual fund industry assets are managed by unions and associations. Mutual funds produced and promoted by these manufacturers are generally organized for specific target groups (e.g. teachers, physicians) and generally only members of those groups can buy them. These mutual funds are typically sold on a no-load basis and often, are managed and priced on a cost recovery basis.

Figure 1 illustrates the share of Canadian mutual fund assets under management that each mutual fund manufacturer category currently holds, along with the categories' growth rates over the last 5 years.

[11] In many cases however, mutual funds of direct sellers may be sold through other distribution channels as well, including the discount brokerage and full service brokerage channels, where loads or other fees may be applicable.

Figure 1: Mutual fund assets by mutual fund manufacturer category



2. The advisors[12]

The number of dealer firms involved in the distribution of investment funds includes 10 deposit-takers, 825 credit unions, 305 insurance distributors and hundreds of independent fund dealers and full service brokerages.[13] These firms employ tens of thousands of individual advisors, who must each satisfy prescribed registration requirements in order to deal in mutual fund securities.[14]

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[12] All data in this section refers to investment funds of which mutual funds make up the largest subset of assets under administration. See note 1.

[13] Investor Economics, *Retail Brokerage and Distribution Advisor Service*, Spring 2012.

[14] Anyone who deals in mutual fund securities must be registered with Canadian securities regulators in an appropriate category of registration or be exempted from registration. Most often, they will be registered as dealing representatives of firms registered in the "mutual fund dealer" or "investment dealer" categories under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103). In addition, under NI 31-103, all investment dealer firms must be members of the Investment Industry Regulatory Organization of Canada (IIROC) and, except in Québec, all mutual fund dealer firms must be members of the Mutual Fund Dealers Association of Canada (MFDA). Under NI 31-103 and the rules of IIROC and the MFDA, all dealing representatives are subject to business conduct requirements, including know-your-client and suitability requirements. Unless they are registered as an advising representative of a firm registered in the "adviser" category, the advice they may provide to clients is limited to suitability advice that is incidental to their dealing activities.

The types of products the advisor may sell and the scope of the services that advisor may provide, can vary widely across the various distribution channels. Some advisors may be registered to sell only mutual funds, while others may be registered to sell a broader range of securities. Some advisors may also be licensed to sell other financial products whose distribution is generally not regulated by the Canadian securities regulators. These include term deposits, life insurance and segregated funds, among others.[15] In addition, some advisors may hold certain designations[16] qualifying them to provide a range of financial services, including financial planning and estate planning.

Distribution channels:

i. Branch direct

This distribution channel is made up of front line advisors at bank branches who are available to 'walk-in' clients. Generally, these advisors only sell mutual funds and traditional deposit products as demand arises. As a result, their services are primarily transaction focused. The dealer firms in this channel are registered as mutual fund dealers with the provincial securities regulators.

ii. Branch advice

This distribution channel is made up of bank branch advisors who are actively engaged in providing investment recommendations and financial planning to the bank's clients. These advisors typically sell proprietary mutual funds and deposit products. However, in some cases, they may also sell other types of financial products and non-proprietary investment funds. The dealer firms in this channel are generally registered as mutual fund dealers with the provincial securities regulators, although some may be registered as investment dealers.

iii. Online/discount broker

This distribution channel serves the do-it-yourself (DIY) investor with a full shelf of securities products that includes equity and fixed income securities, options, exchange-traded funds (ETFs) and mutual funds. Advisors in this channel are primarily order-takers and generally do not offer investment recommendations or advice. Products in this channel are delivered largely through centrally managed technology platforms and call centres. The dealer firms in this channel are registered as investment dealers with the provincial securities regulators.

iv. Direct to public

[15] The Autorité des marchés financiers and the Financial and Consumer Affairs Authority of Saskatchewan regulate the distribution of certain of those financial products in their respective jurisdictions.
[16] These designations are earned through programs that are administered by various financial industry organizations or associations.

This distribution channel is made up of mutual fund manufacturers that sell investment funds directly to the investor.[17] In this case, the mutual fund manufacturer or a related entity will itself be registered as a mutual fund dealer with the provincial securities regulators. The services the advisor provides in this channel are primarily transaction focused.

v. Financial advisors

This distribution channel serves investors looking for a more comprehensive range of investment services. It administers the largest share of investment fund assets.[18] It includes a wide range of dealer firms with varying degrees of independence and variety in their product shelves. Advisors in this channel typically offer their clients mutual funds and deposit products, as well as segregated funds and life insurance.[19] The dealer firms in this channel are registered as mutual fund dealers with the provincial securities regulators, although some are registered as investment dealers.

vi. Full-service brokers

Like financial advisors, full-service brokers tend to serve investors looking for the full range of investment services. They may also provide discretionary investment management.[20] This channel administers the second largest share of investment fund assets.[21] Advisors in this channel typically offer the full shelf of financial products including equity and fixed income securities, options, ETFs, mutual funds, segregated funds and life insurance.[22] The dealer firms in this channel are registered as investment dealers with the provincial securities regulators.

vii. Private Investment Counsel

The Private Investment Counsel channel typically serves high net worth individuals and institutions. Investment funds make up a very small part of the offerings in this channel because the focus tends to be on separately managed accounts and estate management. The firms in this channel are generally registered as portfolio managers with the provincial securities regulators.

Figure 2 shows each distribution channel's share of investment fund assets under administration along with the channels' growth rates over the last five years. Figure 3 highlights the predominant services and the core financial products typically offered to clients in each distribution channel.

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[17] Note that while the constituents of the *direct to public* group would be the same as those included in the *direct to client* group in Figure 7 set out in Part IV of this paper under "**2. Evolution of fund fees in Canada –** *a. Sales charges trends*", the assets under administration cited here are lower than the assets under management cited there. This is due to the fact that some of the assets sold by mutual fund manufacturers in the *direct to client* group will be sold through fee-based accounts and discount brokerages as well as being sold directly to the investor.
[18] See Figure 2. Source: Investor Economics.
[19] If dually licensed.
[20] An advisor in this channel may provide discretionary account management if its firm is a member of IIROC and the advising activities are conducted in accordance with the rules of IIROC.
[21] See Figure 2. Source: Investor Economics.
[22] If dually licensed.

Figure 2: Retail investment fund assets under administration by distribution channel

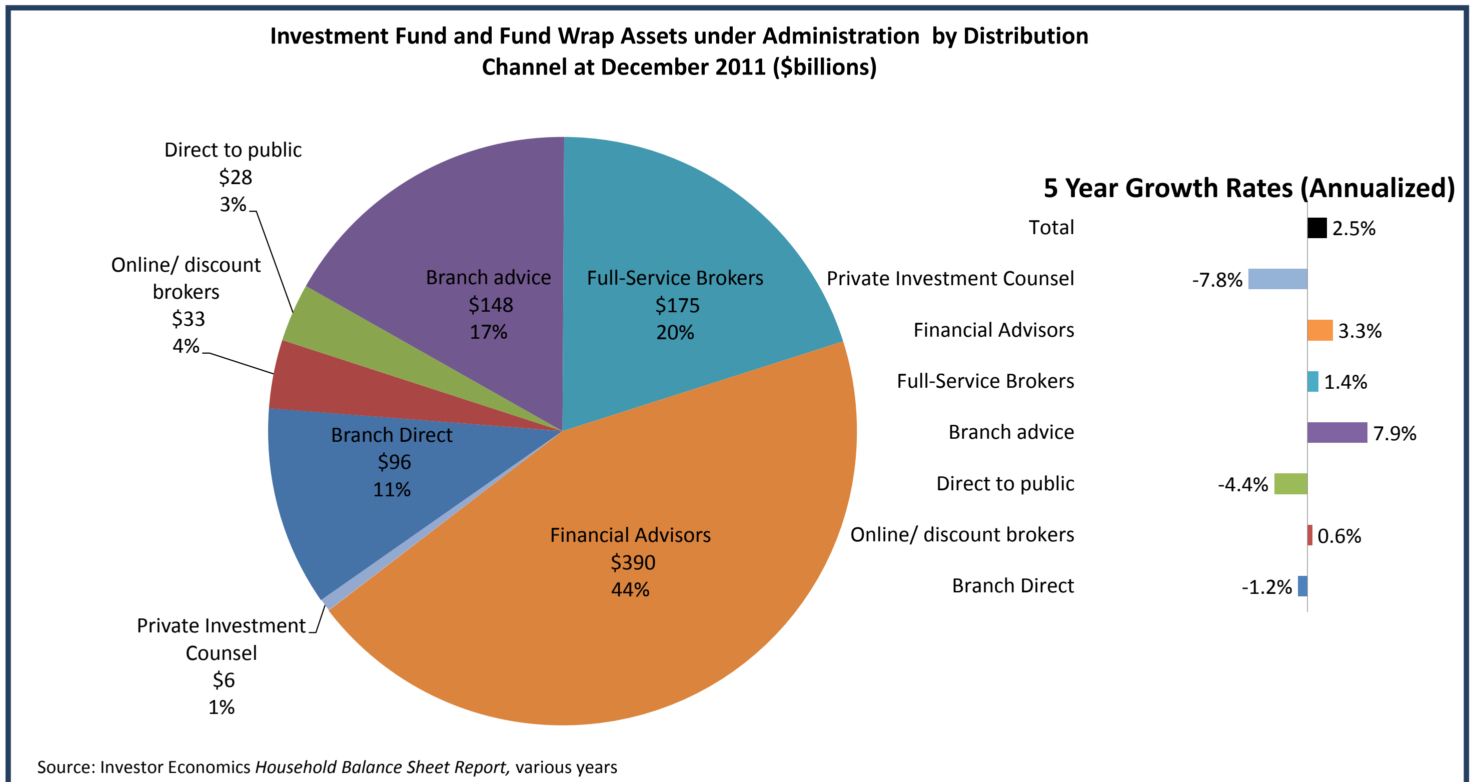

Figure 3: Services and core products per distribution channel

Distribution channel	Services	Core product shelf
Branch direct	Transaction-based services	Mutual funds Deposits
Branch advice	Investment recommendations Financial planning	Mutual funds Deposits
Online/discount brokerage	Order taking only	Equity and fixed income securities Mutual funds ETFs Deposits Options/Futures
Direct to public	Transaction-based services	Mutual Funds
Financial advisor	Investment recommendations Financial planning Insurance and estate planning	Mutual funds Segregated funds Life insurance Deposits
Full-service brokerage	Investment recommendations Discretionary investment management Financial Planning Insurance and estate planning Holistic wealth management	Equity and fixed income securities Mutual funds ETFs Life insurance Segregated Funds Deposits Options/Futures

Private Investment Counsel	Discretionary investment management Private wealth management	Separately managed accounts Pooled funds

IV. MUTUAL FUND FEE STRUCTURE IN CANADA

Mutual fund investors in Canada incur primarily two kinds of fund fees when investing in mutual funds: sales charges and ongoing fund fees.

Sales charges are transaction-based fees paid directly by investors either at the time they buy the fund or at the time they exit or redeem from the fund.

Ongoing fund fees, which include management fees (in which are embedded trailing commissions paid to advisors) and fund expenses, are paid from fund assets. This means that investors pay these fees indirectly.

1. Current mutual fund fees

a. Sales charges

Most Canadian mutual fund manufacturers sell funds under several different purchase options. The options relate generally to the method in which the sales charges are paid. The mutual fund manufacturers set the rate of sales charges that may be payable under the various purchase options.[23]

The different purchase options are:

i. Front-end sales charge

Under this option, investors pay a sales commission directly to the advisor at the time they buy securities of the mutual fund. This is often referred to as a "front-end load". The advisor's sales commission is deducted from the total amount paid by the investor, which means only the remaining amount is invested in the fund.

While the sales commission set by the mutual fund manufacturer may be up to 5% of the purchase amount, investors may typically negotiate a lower sales commission with their advisor. Over the last few years, we understand that Canadian advisors have increasingly been waiving

[23] The purchase options available for a mutual fund, along with the sales charge applicable under each option and the compensation the advisor may receive under each option, must be disclosed in the mutual fund simplified prospectus and the Fund Facts document required under National Instrument 81-101 *Mutual Fund Prospectus Disclosure*. Disclosure of the advisor's compensation in these documents must include disclosure of the trailing commission rate applicable to a mutual fund. We discuss trailing commissions paid to advisors later in this Part under "**b. Ongoing fund fees**".

the front-end sales charge altogether or charging 1% or less.[24] This is further discussed below under "**2. Evolution of fund fees in Canada**".

At the end of 2011, front-end load mutual fund assets accounted for approximately 23% of the Canadian mutual fund industry's asset base.[25]

ii. Deferred sales charge (DSC)

Under this option, investors pay a sales charge at the time they redeem from the mutual fund, rather than at the time of purchase. This is often called a "back-end load". This allows the entire amount paid by the investor to be invested in the mutual fund at the time of purchase.

The rate of the DSC payable by investors when they redeem declines the longer they hold the investment and becomes nil after a specified holding period. This is known as the "redemption schedule". The DSC paid by an investor is typically around 6% in the first year, declining by about 1% each year down to 0% after holding for 5 to 7 years. Mutual fund manufacturers generally offer investors the opportunity to redeem up to 10% (non-cumulative) of their DSC securities annually at no charge.

Depending on the mutual fund manufacturer's DSC policy, the amount of the DSC an investor pays on a redemption can be based either on the original purchase price of the mutual fund securities or their current market value when they are redeemed.

Investors can avoid DSCs by holding their mutual investment until the end of the redemption schedule or redeeming no more than 10% of their DSC securities annually. Mutual fund manufacturers also often permit investors to switch from one mutual fund to another within the same fund family without a charge.[26]

While the investor does not directly pay a sales commission to the advisor at the time of purchase, the advisor typically receives a commission from the mutual fund manufacturer equivalent to 5% of the amount purchased. The mutual fund manufacturer will generally borrow the money necessary to pay these advisor commissions and therefore will incur financing costs. These costs are recouped by the mutual fund manufacturer through ongoing management fees charged to the fund. See the discussion of management fees below under "**b. Ongoing fund fees**".

DSCs paid by investors who redeem before the end of the redemption schedule are not paid to the advisor or the mutual fund, but rather to the mutual fund manufacturer or third party financing services provider that paid the advisor's sales commission at the time of purchase.

[24] See note 54.

[25] Investor Economics, *Investor Economics Insight Monthly Update* (March 2012) at p.3.

[26] Usually, DSCs are only incurred if the investor leaves the 'fund family', not the fund. For example, a switch from mutual fund A to mutual fund B, both offered by the same fund manufacturer typically will not be considered a redemption triggering the application of the DSC. It may however be considered a disposition for tax purposes.

At the end of 2011, DSC mutual fund assets accounted for approximately 19% of the Canadian mutual fund industry's asset base.[27]

iii. Low-load sales charge

Many mutual fund manufacturers offer a low-load sales charge option, which works like the DSC option described above, but on a shorter redemption schedule, typically three years or less.[28] The rate of the DSC ranges from 2% to 3% in year one, declining by 1% each year, down to 0% after a holding period of 2 or 3 years. The commission paid by a mutual fund manufacturer to the advisor at the time the investor purchases securities of a fund on a low-load basis typically ranges from 2% to 3% of the purchase amount.

At the end of 2011, low-load mutual fund assets accounted for approximately 5% of the Canadian mutual fund industry's asset base.[29]

iv. No-load

Funds sold on a no-load basis do not offer any sales commission to advisors (either one paid by the investor or the mutual fund manufacturer), nor do they charge a fee at the time the investor redeems.

Mutual funds purchased on a no-load basis in Canada are generally bought directly from the mutual fund manufacturer or an affiliate, either of which must be a registered dealer firm.

No-load mutual funds are offered by:

- direct sellers[30]
- Canadian banks/deposit takers[31], and
- certain special no-load mutual fund series offered exclusively through online discount brokerages/e-banking platforms.[32]

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[27] Investor Economics, *supra* note 25.

[28] The low-load sales charge option in Canada varies more widely among mutual fund manufacturers who offer it than does the traditional DSC option. The length of the redemption schedule, the upfront commission paid to the advisor by the mutual fund manufacturer, the sales charges payable by the investor at any point along the redemption schedule, and the trailing commissions payable to advisors can be very different between manufacturers.

[29] Investor Economics, *supra* note 25.

[30] See description of 'direct sellers' in Part III above under "**1. The mutual fund manufacturers –** *iii. Independents*". In addition to those direct sellers that are independent, there is currently one direct seller that is owned by a Canadian bank. Mutual fund assets of direct sellers made up 4% of the total 31% of no-load mutual fund assets as at the end of 2011. See 'Direct-to-client' category in Figure 4.

[31] See Part III under "**1. The mutual fund manufacturers –** *i. Canadian banks/deposit takers*". Mutual fund assets of the Canadian bank no-load funds made up approximately 27% of the total 31% of no-load mutual fund assets as at the end of 2011. See 'Retail no-load' category in Figure 4.

[32] Such online discount offerings typically use the D or E series designation and are currently available on select mutual funds offered by a few of the Canadian banks through their online/discount brokerage or e-banking platforms. Mutual fund assets of these series made up 0.3% of the total 31% of no-load mutual fund assets as at the end of 2011. See 'Discount/E-banking category in Figure 4.

No-load mutual funds accounted for approximately 31% of the Canadian mutual fund industry's asset base as at the end of 2011.[33]

v. Fee-based

Some mutual fund manufacturers also offer a series of mutual fund securities, typically known as "Series F", intended for purchase through fee-based accounts with advisors. Investors who select this option do not pay a sales charge to buy into or exit the mutual fund. In addition, they pay reduced ongoing management fees because there are no embedded trailing commissions. (See our discussion of management fees and trailing commissions below under "**b. Ongoing fund fees**".)

Instead of sales commissions and embedded trailing commissions, the advisor's compensation consists of a fee paid directly by the investor for the services rendered in connection with the account. This fee is typically calculated as a percentage of the investor's assets under administration in the fee-based account.

At the end of 2011, fee-based mutual fund assets accounted for approximately 2.6% of the Canadian mutual fund industry's asset base.[34]

vi. High Net Worth/Institutional

Many mutual fund manufacturers also offer series of mutual fund securities specifically intended for purchase by high net worth or institutional investors. These series are generally not sold through traditional retail distribution channels. Minimum account size is usually much larger than for the average retail account, tending to start at $100,000, with minimums for some mutual funds as high as $1 million or more.

Eligible investors who purchase under this option typically pay no or reduced sales charges to buy into the mutual fund. Buying under this option is typically possible only if the investor enters into a series account agreement directly with the mutual fund manufacturer, which specifies the fees applicable to the account. Investors buying under this option typically negotiate their own management fee (described below under "**b. Ongoing fund fees**") as well as an advisory fee[35] that they pay directly to the mutual fund manufacturer.

Overall fund ownership costs for these series are much lower than for the retail mutual fund, largely due to the economies of scale that their sizeable minimum investments provide, as well as the greater bargaining power that their more sophisticated investors and larger investments often command.

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[33] No-load assets data supplied by Investor Economics and obtained by them through various surveys.

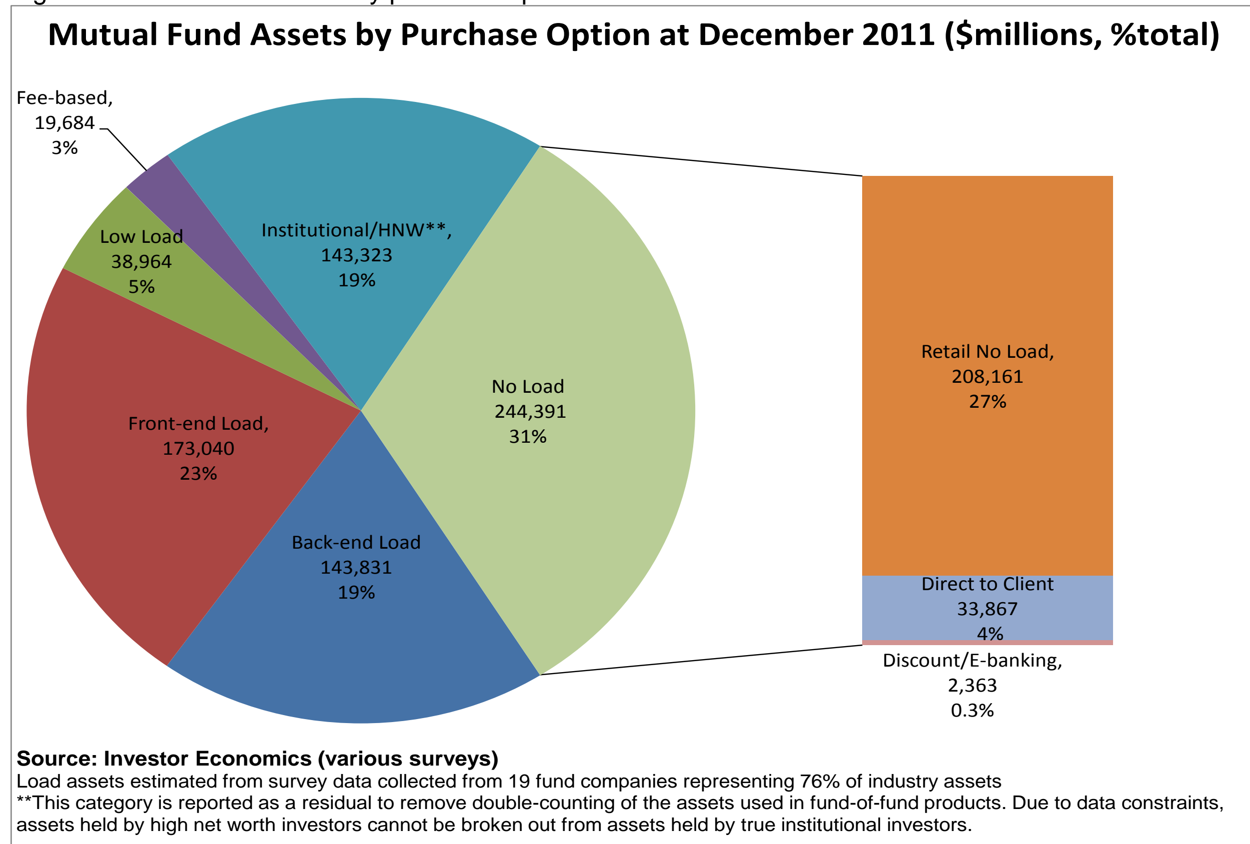
[34] Investor Economics, *Investor Economics Insight Monthly Update* (March 2012) at pages 11-12.

[35] This is a distinct fee for investment advisory services. Accordingly, trailing commissions (discussed below under "**b. Ongoing fund fees**"), are not paid to advisors under this option.

As at the end of 2011, high net worth/institutional mutual fund assets accounted for approximately 19% of the Canadian mutual fund industry's asset base.[36]

Figure 4 shows the respective share of Canadian mutual fund assets under management by purchase option as at December 2011.

Figure 4: Mutual fund assets by purchase option at December 2011



b. Ongoing fund fees

In Canada, mutual funds pay ongoing fees and expenses that are intended to cover the costs of their operation and distribution. These ongoing costs are paid from fund assets and as a consequence reduce investors' net returns. When mutual funds disclose their fund performance, the performance information is net of these ongoing fees and expenses.

A mutual fund's management expense ratio or MER tells investors the costs of operating and distributing a mutual fund. The MER is the total of a mutual fund's annual operating costs

[36] High net worth/institutional assets data supplied by Investor Economics and adjusted to remove double counting from fund-of-fund investments in stand-alone funds.

(except brokerage commission paid by the fund for buying and selling securities the fund owns),[37] expressed as a percentage of the fund's average assets for that year.

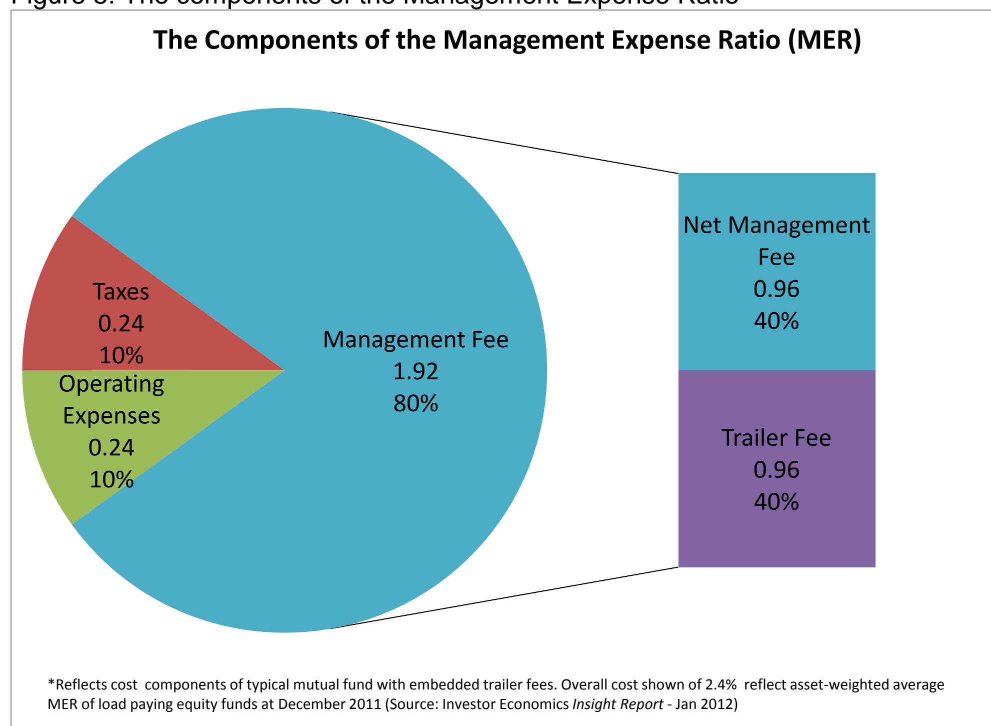
In Canada, the MER is made up of two major components:

i. management fees, and
ii. operating expenses.

Taxes, such as the Goods and Services Tax (GST) and the Harmonized Sales Tax (HST), apply to those components and consequently factor into the overall MER.

Figure 5 shows the two components of the MER and the extent to which each of them typically factors into the MER. It also shows the effect that taxes on those components have on the MER.

Figure 5: The components of the Management Expense Ratio



i. Management fees

In Canada, mutual fund manufacturers charge a management fee to each of their funds, typically to cover the following services or costs:

[37] In order to determine the total operating costs of a mutual fund, the trading expense ratio (TER) must be added to the MER. The TER represents total commissions and other portfolio transaction costs expressed as a percentage of the fund's average net assets for the year. Based on data from Investor Economics, the average TER for long-term mutual funds (Series A) was 0.14 as at December 2011. The TER and MER of a mutual fund are disclosed in the annual and interim management reports of fund performance required under National Instrument 81-106 *Investment Fund Continuous Disclosure* and in the mutual fund's Fund Facts disclosure document required under National Instrument 81-101 *Mutual Fund Prospectus Disclosure*.

- administration of fund operations;
- portfolio advisory services;
- marketing and promotion;
- financing costs of commissions paid to advisors for mutual fund securities sold on a DSC/low-load sales charge basis;
- trailing commissions (discussed further below under "*Trailing commissions*") paid to advisors.

Management fees are charged and calculated as a percentage of the net assets of a mutual fund. They are subject to the GST and HST in certain jurisdictions of Canada.[38]

The typical management fee rate varies depending on:

i. the type of mutual fund (i.e. money market, fixed income, balanced, equity)
ii. the portfolio management strategy utilized for the fund (i.e. passive vs. active management) [39] and
iii. the fund's distribution costs (i.e. the trailing commission payable to the advisors who distribute the fund).

For example, for an actively managed mutual fund distributed through a commission-based advisor (as opposed to fee-based), the median management fee rate may range from 1.00% a year for a money market fund to 2.00% a year for an equity fund.[40] Figure 6 sets out the typical management fee charged per type of mutual fund.

Figure 6: Typical management fee per mutual fund type

Typical Management Fee (with Embedded Trailers)		
Type	Median	Asset-Weighted Average
Money Market	1.00	0.89
Fixed Income	1.50	1.38
Balanced	1.95	1.82
Equity	2.00	1.91

Source: Morningstar Direct at August 14, 2012

In addition to the management fee, some mutual funds may pay incentive or performance fees.[41]

[38] Most mutual funds are sold nationally, however the GST/HST rate that applies is based on the residency of the investor. To deal with this issue, the majority of mutual fund manufacturers have opted to use a "blended rate" approach (one overall 'residency weighted' tax rate applied to all fund assets) to applying these taxes to the fund, although a small minority of mutual fund manufacturers have chosen to offer a separate series for non-harmonized and harmonized provinces.

[39] Passively managed funds, such as index funds (i.e. mutual funds that aim to track the performance of a market index by mirroring the components of that index in their portfolio) are typically less costly to manage because they involve less research and less trading. They consequently tend to have lower management fees than actively managed funds who strive to outperform specific benchmarks.

[40] Source: Morningstar Direct at August 14, 2012. Funds with minimum investments above $10,000 have been excluded from the sample.

[41] These fees, where applicable, are paid as an incentive to the mutual fund manufacturer, the amount of which depends on the performance of the mutual fund, relative to a benchmark or index. A mutual fund manufacturer may

- Trailing commissions

A significant portion of the management fees earned by most Canadian mutual fund manufacturers on the mutual funds they manage is used to pay an ongoing commission to dealer firms. This payment was originally intended to compensate dealer firms for the ongoing services their advisors provide to investors after the mutual fund purchase, including investment advice. This is generally referred to as the "trailer fee" or "trailing commission".

The impact of this is that trailing commissions in Canada are generally embedded in the management fee charged by the mutual fund manufacturer rather than a separate fee charged to the mutual fund.[42]

As illustrated in Figure 5 above, trailing commissions make up about half of the management fees charged to a mutual fund. For example, out of a management fee of 2.00%, half of that amount or 1.00% of average net assets of the mutual fund is generally allocated by the mutual fund manufacturer to the payment of trailing commissions to dealer firms and their advisors.[43] Mutual fund manufacturers must disclose to the public the portion of earned management fees that was allocated to the payment of trailing commissions.[44]

Trailing commissions are usually paid by mutual fund manufacturers to dealer firms quarterly for as long as their clients hold investments in the manufacturers' mutual funds. Each dealer firm then pays out a portion of those trailing commissions to its advisors according to the firm's own compensation grid. Generally, under this compensation grid, the more commission or fee revenue the advisor generates for the firm, the greater the portion of that revenue the advisor gets to keep.[45]

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charge an incentive fee to a mutual fund provided that fee is calculated in accordance with the requirements of Part 7 of National Instrument 81-102 *Mutual Funds* and the method of calculation of the incentive fee and details of the composition of the benchmark or index are described in the prospectus of the mutual fund.

[42] This is different than in the U.S. where trailing commissions, known there as "12b-1 fees", are charged as a separate fee to the mutual fund, and are therefore a distinct component of the MER.

[43] In *Investor Economics Insight Monthly Update* (March 2012), Investor Economics states at p. 14 that "*[t]oday advisor compensation typically represents more than one-half of the management fees collected by load funds.*" See also article by Rob Carrick, *Shedding light on a hidden mutual fund fee*, Globe and Mail (June 29, 2012) at http://m.theglobeandmail.com/globe-investor/personal-finance/shedding-light-on-a-hidden-mutual-fund-fee/article4382237/?service=mobile.

[44] A mutual fund investor may determine the portion of management fees that a mutual fund manufacturer allocates to the payment of trailing commissions by reviewing the mutual fund's simplified prospectus and its management report of fund performance. A mutual fund must disclose in its simplified prospectus required under National Instrument 81-101 *Mutual Fund Prospectus Disclosure* the approximate percentage of management fees paid by mutual funds in the same family as the mutual fund that were used to fund commissions to advisors in the most recently completed financial year of the manager of the mutual fund. Similarly, in its management report of fund performance required under National Instrument 81-106 *Investment Fund Continuous Disclosure*, the mutual fund must provide a breakdown of the major services paid for out of the management fees, including trailing commissions and sales commissions, as a percentage of management fees.

[45] See note 98 and related discussion in Part V under "**2. Potential conflicts of interests at the mutual fund manufacturer and advisor levels** – *ii. Advisor*".

The amount of the trailing commission payment is determined by applying the specified trailing commission rate to the value of a fund investment held by the advisor's clients at the calculation date. The mutual fund manufacturer sets the trailing commission rate applicable to each of its mutual funds and must disclose the rate in the mutual fund's simplified prospectus and Fund Facts[46] document in accordance with National Instrument 81-101 *Mutual Fund Prospectus Disclosure*.

The trailing commission rate typically varies depending on:

i. the type of mutual fund (i.e. money market, fixed income, balanced, equity) and
ii. the purchase option under which the fund investment is made.

For example, the trailing commission rate typically ranges from 0.25% a year for a money market fund, to as much as 1.50% a year for an equity fund sold under a front-end sales charge.[47] The trailing commission rate on mutual funds sold under a front-end sales charge is generally double that paid to advisors for mutual funds sold under the DSC option.[48]

Even mutual funds sold on a no-load basis pay trailing commissions, which can be as high as 1.50% a year.[49]

ii. Operating expenses

In Canada, each mutual fund pays its own operating expenses, including:

- registrar and transfer agency fees
- safekeeping and custodial fees
- accounting, audit and legal fees
- fund valuation costs
- administration costs and trustee services relating to registered tax plans
- fees and expenses payable in connection with the independent review committee

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[46] The Fund Facts is a summary document that is designed to give investors key information about a mutual fund. We further discuss the Fund Facts, and its ongoing implementation under the CSA Point of Sale project, in Part VII under "**1. Regulatory initiatives in Canada**".

[47] Typically, equity funds sold on a front-end load and no-load basis carry trailing commissions of around 1%, fixed income funds carry trailing commissions of around 0.50%, and money market funds carry trailing commissions of 0.25%. In *Investor Economics Insight Monthly Update* (February 2010) at p.11, Investor Economics reports that in the case of Canadian equity, Canadian balanced and international equity funds, 70%-85% of the funds in those categories pay trailing commissions of 1%. For the Canadian long-term bond category, close to two-thirds of funds carry a trailer of 0.50%. An additional 30% of funds in the long-term bond category pay trailing commissions higher than the standard.

[48] For example, while the trailing commission rate on an equity fund sold under the front-end sales charge option is typically around 1%, the trailing commission rate on that same fund sold under the DSC option will typically be around 0.50%.

[49] The simplified prospectuses of mutual funds offered by some of the Canadian bank-owned mutual fund manufacturers disclose trailing commission rates as high as 1.50% payable on both mutual funds sold on a no-load basis through bank branches and mutual funds sold on a load basis through third party advisors (i.e. the *Advisor* series). One can encounter load paying funds offered for sale by non-bank owned mutual fund manufacturers with trailing commission rates as high as this as well.

- costs of preparing and distributing prospectuses, financial reporting, and other types of investor communications
- regulatory filing fees
- bank and interest charges
- taxes, such as GST/HST, applicable to the operating expenses of the fund.

Operating expense costs are usually allocated to a mutual fund as they are incurred, and can fluctuate from one year to the next. Over the last several years, some mutual fund manufacturers have capped operating expenses with a view to bringing stability and predictability to their mutual funds' expenses and potentially reducing their MERs. They implemented the cap on operating expenses by charging a fixed rate "Administration Fee", calculated as a percentage of net assets of the mutual fund, intended to cover most of the expenses of the mutual fund.[50] The Administration Fee is paid to the mutual fund manufacturer in exchange for the manufacturer bearing the operating expenses of the mutual fund. Any operating expenses incurred by the mutual fund in any one year over and above the amount of the Administration Fee are absorbed by the mutual fund manufacturer.[51] While the fixed rate Administration Fee can bring stability and predictability to the level of a mutual fund's operating expenses, it can also effectively prevent mutual fund expenses from declining as a percentage of assets as the fund grows.

2. Evolution of fund fees in Canada[52]

a. Sales charges trends

Trending away from transaction-based sales commissions

In the early 1980s, advisors selling mutual fund securities were typically compensated by a front-end sales charge, then ranging between 8%-9% of the purchase amount, paid by the investor at the time of the purchase transaction. In the late 1980s, mutual fund manufacturers introduced the DSC option at about the same time they introduced trailing commissions. Both developments rapidly changed the dynamics of the fund industry and how the cost of distribution was funded. When a sale occurred under the DSC option, the mutual fund manufacturer, rather than the investor, paid the advisor a sales commission of generally 5% of the purchase amount at the time of the purchase, followed by an ongoing trailing commission of 0.5% per year based on the value of the investment for as long as the investor held the mutual fund. The mutual fund manufacturer funded the cost of both the sales and trailing commissions it paid on DSC sales from the management fees it earned on mutual fund assets. Consequently, the ongoing cost of trailing commissions was embedded in the management fee charged to a mutual fund.

[50] The Administration Fee often does not cover the fund's independent review committee costs, taxes on fees and expenses paid by the fund, interest charges on borrowing, or certain governmental or regulatory costs.
[51] Where the actual expenses incurred by the fund total less than the Administration Fee, the mutual fund manufacturer keeps the difference.
[52] Information for our overview of the evolution of fund fees in Canada was largely sourced from the following *Investor Economics Insight Monthly Updates*: January 2003, January 2006, February 2010, September 2010 and March 2012.

The DSC option, together with the trailing commission, quickly became the popular alternative to the front-end sales charge option as it offered advisors a similar level of compensation, albeit paid in instalments. It also addressed investors' growing aversion to the front-end sales charge which had the effect of reducing an investor's initial investment in the mutual fund.

Mutual fund manufacturers eventually changed the commission structure of the front-end sales charge option. They decreased the front-end sales charge to a maximum of around 5% of the purchase amount, negotiable between the investor and the advisor, and added an ongoing trailing commission at double the rate paid on mutual funds sold under the DSC option.

Following the market crash of the late 1990s, the DSC option began to fall out of favour with investors, as mutual funds faced unsettled market conditions and a prolonged period of poor performance. The prospect of paying a sales charge to exit a mutual fund at that time became unpalatable to many investors, particularly as no-load funds became more widely available through the Canadian bank branches, thus presenting an attractive option for investors.

In response, the mutual fund industry began offering DSC funds with shortened redemption schedules (typically between two and four years), as a new 'low-load' sales charge option. This purchase option, first introduced by a mutual fund manufacturer in 1999, was quickly adopted by others in the first half of the 2000s. Under this purchase option, the advisor's sales commission (paid by the mutual fund manufacturer at the time of the investor's purchase) was reduced to between 2% and 3%. However, the accompanying trailing commission was typically set at the higher front-end load rate of around 1% per year.[53]

At the same time, the fund management arms of Canadian banks sought to expand their distribution network beyond their own branches and full-service dealers by permitting third party advisors to sell their mutual funds. To interest these third party advisors in their funds, Canadian banks introduced their *Advisor* fund series, a load equivalent of their no-load fund series, that pays sales and trailing commissions to those who sell them.

Investors' increasing avoidance of the cost of sales commissions, together with the Canadian banks' inroads into the third-party distribution channel, put increasing competitive pressure on independent 'load only' mutual fund manufacturers and those selling their funds. This led many advisors to offer a 'quasi no-load' alternative to their clients in the form of a front-end sales charge option where the advisor agreed to waive the sales commission they would normally charge. This option continues to be offered today.[54]

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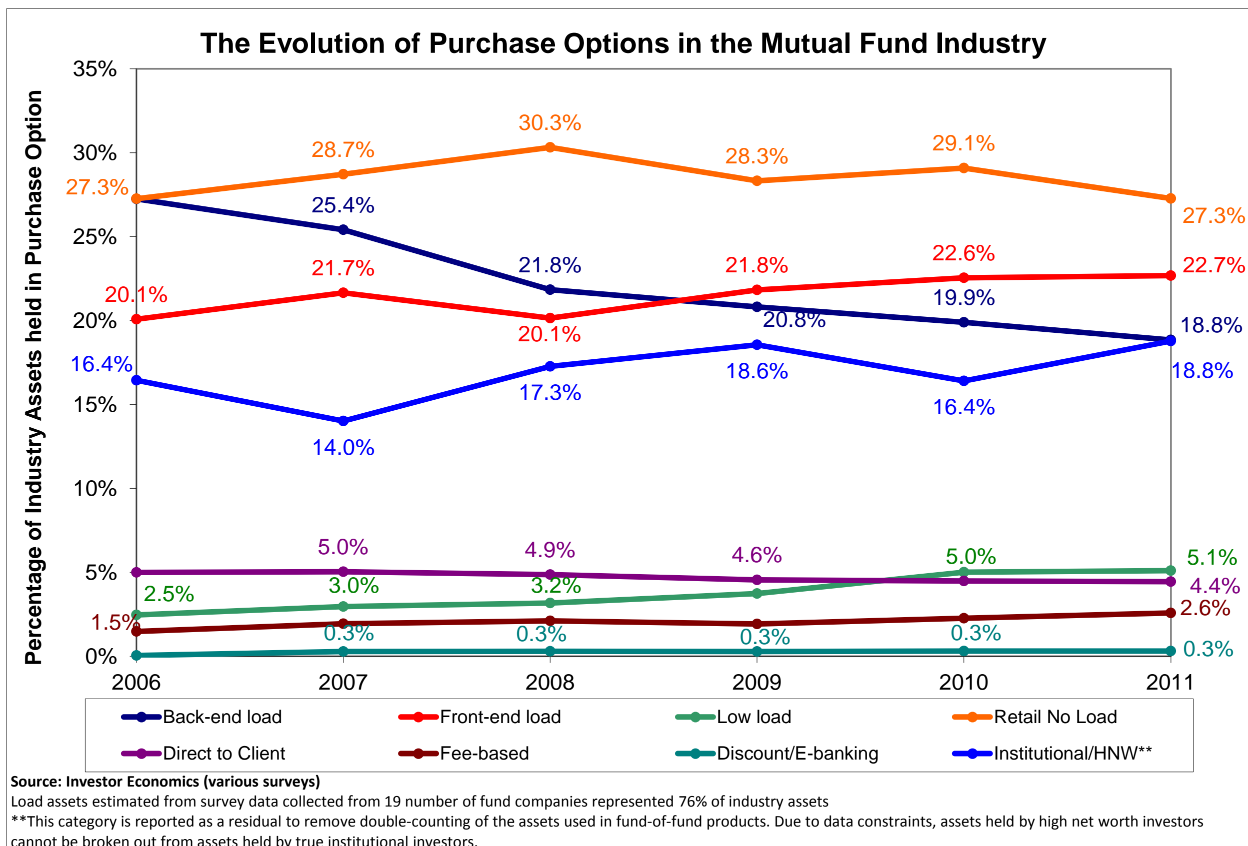
[53] See note 28. The trailing commission rate payable to advisors on mutual funds sold under the low-load sales charge option often varies from one mutual fund manufacturer to another.

[54] See IFIC, *Understanding Management Expense Ratios*, (April 2011), at p.10 where IFIC states: "*typically, 90% or more of the trades made* ***[under the front-end load]*** *purchase option each year incur no front end commission at all (the commission is waived by the advisor).*". Also see *Investor Economics Insight Monthly Update* (March 2012) at p.6 where Investor Economics reports, based on their interviews with a few fund manufacturers and survey data by themselves and by the Investment Funds Institute of Canada, that anything between two-thirds to three-quarters of front-end sales reportedly take place at 0% load. In the remaining cases when an investor is charged an upfront commission, the fee typically falls at 1% or less.

Figure 7 shows the extent to which the use of the various purchase options has changed since 2006. It shows that, since 2006, the mutual fund industry has seen a steady decline in the use of the DSC option and an expansion in the use of both the low-load sales charge and high net worth/institutional purchase options. The front-end sales charge, retail no-load (i.e. bank no-load funds) and DSC purchase options continue to dominate the market however, and together, make up close to 70% of industry assets. Although growth rates in certain years may be high, the use of the fee-based series is still relatively low by market share. Use of the discount/e-banking purchase option is essentially unchanged since 2006, while the direct-to-client purchase option has declined slightly since that time.[55]

Figure 7: The evolution of purchase options in the mutual fund industry



b. Ongoing fund fees trends

i. MERs trending down

[55] The discount/e-banking purchase option and direct-to-client purchase option are subsets of the broader no-load purchase option discussed above under "**1. Current mutual fund fees – a. Sales charges** – *iv. No-load*". Also see Figure 4 for a breakdown of the no-load category in terms of assets under management.

At the end of 2011, the asset-weighted average MER[56] of all Canadian mutual funds was 1.93%.[57]

Figure 8 shows the asset-weighted MER trend since 1990 for long-term mutual funds[58] (both no-load and load paying funds) and the market share for load paying funds over time.[59] The graph also shows the asset-weighted MER trend for load paying and no-load series mutual funds individually.

Figure 8: Trends in MERs 1990-2011 – Long term funds only

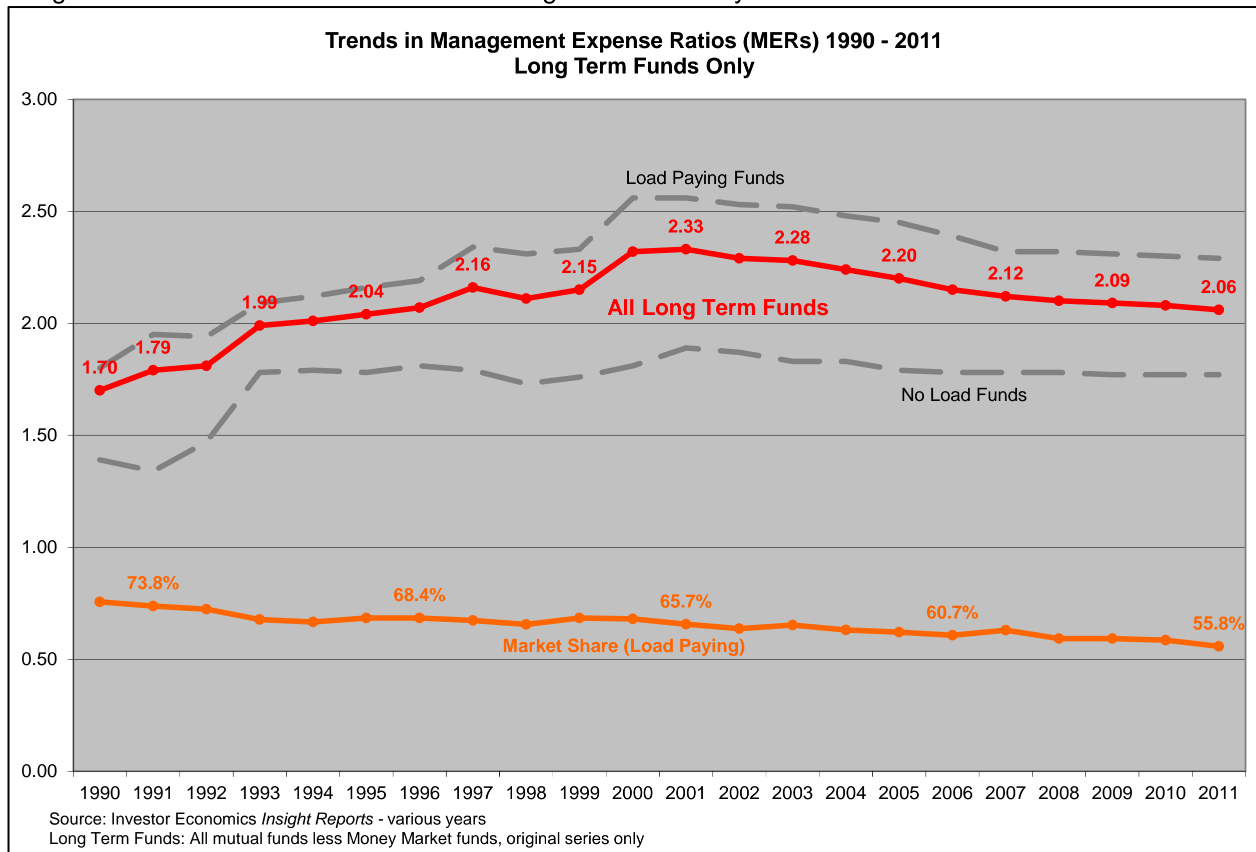


Figure 8 shows that overall MERs for long term mutual funds rose over the period from 1990 to 2001 but have been declining incrementally since 2001 due to a number of factors, which generally include:[60]

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[56] An asset-weighted average MER is calculated by weighting each fund's MER by its market share.
[57] Investor Economics, *Investor Economics Insight 2012 Annual Industry Review* (January 2012) at p. 77.
[58] Long-term mutual funds are all funds less money market funds.
[59] Note that market share here refers to the share of the market for *original series* (i.e. not including fee-based, institutional or other newer series such as T or D series funds). Long term mutual funds are all funds less money market funds.
[60] See Investor Economics, *Investor Economics Insight Monthly Update* (September 2011) for a discussion of factors triggering changes in the level of MERs.

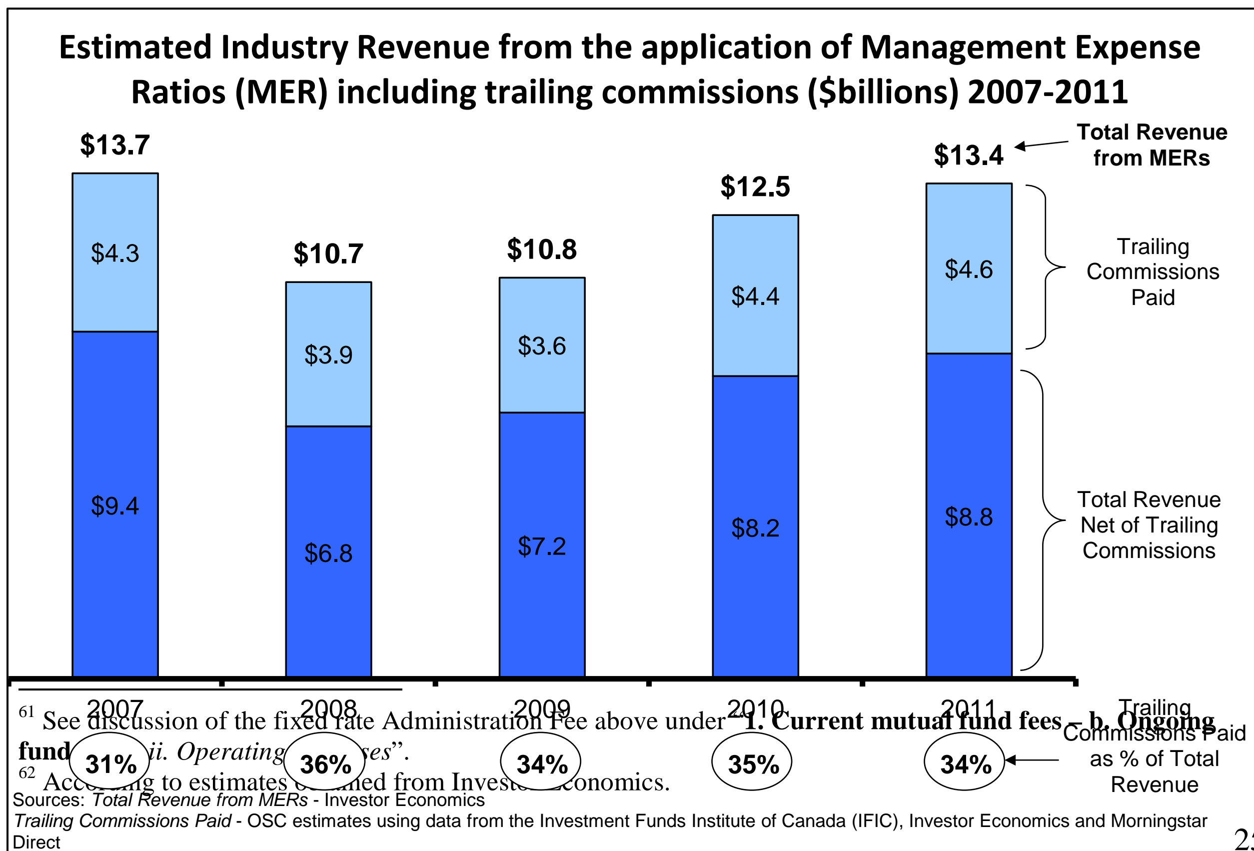
- tax changes (GST decline in 2006 and 2007, but application of HST in 2010 subsequently increased taxes on fund fees);
- changes in asset mix resulting in a lower weighting in higher MER equity funds and a higher weighting in lower MER fixed income funds (particularly after the financial crisis of 2007-2008);
- the popularity of no-load funds, which tend to have lower MERs than load mutual funds, and whose assets account for a substantial portion of mutual fund assets under management (see Figure 4);
- downward adjustments to management fee levels by some mutual fund manufacturers;
- the fixing of expenses on certain mutual funds through the introduction of the fixed rate Administration Fee.[61]

Load paying funds have seen a steeper decline in MERs since 2001 than have no-load funds.

Figure 9 shows the estimated mutual fund industry revenue generated from the application of MERs since 2007. In 2011, MERs generated an estimated $13.4 billion in revenue for mutual fund manufacturers. Over the last five years, MERs generated an estimated $12.2 billion in revenue for mutual fund manufacturers each year on average.[62]

The increase in revenue from MERs since 2009 is largely due to the rebound of the equity markets in 2009, which increased assets under management for the mutual fund industry.

Figure 9: Estimated Mutual Fund Industry Revenue from MERs and Trailing Commissions Paid 2007-2011



[61] See discussion of the fixed rate Administration Fee above under "**1. Current mutual fund fees – b. Ongoing fund** ... *ii. Operating expenses*".

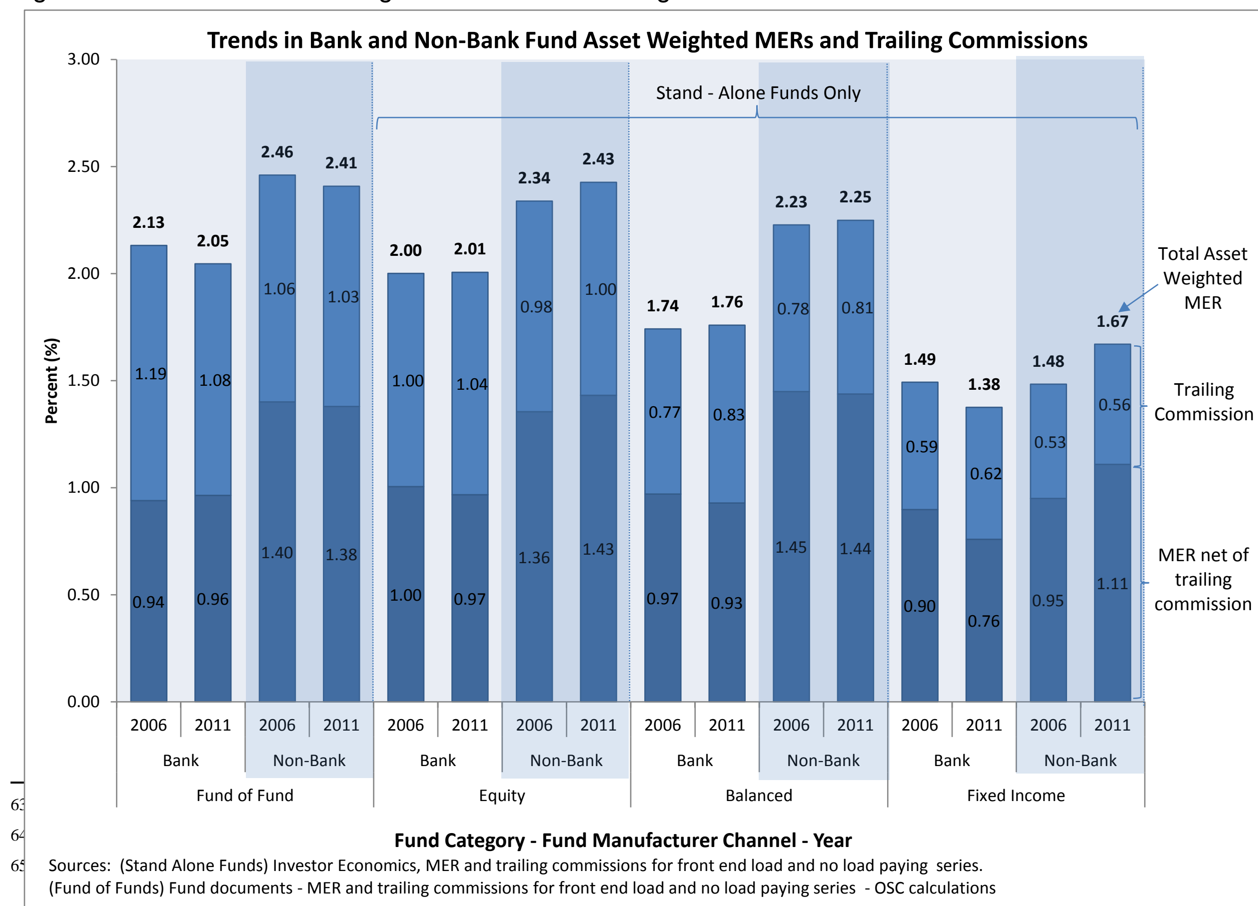
[62] According to estimates obtained from Investor Economics.

ii. Trailing commissions generally remaining steady or increasing

Figure 9 above shows that, in 2011, mutual fund manufacturers paid an estimated $4.6 billion in trailing commissions to advisors and their firms, representing 34% of total revenue from MERs for that year.[63] Over the last five years, trailing commissions paid by mutual fund manufacturers to advisors represented 34% of total revenue from MERs each year on average, thus remaining a relatively constant component of the MER throughout those years.

Figure 10 below shows that, since 2006, trailing commissions for stand-alone mutual funds[64] have risen slightly. The trend appears to be towards higher average trailing commissions for both bank and non-bank mutual funds and across asset classes. For fund-of-fund products[65], there has been a decrease in average trailing commissions; however they remain well above the amounts paid on stand-alone mutual funds. This suggests the payment of a premium to the advisor on the distribution of fund-of-fund products.

Figure 10: Trends in Asset-Weighted MERs and Trailing Commissions



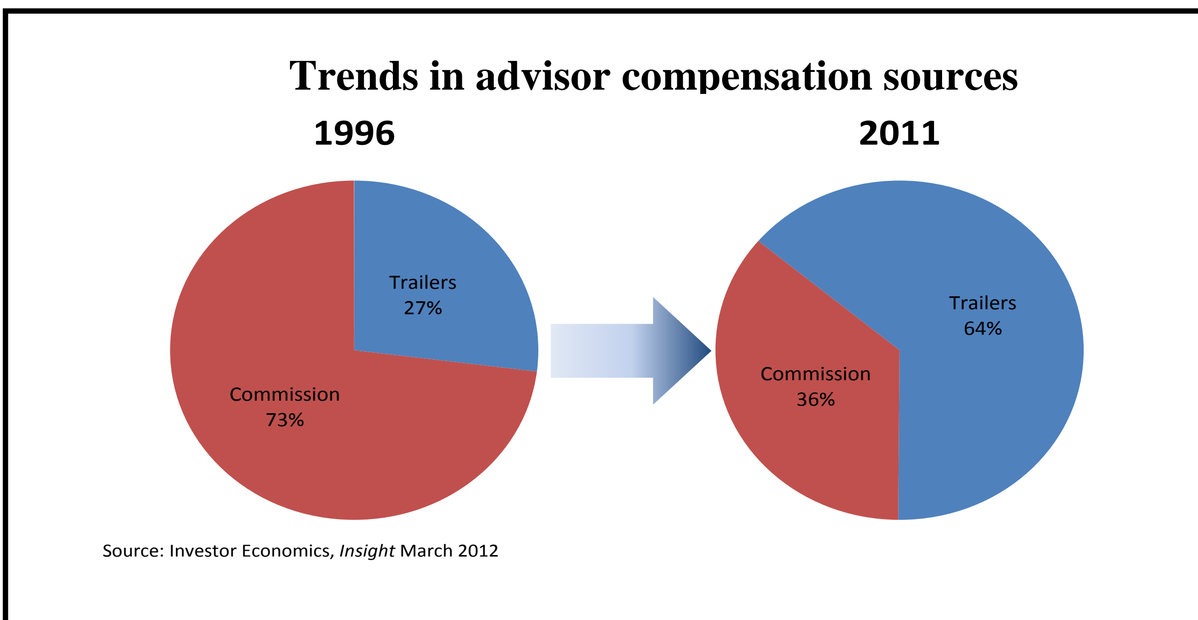
The Canadian banks appear to be paying higher average trailing commissions relative to the non-bank mutual fund manufacturers, retaining less of the management fee and lowering or maintaining average MERs for their mutual funds in all categories with the exception of funds-of-funds where average MERs net of trailing commission have increased slightly.

The non-bank mutual fund manufacturers appear to be increasing average fund MERs in all stand-alone fund categories, increasing average trailing commissions and maintaining or increasing average MERs net of trailing commission. Average fund-of-fund MERs and trailing commissions have fallen, though both remain well above the amounts paid on similarly invested stand-alone funds.[66]

iii. Advisors increasingly relying on trailing commissions as source of revenue

The importance of trailing commissions as a source of revenue for advisors appears to have substantially increased over the years. As shown in Figure 11, in 1996, trailing commissions accounted for slightly more than one quarter of the advisor's book of business. In 2011, their share is 64%.[67]

Figure 11: Share of advisor's compensation coming from sales commissions and trailing commissions in 1996 and 2011



[66] The average asset-weighted MER of funds-of-funds and stand-alone funds categorized as equity funds offered by non-bank mutual fund manufacturers was 2.72% and 2.43% respectively at 2011.
[67] Investor Economics, *Investor Economics Insight Monthly Update* (March 2012), at p. 9.

This trend away from transaction-based sales commissions[68] has resulted in advisors today being compensated largely through trailing commissions in connection with the distribution of mutual funds. An important outcome of this trend is that the majority of retail investors today are 'seeing' less and less of the cost of distribution.

V. CURRENT ISSUES ARISING FROM THE MUTUAL FUND FEE STRUCTURE IN CANADA

1. Investor understanding of fund costs and control of advisor compensation

i. Investor understanding of fund costs

The gradual shift in the Canadian mutual fund market away from transaction-based sales commissions paid directly by investors to a greater reliance by advisors on trailing commissions and sales commissions funded from mutual fund management fees seems to have led many of today's investors to mistakenly believe there is no cost to purchasing or owning a mutual fund. This is despite disclosure in the prospectus, and more recently in the summary disclosure document, Fund Facts, for mutual funds.

A study on performance reporting and cost disclosure prepared for the CSA (the CSA Study) shows that mutual fund investors tend not to review disclosure documents for cost information and instead primarily rely on advisors to tell them about costs.[69] However, further research indicates that many advisors do not tell their clients about costs. In a study on advisor relationships and investor decision-making prepared for the Investor Education Fund[70] (the IEF Study), only 64% of investors indicated that their advisor told them about costs before asking them to buy.[71] In addition, only 45% of investors indicated their advisor told them how much compensation he or she would receive for the investments they made.

A study commissioned by the Investment Funds Institute of Canada similarly reports that only 54% of investors recalled that their advisor discussed his/her compensation when they last

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[68] See note 54.
[69] The Brondesbury Group, *Report: Performance Reporting and Cost Disclosure*, prepared for: Canadian Securities Administrators (September 17, 2010) at p.17. That study found that only 1 out of 6 investors obtain cost information about a mutual fund by reading the prospectus. This level however rises to 1 out of 3 for the more sophisticated investors (with $500K+ under management).
[70] The Investor Education Fund develops and promotes unbiased, independent financial information, programs and tools to help consumers make better financial and investing decisions. It was established as a non-profit organization by the Ontario Securities Commission (OSC) and is funded by settlements and fines from OSC enforcement proceedings.
[71] The Brondesbury Group, *Investor behaviour and beliefs: Advisor relationships and investor decision-making study*, a report prepared for the Investor Education Fund, 2012, at p.16, available at: http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf

purchased a mutual fund.[72] The same study found that only 64% of investors recalled that mutual fund fees such as front-end sales charges and DSCs were discussed.

Consequently, investors have limited understanding of the different kinds of mutual fund costs. The CSA Study found that the fees that investors understand the most appear to be those that are most visible, such as transaction-based commissions and account fees[73], which were understood by two-thirds of investors who participated in the study. Only 4 out of 10 respondents indicated they understood DSCs, and only one-third of respondents indicated they were aware of trailing commissions.[74]

Research also shows that investors have little to no idea of how advisors can get paid. In the IEF Study, only one-third of investors were able to recognize several common compensation arrangements. Furthermore, out of the one-third of respondents who indicated they were aware of trailing commissions, about 4 out of 10 respondents agreed that the amounts of these commissions may vary depending on the type of mutual fund and the mutual fund manufacturer that offers the fund.[75]

To date, advisors have not been required to disclose all forms of compensation they receive from their clients' mutual fund investments.[76] Rather, the rules of the self-regulatory organizations (SROs) that govern the business conduct of advisors only require the advisor to inform the client of any sales or other charges that are to be deducted from the amount of a mutual fund trade prior to the acceptance of any order.[77] Similarly, the confirmation of the trade need only disclose a commission where that commission is charged on, or deducted from, the amount of the trade.[78]

While this requires the advisor to tell mutual fund investors about applicable front-end sales charges on a purchase and DSCs on a redemption, it does not require the advisor to tell mutual fund investors about trailing commissions or sales commissions on DSC/low-load sales paid to them by the mutual fund manufacturer as neither of these are deducted from the amount of the mutual fund trade but rather are paid out of management fees earned on mutual fund assets. The

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[72] POLLARA, *Canadian Investors' Perceptions of Mutual Funds and The Mutual Fund Industry – 2011*, Report Prepared for the Investment Funds Institute of Canada.
[73] These fees would show up on trade confirmations and/or account statements.
[74] *Supra* note 69, at pages 15-16.
[75] *Supra* note 71, at pages 25-27.
[76] Regulatory reforms underway by the CSA under the Client Relationship Model (Phase 2) project discussed in Part VII of this paper propose to require advisors to disclose to a client all compensation they receive in connection with the client's account. Please refer to Part VII for details of that initiative.
[77] See section 2.4.4 of the Mutual Fund Dealers Association (MFDA) Rules. For those advisors who are however governed by the Investment Industry Regulatory Organization of Canada (IIROC), new IIROC Dealer Member Rule 3500.5(2)(g), to be in effect as of March 26, 2013, will require IIROC Dealer Members to provide investors with "a description of all charges the client may incur in making, disposing and holding investments by type of investment product.". In IIROC Rules Notice 12-0108 issued March 26, 2012, IIROC advises that this relationship disclosure should include a discussion of transaction fees/charges a client may incur in the course of acquiring, selling or holding an investment product position, including amounts to be paid indirectly to the Dealer Member by the client. This would include a discussion of the management fees that are deducted from fund performance by the mutual fund manufacturer and the types of fees/charges, such as trailing commissions, that may be paid to the Dealer Member by the mutual fund manufacturer from these collected management fees.
[78] See, for e.g., paragraphs 5.4.3(h) and (i) of the MFDA Rules and IIROC Dealer Member Rule 200.1(h).

limitations in these disclosures contribute to investors' limited awareness and understanding of these mutual fund costs.

It also means that these costs do not figure significantly into investor decision-making. The IEF Study found that the cost of buying is a factor for just 2 out of 10 investors and is almost never a decisive factor. Management fees are treated similarly. Costs deter only 1 out of 6 investors from buying.[79] This suggests that very few investors are aware of the impact costs have on net returns. This may mean that investors are not trying to choose lower-cost mutual funds, which could influence their returns.

ii. Investor control of advisor compensation

The embedded nature of advisor compensation costs limits the ability of mutual fund investors to control or influence these costs. Under current mutual fund rules, a proposed increase in certain discrete fees and expenses charged to a mutual fund, such as a proposed increase in the management fee rate, must be put to a security holder vote.[80] Since trailing commissions are generally embedded in management fees as opposed to charged as a discrete fee to the mutual fund, trailing commission rates can be increased without security holder approval.

At present, mutual fund manufacturers may fund increased trailing commissions to advisors by simply allocating a greater portion of the management fees they earn to the payment of these commissions. While overall fund costs do not increase in this scenario, investors have no say in the extent to which their mutual fund assets are used to pay for advisor compensation.

Currently, the only means a mutual fund investor has to express disapproval with an increase in a mutual fund's trailing commission rate is to exit the mutual fund. However, a redemption could be detrimental to the investor if tax consequences and/or sales charges are triggered under the DSC or low-load option. Faced with these potential costs, an investor may opt to remain invested in the mutual fund.

The potential or perceived benefit of an increase in trailing commissions to the mutual fund manufacturer is the potential to attract increased sales, which in turn would increase assets under management resulting in greater management fees. The potential or perceived benefit to investors of an increase in the trailing commission is less clear. While investors might reasonably expect a commensurate increase in services and advice from their advisor, or some other observable benefit, there is currently no evidence to substantiate that this is what occurs. This lack of a clear benefit to investors gives rise to the conflict of interest issues we discuss below.

2. Potential conflicts of interests at the mutual fund manufacturer and advisor levels

The use of mutual fund assets to pay for trailing commissions may give rise to actual or perceived conflicts of interest at both the mutual fund manufacturer and advisor levels.

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[79] *Supra* note 71, at p. 22.
[80] Section 5.1 of National Instrument 81-102 *Mutual Funds*.

i. Mutual fund manufacturer

The shift towards trailing commissions in Canada as the primary source of advisor compensation for mutual fund sales appears to have given rise to increased pressure on mutual fund manufacturers to attract distribution on the basis of the trailing commissions they pay.[81] As a result, while overall MERs have incrementally trended down over the last several years, the cost of distribution has remained steady or increased during this time.[82] This means that mutual fund manufacturers seem to be using a greater proportion of the management fees they earn to pay for trailing commissions.

Using fund assets to pay for trailing commissions could encourage additional sales of the fund. This could increase the fund's assets under management, which would increase the management fees payable. This creates an actual or a perceived conflict of interest between the mutual fund manufacturer and the fund's investors.[83] This practice could put the mutual fund manufacturer at odds with its statutory duty to act in the best interest of the mutual fund[84] to the extent the mutual fund manufacturer, rather than the fund and its investors, is the primary beneficiary of the fund's asset growth. The mutual fund manufacturer must be able to demonstrate that it is acting in the

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[81] See G. Stromberg, *Regulatory Strategies for the Mid-'90s, Recommendations For Regulating Investment Funds in Canada*, January 1995, at p. 16, where Stromberg states: "*The comment has been consistently made that virtually all aspects of the investment fund industry are being driven today by distribution and the competition for distribution. This is not an overstatement. Independent investment fund organizations that do not have their own sales force must secure distribution channels in order to build the critical mass of assets under administration that is required to make their operations viable and profitable. This has resulted in intense competition by independent investment fund organizations for "shelf space" with distributors and in the costs of securing this distribution continually increasing.*";
See also *Investor Economics Insight Monthly Update* (March 2012) at page 13 where Investor Economics states: "*Not only are trailers a relatively unaffected ingredient of the advisor fund compensation formula, some companies are recognizing their growing importance and strategically pushing the envelope on the trailer levels.*". Also see their discussion of "Compelling Compensation" on pages 13 and 14. In addition to this commentary, we have seen examples where advertisements by mutual fund manufacturers targeting advisors present no quantitative information about a mutual fund product other than the trailing commission payable to the advisor – see *Investment Executive* (July 2012) at p. B2 and *Investment Executive* (November 2012) at p.32 for examples.

[82] See the data we present in Part IV of this paper under "**2. Evolution of fund fees in Canada – b. Ongoing fund fees trends**". Also see *Investor Economics Insight Monthly Update* (March 2012) at p. 14, *Investor Economics Insight Monthly Update* (February 2010) at p. 9, and *Investor Economics Insight Monthly Update* (September 2011) at p. 5. At p.16 of the September 2011 Update, Investor Economics states: "*The final frontier for upcoming changes in MERs in the future lies in the cost of distribution. While MER levels have trended down, changes in the past several years can be characterized as incremental rather than sweeping. The embedded cost of distribution remains a key obstacle to a significant reduction in the MER levels.*"

[83] G. Stromberg, *supra* note 81, at pages 16-17, comments on this conflict of interest as follows: *"A result of this perspective is that independent investment fund organizations have increasingly become marketing companies, more focussed on gaining market share than on being investment management companies focussed on managing investment funds for the benefit of the investors in these funds. The major concern that arises from the focus on marketing considerations is whether marketing considerations are prevailing over investment management decisions and resulting in conflicts of interest between the fund manager and the fund investors."*

[84] See s. 2.1 of National Instrument 81-107 *Independent Review Committee for Investment Funds*, which requires the manager of the investment fund to (a) act honestly and in good faith, and in the best interests of the investment fund, and (b) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. The Securities Acts of most of the CSA jurisdictions also contain a similar provision.

best interests of the mutual fund and its investors, and not itself, when engaging in this practice.[85]

The perceived practice of mutual fund manufacturers competing for distribution on the basis of trailing commissions also raises a perception that mutual fund manufacturers may consider the advisor, rather than the investor, to be their customer, which could lead them to favour the needs of the advisor over the interests of the investors in their mutual funds.[86]

Examples of potential conflicts:

1. mutual fund pricing model

As mentioned in Part IV, management fees, and the trailing commissions paid from those fees, vary based on the type of mutual fund. They are generally highest on equity funds and balanced funds, lower on fixed income funds, and lowest on money market funds. This gives rise to the perception that the pricing model favours the manufacturing and distribution of higher cost mutual funds, in order to maximize the mutual fund manufacturer's profitability.

Figure 12 below illustrates the potential conflict of interest that the current mutual fund fee pricing model raises for the mutual fund manufacturer. The graph suggests a number of pricing

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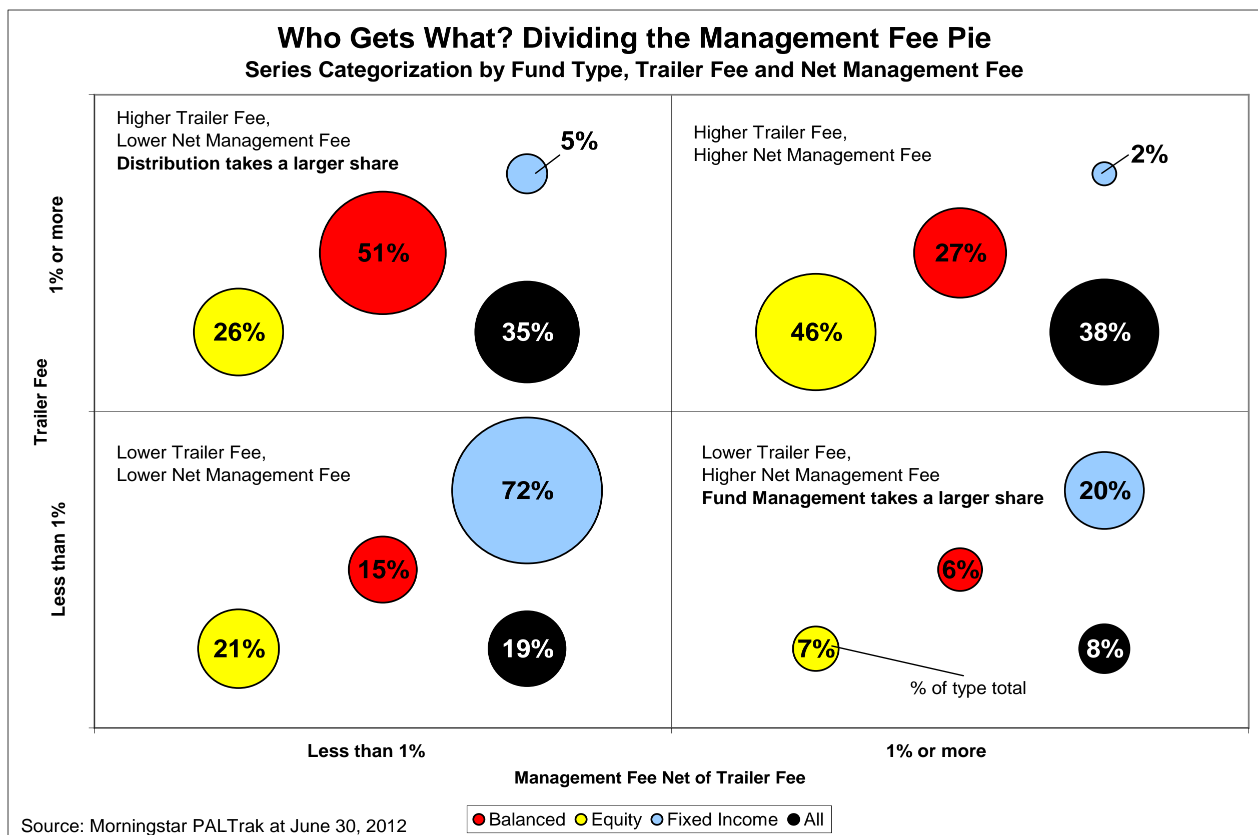
[85] A mutual fund manufacturer could demonstrate this, for example, by reducing the management fees and expenses it charges to a mutual fund as its assets grow, thus yielding a benefit to the fund and its investors. Interestingly however, U.S. studies on trailing commissions, known in the U.S. as "12b-1 fees", have concluded that trailing commissions don't yield the expected benefit for investors. When 12b-1 fees were originally adopted in the U.S., mutual funds were experiencing net redemptions. The belief was that if fund flows could be attracted through the use of 12b-1 fees, existing investors would benefit through lower expense ratios as assets under management increased. Subsequent U.S. experience has shown this not to be the case with 12b-1 fees increasing expense ratios on a one-for-one basis even as assets under management increase. See S. Collins, *The Effect of 12b-1 Plans on Mutual Fund Investors, Revisited* (March 2004) ICI working paper, and L. Walsh, *The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns* (June 2004) SEC discussion paper available at: http://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf.

[86] G. Stromberg, *supra* note 81, at pages 17-18, discusses this concern as follows: *"Another result that has flowed from the need to secure distribution channels is that independent investment fund organizations no longer appear to regard the investors in their sponsored investment funds as being their "customers" in terms of such investors being the persons whose needs, expectations and interests that their operations are intended to serve. Instead, these organizations regard the distributors – i.e. mutual fund dealers, mutual fund specialists, financial planners, investment dealers and, in some cases, the individual sales representatives that are employed by these firms – as being their "customers" and their immediate focus is on satisfying the needs of these people instead of the needs of the investors in their sponsored investment funds."*

We note that the U.K.'s Financial Services Authority (FSA) also made similar observations in the work leading up to its Retail Distribution Review reforms discussed in Part VI of this paper. In a speech entitled "*Is the present business model bust?*" (http://www.fsa.gov.uk/library/communication/speeches/2006/0916_cm.shtml) given on September 16, 2006, the Chairman of the FSA stated the following: *"And one of the key questions that must be addressed is this: who is the real customer of the provider – is it the policyholder who invests their money in the hope of seeing a decent return? Or is it the distributor, who in the main, secures access to the end-consumer for the provider? If, as many commentators would have it, it is indeed the distributor who is the actual customer of the provider, this raises all manner of difficulties which further perpetuate the shortcomings of the current model – particularly with regard to treating the real customer fairly. I understand well that many are frustrated by what they describe as the "commission stranglehold" that the advisory community enjoys, but so long as providers continue to compete over the attractiveness of their commission proposition, the fundamental flaws in the present business model will remain."*

strategies that may align the interests of the advisor with those of the mutual fund manufacturer.[87] Explanations for the graph are provided below.

Figure 12: Who Gets What? Dividing the Management Fee Pie



In the graph above, fund series are sorted along two dimensions - by the rate of the trailer fee and by the rate of the management fee net of trailer fees. Typically, trailer fees and net management fees go up and down together – funds that pay higher(lower) trailer fees, pay higher(lower) net management fees. For most asset classes, where mutual fund manufacturers have tended to deviate they have chosen to pay a higher trailer fee and forgo their net management fees.

[87] For purposes of Figure 12, we used management fee and trailer fee data for over [illegible] front-end load and no-load sales charge fund series from Morningstar.

In the graph, all mutual funds are categorized along two dimensions – the fund's management fee *net of trailer fee*[88] and the fund's trailer fee. Mutual funds are then grouped into one of four quadrants.

The first group in the upper left quadrant is made up of mutual funds with trailer fees that are greater than or equal to 1% and net management fees that are less than 1%. Payments made to advisors and their firms make up the majority of the overall management fee paid.

The second group, located in the lower right quadrant, is made up of mutual funds with trailer fees that are less than 1% and net management fees greater than or equal to 1%. The majority of the overall management fee paid is retained by the mutual fund manufacturer.

The third group, in the upper right quadrant, is made up of mutual funds with both trailer fees and net management fees greater than or equal to 1%. These funds have relatively higher overall management fees – total management fees are greater than or equal to 2%.

The fourth group of funds, located in the lower left quadrant, is made up of mutual funds with both trailer fees and net management fees that are less than 1%. These funds have relatively lower overall management fees - total management fees are less than 2%[89].

In addition to showing the percentage of all mutual funds in each quadrant, Figure 12 illustrates the percentage of each fund type – equity, balanced, fixed income – in each quadrant. It shows that the majority of fixed income funds, 72%, are in the lower trailer fee/lower net management fee group but only 21% of equity funds and 15% of balanced funds are in this group. Similarly, only 2% of fixed income funds reside in the higher trailer fee/higher net management fee group versus 27% for balanced funds and 46% for equity funds.

For 57% of the funds in the total sample, compensation to distribution appears aligned with the mutual fund manufacturer's compensation – lower fund manufacturer compensation is associated with lower compensation for distribution and higher fund manufacturer compensation is associated with higher compensation for distribution[90].

[88] The management fee *net of trailer fee* is computed by subtracting the series trailer fee from the series total management fee. We acknowledge that this may not represent the actual amount the mutual fund manufacturer has retained from the fund's management fee or equivalently, what has been charged by the mutual fund manufacturer to the fund for distribution costs (see note 44). Rather, it represents the cash flow of what has been charged in total management fees to the fund versus what has been allocated back (from the total pool of management fees collected from all funds managed by the manufacturer) to the payment of trailing commissions to advisors.
[89] Note that mutual funds that equally split the trailer fee and net management fee will be grouped in third and fourth group, however not all of the funds in these groups equally split the overall management fee.
[90] It's interesting to note here that 73% of all passively managed funds in the sample are in the lower net management fee, lower trailer fee group, which highlights another potential barrier (and potential conflict) to a more widespread use of passively managed funds in the industry.

In the scenarios where the net management fee and trailer fee do not align – the lower right and upper left quadrants – overall, the industry practice seems to be to pay a higher trailer fee and undercut the net management fee. Only 8% of mutual funds in the sample are in the lower trailer fee/higher net management fee group versus 35% in the higher trailer fee/lower net management fee group. This industry pricing model seems to be most prevalent for balanced funds, the category which contains the bulk of fund-of-fund products in the industry, since 51% of balanced funds in the sample have a trailer fee that is greater than or equal to 1% and a net management fee that is less than 1%.[91]

This approach by mutual fund manufacturers of retaining less in net management fee in order to allocate a greater portion of the overall management fee to the payment of high trailing commissions on fund-of-fund products may be a significant contributing factor to the growth of those products.

Over the last several years, fund-of-fund products have grown in popularity, now accounting for approximately 47% of long-term mutual fund assets under management, up from 37% in 2006.[92] Industry data shows that in four out of the last five years, the majority of new money flowing into the mutual fund industry through long-term mutual funds has come through fund-of-fund products.[93]

Funds-of-funds may hold substantial appeal for advisors since they are pre-packaged mutual fund investment portfolios which relieve the advisor from having to do the fund selection and asset allocation they may previously have been expected to do on their own for a client. In the case of a fund-of-funds, the advisor need only assess the suitability of the top fund rather than assess the suitability of every fund in the portfolio. Notwithstanding the efficiencies that funds-of-funds may provide for advisors, the trailing commissions payable on funds-of-funds are the same or higher than on stand-alone equity mutual funds.[94]

While the higher trailing commission payable on funds-of-funds appears to result in a lower net management fee to the mutual fund manufacturer, the manufacturer benefits from the fact that the funds-of-funds help to fuel the growth of its proprietary stand-alone funds, as these are generally the underlying investments held by the funds-of-funds.[95] This increases the

[91] Note that the funds-of-funds in this group would seem to contradict the argument that fund-of-fund management fees are higher than the asset-weighted average costs of their underlying fund because of the added rebalancing and asset allocation management costs.

[92] Investor Economics, *Investor Economics Insight Monthly Update* (April 2012), Exhibit 1.

[93] Net sales into funds-of-funds and long-term stand-alone funds were as follows over the five years ending 2011:

Net Sales -excl. reinvested dist. ($billions)	2007	2008	2009	2010	2011
Long-term stand-alone funds	11.1	-17.0	12.1	10.6	6.5
Fund-of-funds	20.4	3.2	9.6	18.6	19.5
Total Net Sales	**33.4**	**-11.8**	**23.7**	**31.2**	**28.1**

Source: Investor Economics, net sales have been adjusted to remove double-counting

[94] See Figure 10 in Part IV.

[95] The industry trend for funds-of-funds has been towards the use of related (proprietary) mutual funds as underlying funds and away from the use of mutual funds offered by other mutual fund manufacturers (third-party funds). At the end of 2011, assets under management (AUM) for funds-of-funds that invest in proprietary mutual funds totalled

manufacturer's overall assets under management which in turn increases total management fees payable to the manufacturer.

2. automatic conversion arrangements

These are arrangements under which mutual fund manufacturers facilitate the automatic conversion of DSC mutual fund securities to front-end load securities of the same fund. Under these arrangements, the 10% free DSC securities that an investor in a mutual fund is entitled to redeem without penalty each year are automatically converted into securities of the same fund carrying a 0% front-end sales charge. These arrangements may further provide for the automatic conversion of matured securities at the end of the DSC redemption schedule (when the DSC has fallen to zero) into securities of the same fund carrying a 0% front-end sales charge.[96] Since trailing commissions on mutual funds sold under a front-end sales charge are generally twice as high as trailing commissions on mutual funds sold under a DSC,[97] the conversion yields a 100% increase in trailing commission compensation for the advisor without any consent from or disclosure to the client at the time of the conversion.

We understand that these conversion arrangements are intended to provide a disincentive for advisors to churn their clients' free/matured DSC investments into new mutual fund investments in order to generate new sales commissions. While arrangements intended to mitigate the potential for churning by advisors are beneficial for investors, at the same time they can create an actual or perceived conflict of interest between the mutual fund manufacturer and investors. This is because these arrangements, which create a perceived incentive for the advisor to keep the client invested in the mutual fund for the longer term, in turn satisfy the mutual fund manufacturer's perceived need to preserve assets under management. While longer term mutual fund investments yield economic benefits for the mutual fund manufacturer and the advisor, they may not yield the same benefits for the investor.

These conversion arrangements therefore appear to display an alignment of interests between the mutual fund manufacturer and the advisor that could be detrimental to mutual fund investors.

$150.2 billion, while AUM for funds-of-funds that invest in third party mutual funds totalled $17.5 billion. The AUM of funds-of-funds that invest in proprietary mutual funds grew an average of 10.5% per year between 2007 and 2011, compared to the AUM of funds-of-funds that invest in third-party funds which declined by 0.1% per year. (Source: Investor Economics). Because of the popularity of fund-of-fund products generally and the preference towards the use of proprietary funds as the underlying investments, we now see many cases where investments by related mutual funds account for as much as 70% to 90% of the total assets of a mutual fund.

[96] The MFDA addresses this practice in member regulation notice MR-0041 (June 8, 2005). Under that notice, in order for automatic conversion programs to comply with MFDA rules, members must ensure that appropriate disclosure is provided and the consent of the client is obtained prior to engaging in an automatic conversion program. The disclosure/consent form should include the following:

- a signature line to evidence client consent to the conversion;
- disclosure of any increased remuneration, including trailer fees;
- disclosure of any tax implications; and
- reference to the applicable fund prospectus.

However, according to the notice, the above disclosure/consent requirement need not be complied with if the mutual fund has included the above information in the fund prospectus.

[97] See note 48.

ii. Advisor

Sales commissions and trailing commissions embedded in mutual fund management fees may:

- incent or be perceived to incent advisors to sell a particular mutual fund to investors over another comparable mutual fund or comparable financial product with lower compensation to the advisor,
- cause the advisor to promote a particular purchase option with investors, or
- incent the advisor to keep them invested in a particular mutual fund.

Generally, the higher is the compensation, the greater is the perceived incentive.

This perceived incentive for advisors to recommend the sale of mutual funds that pay higher sales commissions and trailing commissions may be made even greater by the 'compensation grid', the mechanism that dealer firms use to determine the pay of an advisor.[98] Under this grid, the more commission or fee revenue the advisor generates for the firm, the greater the portion of that revenue the advisor gets to keep. Some dealer firms impose a minimum amount the individual advisor is expected to generate.

These compensation incentives can potentially result in a misalignment of the advisor's interests with those of investors.[99] For example, because trailing commissions on equity mutual funds and balanced/asset allocation funds (as discussed above) are typically higher than trailing commissions on fixed income and money market mutual funds, advisors may be incentivized to favour such mutual funds in portfolio allocations. Similarly, since trailing commissions on mutual funds sold under a front-end sales charge are generally twice as high as trailing commissions on mutual funds sold under a DSC, an advisor may be induced to favour the front-end sales charge option over other available purchase options.

On the other hand, advisors who are new to the business and who don't yet have a large trailer fee-paying fund book of business may be more incented to favour mutual funds sold under a DSC, despite their lower trailing commissions, in order to receive the 5% sales commission payable by the mutual fund manufacturer at the time of sale.

Similarly, the automatic DSC conversion arrangements facilitated by certain mutual fund manufacturers (see related discussion above) which yield a 100% increase in trailing commission

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[98] See the following articles which describe the compensation grid: Investor Education Fund, *How your adviser is paid*, Globe and Mail (March 31, 2009), available at: http://www.theglobeandmail.com/globe-investor/investor-education/investor-education-fund/getting-financial-advice/how-your-adviser-is-paid/article4203756/; and Barrie McKenna, *The flaws in Canada's financial adviser system*, Globe and Mail (February 17, 2012), available at: http://www.theglobeandmail.com/globe-investor/the-flaws-in-canadas-financial-adviser-system/article4171749/?page=all.

[99] See article by Rob Carrick, *Rogue sales reps or Standard thinking?; E-mail to investment advisers, disavowed by insurance company, lists seven ways to make more money from clients*, Globe and Mail (July 5, 2012) available at http://www.theglobeandmail.com/globe-investor/personal-finance/mixed-message-rogue-sales-reps-or-standard-thinking/article4391164/?cmpid=rss1. The article describes an email that sales representative of a Canadian insurance company sent to advisors to suggest ways of generating maximum commission and fee revenue from the sale of mutual funds. Suggestions included selling mutual funds under the DSC option (as this yields an up-front commission to the advisor of up to 5%) or that offer trailing commissions of 1.25%.

compensation for advisors on free or matured DSC securities, may incent advisors to recommend to investors that they remain invested in a mutual fund over a longer term. All of these perceived compensation incentives carry the potential to influence the quality of an advisor's investment advice to the investor.

The advisor's standard of conduct under the securities legislation may not sufficiently mitigate these perceived compensation incentives.[100] Under current securities legislation, the prevalent standard in the common law jurisdictions[101] is that advisors must deal fairly, honestly and in good faith with clients.[102] The CSA are not aware of any court or regulatory decision that has concluded that this duty creates, or is equivalent to, a statutory fiduciary duty requiring the advisor to put the client's best interests ahead of his or her personal interests. Canadian courts in the common law jurisdictions, however, can find that an advisor owes a fiduciary duty to his or her client depending on the nature of the advisory relationship.[103]

Complementing the fundamental duty of an advisor to deal fairly, honestly and in good faith is the duty of an advisor to make suitable investment recommendations for the client, along with

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[100] The CSA recently identified key investor protection concerns with the advisor's current standard of conduct in CSA Consultation Paper 33-403: *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients* (October 25, 2012), available on the websites of members of the CSA. Among concerns identified are: (i) that advisor compensation arrangements can create a conflict of interest between the interests of advisors and their clients (see Concern 1: Principled foundation), and (ii) that the advisor's current suitability obligation may result in investors acquiring a "suitable" investment but at an inflated price, and this can have a significant impact on the value of a client's investment portfolio over the long term (see Concern 4: Recommendation of suitable investments versus investments in the client's best interests). We refer you to CSA Consultation Paper 33-403 for a full discussion of these and other identified investor protection concerns with the advisor's current standard of conduct.

[101] Excludes Québec which follows civil law. In Québec, according to both the *Securities Act* (Québec) and the general civil law under the *Civil Code of Québec*, advisors are subject to a duty of loyalty and a duty of care and must act in the client's best interest. See sections 1309, 2138 and 2100, respectively, of the *Civil Code* and sections 160 and 160.1 of the *Securities Act* (Québec).

[102] Rules governing the conduct of advisors in Canada are set out under the various Securities Acts and related rules enacted by each province and territory of Canada. The prevalent standard for advisors across the CSA jurisdictions is that advisors must deal honestly, fairly and in good faith with their clients. In Ontario, for example, that standard is set out in section 2.1 of OSC Rule 31-505 – *Conditions of Registration.* The securities legislation of several other Canadian provinces and territories sets out the same (or virtually the same) requirement for advisors. See also section 2.1.1 of the MFDA Rules. It is worth noting, however, that a statutory 'best interest' standard may apply to advisors in the context of certain advisory relationships under the legislation of four provinces. Specifically, Alberta, Manitoba, New Brunswick and Newfoundland and Labrador have a statutory requirement that when an advisor has discretionary authority over a client's investments, the advisor must act in the client's best interests. See subsection 75.2(2) of the *Securities Act* (Alberta), section 154.2 of the *Securities Act* (Manitoba), section 54 of the *Securities Act* (New Brunswick) and subsection 26.2(2) of the *Securities Act* (Newfoundland and Labrador).

[103] Canadian courts note that advisors fall into a continuum in providing advice, with discount brokers at one end (who provide no advice but simply execute transactions on a client's express instructions and who therefore are not subject to a common law fiduciary standard) and advisors with clients in discretionary accounts at the other end (who have complete discretionary trading authority and who therefore would be subject to a common law fiduciary duty). Whether a common law fiduciary duty applies to a relationship that falls somewhere in this continuum is a question of fact to be determined based on the nature of the client relationship in all the circumstances. See *Kent v. May* (2001), 298 A.R. 71 (Alta Q.B. at paragraphs 51-53). See also: *875121 Ontario Ltd. V. Nesbitt Burns Inc.*, [1999] O.J. No. 3825 (Sup.Ct.); *Hunt v. TD Securities Inc.* (2003), 66 O.R. (3d) 481 (Ont. C.A.); and *Young Estate v. RBC Dominion Securities* (2008), [2008] O.J. No. 5418 (Ont. S.C.J.).

the obligation to identify and respond to conflicts of interests.[104] Based on current rules and related SRO guidance, whether or not a particular investment is suitable for a client must generally be determined having regard to the client's investment needs and objectives, financial circumstances, risk tolerance, and time horizon.[105] The sales commissions and ongoing costs associated with a mutual fund investment may not be a primary consideration in the advisor's suitability process.

Similarly, conflict of interest requirements do not specifically identify compensation for advisors as being conflicts of interests that should be resolved in the best interests of the client. This would seem to allow the advisor to recommend investments in higher fee (and correspondingly, higher trailer fee) mutual funds over other less costly, comparable and equally suitable investment options, potentially to the detriment of the investor's best interests.

While advisors may not be fiduciaries under securities legislation, most Canadian investors trust their advisor to provide recommendations that put the client first. The IEF Study reports that 7 out of 10 investors believe their advisor has a legal duty to put the client's best interests ahead of his or her own. They rely on their advisor to select the best investment for them and most believe the advisor will recommend what is best for the client even at the expense of their own commission. In addition, half the respondents in this study (51%) had no view as to whether commissions could potentially create a conflict of interest. Among the half of investors with an opinion on conflict of interest, three-quarters believe that their advisor would look out for their best interest regardless of how the advisor was paid.[106] With this belief, investors may not be prone to question their advisor's investment recommendations and the compensation incentives that potentially influence them.

3. The potential for cross-subsidization of commission costs

As discussed, part of the management fees earned by a mutual fund manufacturer on the assets of a mutual fund are typically used to pay for some of the costs of financing the payment of sales commissions to advisors on sales of the mutual fund's securities under the DSC or low-load sales charge option.[107]

The prevalent practice in Canada is that all investors in the mutual fund bear the financing costs equally, irrespective of the purchase option under which they made their mutual fund investment. This is because, with very few exceptions, mutual funds in Canada generally do not offer a

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[104] National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) imposes suitability and conflict of interest requirements on advisors and their firms. See Part 13, Divisions 1 and 2 of NI 31-103. The rules of the SROs similarly impose suitability and conflict of interest requirements on their members. See MFDA Rules 2.1.4 and 2.2.1, IIROC Dealer Member Rule 1300.1, paragraphs (p) and (q), and IIROC Dealer Member Rule 42.

[105] See NI 31-103, sections 13.2 and 13.3. See also MFDA Member Regulation Notice MR-0069 – *Suitability Guidelines* (April 14, 2008) and IIROC Notice 12-0109 – *Know your client and suitability – Guidance*, (March 26, 2012).

[106] *Supra* note 71, at pages 17 and 28.

[107] In addition to commission costs, the DSC and low-load purchase options require complex record keeping systems to keep track of maturity dates and 10% free allotments. They also draw more on the call centre staff of the mutual fund manufacturer to address investor and advisor inquiries about schedule, date of maturity and estimated redemption costs, etc.

different class or series, each bearing a different management fee, for each of the various purchase options available. As a result, investors who purchase mutual fund securities under the front-end sales charge option bear the same management fee (out of which the financing costs of the DSC and low-load sales commissions are paid) as those who purchase under the DSC and low-load sales charge options. This is known as "cross-subsidization".[108]

Cross-subsidization by investors may also occur to a certain extent if different trailing commissions are paid on different purchase options. As discussed, the trailing commission on mutual fund securities sold under a front-end sales charge is typically double the trailing commission on mutual fund securities sold under a DSC. That higher trailing commission is similarly applied to any free or matured DSC securities that are converted to the front-end sales charge under the automatic DSC conversion arrangements discussed above.[109] Since the different trailing commissions payable on the different purchase options are generally funded from the same management fee, investors in the mutual fund who purchased under the DSC option may be subsidizing the payment of the higher trailing commission payable under the front-end sales charge option.

This potential cross-subsidization by a mutual fund's investors of the various costs associated with different purchase options may result in certain mutual fund investors unknowingly paying a higher management fee than would otherwise apply if investors were segregated in a separate class or series for each purchase option.

4. Alignment of advisor compensation and services

As discussed in Part IV, trailing commissions were originally intended to compensate the dealer firms for the ongoing services their advisors provide to investors after the mutual fund purchase.

Currently, however, there are no rules or guidance that articulate the purpose of trailing commissions or define the services that an advisor is expected to provide in exchange for a trailing commission.[110]

In the absence of relevant rules relating to trailing commissions, one could presume that the higher the trailing commission rate is, the greater the service an investor would expect to receive from the advisor.

Based on industry practice, trailing commission rates typically vary based on the following factors:

- the type of mutual fund (i.e. they are higher on equity funds and balanced funds and lower on fixed income funds and money market funds) and

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[108] See article by Rudy Luukko, *Most mutual funds with front-end loads sell investors short*, The Toronto Star (March 21, 2002) at page D06, which discusses this cross-subsidization issue.

[109] We discuss the automatic conversion arrangements in this Part under "**2. Potential conflicts of interests at the mutual fund manufacturer and advisor levels** – *i. Mutual fund manufacturer*".

[110] While National Instrument 81-105 *Mutual Fund Sales Practices* imposes conditions around the calculation of the amount of the trailing commission (see section 3.2), it does not define what is a trailing commission, nor does it mandate the provision of any services by the advisor in exchange for the payment of such commission.

- the purchase option under which the fund investment is made (i.e. they are higher on mutual fund investments made on a front-end load basis and lower on mutual fund investments made on a DSC basis).

In addition to those factors, we have observed trailing commission rates that:

- increase in steps with each year the investor continues to hold the investment, reaching a specified maximum after a certain number of years;
- double at the expiration of a DSC redemption schedule under automatic conversion arrangements;[111] and
- vary depending on the dealer firm distributing the mutual fund.[112]

Furthermore, under a dealer firm's compensation grid, the amount of the trailing commission paid out to an advisor may vary based on:

- the fee revenue the advisor generates for the firm;[113]
- the tenure of the advisor with the dealer firm;[114]
- whether the mutual funds sold are proprietary or third party mutual funds.[115]

Considering all these factors, there is not a clear correlation between the rate or amount of the trailing commissions payable and the level of services the advisor may provide to investors in exchange for those commissions.

Investor research shows that the level of service expected by investors is independent of the products they choose or the manner in which they purchase them. Service expectations instead tend to vary by age, life event (divorce, death of a spouse, etc.) and by the amount invested.[116]

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[111] See our discussion of automatic conversion arrangements in this Part under "**2. Potential conflicts of interests at the mutual fund manufacturer and advisor levels** – *i. Mutual fund manufacturer*".

[112] This occurs where a mutual fund manufacturer establishes specific series of mutual fund securities with a view to distributing each individual series through a specific full-service dealer firm. The different management fees applicable to each series reflect the different trailing commissions that each of the dealer firms command for distributing securities of the mutual fund.

[113] Typically, the greater the fee revenue the advisor generates for the firm, the greater the portion of that revenue the advisor gets to keep.

[114] This may be a factor where the mutual fund manufacturer has a captive sales force. For example, in the case of one such manufacturer, the manufacturer pays a base trailing commission to all advisors, plus an additional trailing commission to those advisors who have been with the business for less than 3 years. Disclosure in the prospectus of this manufacturer's mutual funds states that this bonus amount is intended to help the advisor establish their practice.

[115] Advisors may receive greater trailing commissions for the sale of proprietary mutual funds (i.e. mutual funds offered by a mutual fund manufacturer that is related to the dealer firm) than for the sale of third party mutual funds.

[116] See The Brondesbury Group, *supra* note 71. This research shows that there are differences in service expectations by age. **Advice on types of investments to buy** is one of the top two services for all age groups. **Building a financial plan** is one of the top two up through age 59, but **Regular reports on progress** is the second choice for 60+. For those with less than $50k invested, the most critical need is **Help in figuring out financial needs for the long term**. As the amount increases to the $50-99k range, the top service shifts to **Building a financial plan**. After that, **Advice on types of investments to buy** (not specific stocks or funds) is the leading choice of service expected. See also POLLARA, *supra* note 72. This research similarly finds that the use of advisors for services other than simply purchasing mutual funds increases with income and the total amount each

Asset mix and financial planning are the services that investors most frequently seek, followed closely by recommendations for specific stocks or funds to buy.

Investor research further shows a variance in the extent to which investors rely on the recommendations or advice they receive. Some investors are comfortable giving their advisors certain discretion in the investment decision-making process, while others prefer to remain more hands-on.[117]

The current mutual fund embedded trailing commission structure, which offers a "one size fits all" approach, seems potentially misaligned with the current practice of providing services tailored to an investor's personal circumstances, expectations and preferences. It also does not recognize the different range of services that may be provided by the various types of advisors and their dealer firms. The trailing commission that applies to a mutual fund investment is payable regardless of whether the advisor performs basic suitability requirements only or provides a broader range of investment services.

Absent a clear relationship between the level of trailing commission compensation paid to the advisor and the level of services received by an investor in exchange, the payment of trailing commissions may be perceived to be tied to the sale of the mutual fund as opposed to the provision of ongoing services. In that instance, the trailing commission may be seen to function more like a sales commission that is paid to advisors over time.

This perceived disconnect between the compensation received by advisors and the services provided to investors is further evidenced by the fact that do-it-yourself investors who consciously decide to forego investment advice from advisors by opting to purchase mutual funds through a discount broker are, with few exceptions, paying the same trailing commission (through the management fee of the mutual fund) as that paid by investors purchasing the mutual funds through full-service advisors. This issue is further discussed below.

5. Low-cost options for do-it-yourself (DIY) investors

In Canada, DIY investors wishing to purchase mutual fund securities without having to pay for the services of an advisor have few options available. Current options are:

i. Directly-sold mutual funds

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individual has invested. According to this research, 54% of people with total investments under $25,000 use their advisors for other purposes, compared to 70% of investors with total values of $75,000 or more. This research further finds that two-thirds (66%) of mutual fund investors say that they receive other services such as investment advice, budgeting, or planning for future expenses. One-third of investors (33%) do not.

[117] See POLLARA, *supra* note 72. That research finds that 51% of mutual fund investors discuss options and make a decision with their advisor while another 40% make the final decision themselves based on information from their advisor. Similarly, The Brondesbury Group study referenced in note 71 finds that about one-quarter of investors prefer an advisor to decide what to buy on their behalf, and then buy it either with or without explicit permission for that single decision. For those people who want to talk about what to do, the advisor typically gives them several choices to discuss and they jointly come to a decision. Those who don't want to talk will either call the advisor to tell the advisor what to buy for them, or alternatively, listen to what the advisor wants to buy on their behalf and give them an okay.

Investors may look for direct sellers who make their mutual funds available for sale on a no-load basis directly to the investor.[118] There are currently only a handful of direct sellers in Canada, and the number has been decreasing over the last several years as some have been acquired by larger fund manufacturers whose distribution remains primarily focused on full-service advisor distribution channels. Direct sellers generally pay no or reduced trailing commissions, resulting in below-average MERs. As of December 2011, the average asset-weighted MER of mutual funds offered by direct sellers was 1.00%[119], while the industry average asset-weighted MER was 1.93%.[120] The mutual funds offered by direct sellers typically have a substantial initial investment requirement (at least $5,000 and up) which may potentially impede access to those funds for certain investors. These mutual funds represented approximately 4.4% of mutual fund industry assets as at the end of December 2011.[121]

ii. Mutual funds offered through discount brokerages/online

Many mutual fund manufacturers make their mutual funds available for sale through discount brokerages. As discussed in Part III, discount brokerages are primarily order-takers and generally do not offer investment advice. Investors may typically purchase mutual funds offered on these platforms on a commission-free basis, which allows investors to save on transaction costs. However, with few exceptions, the mutual fund series that fund manufacturers offer through the discount brokerage channel is typically the same trailer fee-bearing series that is sold through advisors. The embedded trailing commission component of the management fee is not discounted. This results in DIY investors who hold mutual fund securities through discount brokerages potentially paying for services or advice that they never receive and do not want.

Mutual fund securities available for purchase through certain online discount brokerages may however offer DIY investors some savings relative to the traditional discount brokerage. Currently, one independent online discount brokerage offers rebates of the trailing commissions embedded in the management fees charged by the mutual funds offered on their platform. This rebate service is provided in exchange for a set monthly fee. In addition, each fund trade is subject to a trading fee. Clients of the service realize a net benefit provided the amount of the mutual fund investment they hold through the brokerage is sufficiently high for the quarterly trailing commission rebates to offset the monthly fee.

An alternative to this rebate process is to invest in discount online/e-series securities which are currently available on select no-load mutual funds offered by a few of the Canadian banks through their online/discount brokerage or e-banking platforms.[122] Most, but not all, of the trailing commission is typically stripped out of the management fee charged on this series, resulting in a reduced MER relative to the original series of that fund distributed through the bank branches. The reduced pricing is intended to reflect the fact that investors in this series of the mutual fund make their own investment decisions, and therefore do not receive nor want

[118] See description of direct sellers in Part III under "**1. The mutual fund manufacturers –** *iii. Independents*".
[119] Source: Morningstar Direct, OSC calculations.
[120] Source: Investor Economics.
[121] See Figure 4 in Part IV.
[122] See note 32.

recommendations, but are still being serviced by a dealer firm. The average asset-weighted MER of the discount online/e-series currently stands at approximately 0.91%,[123]versus the industry average asset-weighted MER of 1.93%.

At the end of 2011, there were 66 discount online/e-series available for purchase. However, these assets represented just 0.3% of mutual fund industry assets under management.[124] At this time, the discount online/e-series segment remains dominated by the Canadian bank-owned mutual fund manufacturers. None of the independent 'load only' mutual fund manufacturers have similar discounted offerings.[125]

VI. GLOBAL REGULATORY REFORMS

Regulators in major international jurisdictions, in particular, the U.K., Australia, Europe and the U.S., have implemented or proposed regulatory reforms aimed at addressing some of the issues identified in this paper, including conflicts of interest that exist in the embedded compensation structure and improving transparency of the cost of advisors.

1. U.K. - FSA Retail Distribution Review

In March 2010, the Financial Services Authority (FSA) published final rules and guidance on the implementation of an 'Adviser Charging' system, as part of its Retail Distribution Review (RDR).[126] These new rules, to be in effect as of January 1, 2013, end the current commission-based system of advisor remuneration in the U.K.

The rules require advisors to set their own charges for their services in agreement with their clients. Advisors may no longer receive commission set by product providers or otherwise embedded in the cost of the product. Their charging structures will therefore have to be based on the level of service they provide, rather than the particular provider or product they recommend. Whether the charging structure is based on a fixed fee, an hourly rate or a percentage of funds invested will be up to the advisor to decide together with the client, provided the advisor always bears in mind its duty to act in the client's best interests.[127] Ongoing fees will only be permitted where a client is paying for an ongoing service that has been properly disclosed or where the

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[123] *Investor Economics Insight Monthly Update* (July 2012) at p.12. We note that the lower MER of this mutual fund series may not only be on account of the reduced trailing commissions, but may also reflect the passive management strategy utilized by many of the mutual funds on which this online/e-banking series is offered.
[124] See Figure 4 in Part IV.
[125] In *Investor Economics Insight Monthly Update* (July 2012), Investor Economics states at p.3: "*Despite their rapid growth, only three sponsors currently offer D-series. The limiting factor is the lack of access to distribution. The series is currently used mostly by proprietary bank delivery conduits, notably the fast-expanding online/discount brokerage channel. Major independent fund companies have to date eschewed this "stripped-down" management fee version to avoid any potential conflict with their advice channels.*"
[126] For an overview of the FSA Adviser Charging rules, see *FSA Factsheet for Financial Advisers – Improving your understanding of the Retail Distribution Review (RDR) – Adviser Charging*, available at: http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/rdr_adviser.pdf.
[127] Currently, all UK securities firms (whether advising or dealing) are subject to a statutory requirement to "*act honestly, fairly and professionally in accordance with the best interests of its clients*". See FSA Conduct of Business Sourcebook, COBS 2.1.1. This seems to constitute a qualified best interest standard.

product is one in which the client makes regular payments, and may be cancelled by the client at any time without penalty.

The new rules under the RDR also aim to ensure that investors understand the services they receive by requiring advisors to clearly describe their services as either 'restricted' or 'independent'. A 'restricted' advisor[128] would offer advice limited to proprietary products or a small range of products. An 'independent' advisor would not be restricted by product provider, but rather would objectively consider a broad range of retail investment products, and provide unbiased and unrestricted advice based on a comprehensive and fair analysis of the relevant market. In all cases, individual advisors will be required to adhere to consistent professional standards, including a code of ethics.[129]

2. Australia – Financial Advice reforms

In April 2010, the government of Australia announced its *Future of Financial Advice* (FoFA) reforms which came into effect July 1, 2012.[130] Compliance with the new rules will be voluntary in the first year of operation, becoming compulsory from July 1, 2013. The reforms include a ban on commissions that may allow product providers to influence advisor recommendations, such as sales commissions and trailing commissions.

Consistent with the FSA's Adviser Charging regime, advisor firms in Australia will be required to negotiate fees for advice directly with their retail clients. Also similar to the FSA's reforms, the rules under FoFA allow advisor firms to charge ongoing fees only if the client has agreed to a payment plan, or if the ongoing charges relate to the provision of an ongoing service. The Australian reforms further stipulate that an advisor must renew their advice agreements every two years if clients are paying ongoing fees. A client may cancel an arrangement in which ongoing fees are paid at any time.

In order to ensure that financial advice will be within the reach of a wider range of Australians, the FoFA reforms introduce a new form of advice called "scaled advice". Scaled advice would not have to be comprehensive and could be tailored to the client's expressed needs, thereby reducing the cost to the client. It would allow investors to obtain simple advice rather than a complete financial plan, and incur advice costs commensurate with the scale of the advice provided.

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[128] The new rules under RDR provide that 'restricted' advice may include 'basic' advice. Basic advice is a short, simple form of financial advice where advisors use pre-scripted questions to identify the investor's financial priorities and decide whether a product from within their range of low-cost, highly regulated saving and investment stakeholder products is suitable for the investor. While advisors providing 'basic' advice will need to disclose that they are providing 'restricted' advice, they will not be subject to the new Adviser Charging rules, and may therefore continue to be compensated by way of commissions on the sale of financial products.

[129] From December 31, 2012, every financial advisor will:

- subscribe to the FSA code of practice;
- hold a higher standard qualification for giving financial advice;
- spend at least 35 hours a year learning as part of continuing professional development requirements; and
- hold a Statement of Professional Standing (SPS) as evidence they are meeting the standards, issued by an accredited body.

[130] See overview of FoFA reforms at: http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=home.htm

An additional change to be introduced under FoFA is the introduction of a statutory best interest duty, which will require that advisors act in the best interests of their retail clients and place clients' interests ahead of their own when developing and providing personal advice. This duty will include a 'reasonable steps' qualification, so that advisors will only be required to take reasonable steps to discharge the duty. This would include making reasonable inquiries to obtain client information and conducting a reasonable investigation into relevant financial products for the client. Similarly, compliance with this duty will be measured according to what is reasonable in the circumstances in which the advice is provided. What is reasonable in the circumstances is commensurate and scalable to the client's needs. Accordingly, if the client's needs indicate that only limited advice is necessary, the advisor is not obligated to provide holistic advice.

3. Europe

i. UCITS IV - Key Investor Information Document

Under the UCITS[131] IV Directive implemented July 1, 2011, fund manufacturers in each of the European Union (EU) member states are required, as at June 30, 2012, to prepare, distribute, update and maintain a Key Investor Information Document (KIID) for all their UCITS funds and their share classes.

The KIID is a two-page fact-sheet style document, written in plain language, which constitutes the pre-contractual information which must be provided to investors prior to investment. It contains concise descriptions of key fund information, including information about one-time sales charges and ongoing fund costs that an investor needs to know in order to make an informed investment decision. The KIID must follow a standardized format to allow easy comparison of funds from different providers. The KIID must be written in the local language of each country in which a fund is sold.

The KIID provides standardized data on fund charges for UCITS funds sold across the EU. The ongoing fund charges shown in the KIID represent the annualized ratio of total costs related to the assets of the fund. The calculation is based on a standardized methodology which identifies specific items for inclusion and exclusion.[132]

ii. Markets in Financial Instruments Directive II

In October 2011, the European Commission published legislative proposals[133] to reform the overall Markets in Financial Instruments Directive (MiFID) framework that currently governs

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[131] The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive was created in 1985 to form a single EU market for investment funds. This initial Directive laid down a set of regulatory requirements which collective investment schemes must comply with to be eligible to be sold across borders within the EU. The UCITS IV Directive, implemented July 1, 2011, constitutes the latest amendment to the Directive.

[132] All fees paid to the fund manager, the custodian, Directors of the UCITS or portfolio managers have to be accounted for. In addition, all fees paid in relation to specific delegated activities (fund administration, accounting, valuation, distribution, legal and regulatory fees, etc.) also have to be accounted for.

[133] See European Commission, *Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council* (Oct. 20, 2011), available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF. On

capital markets in the European Economic Area.[134] The draft legislation (MiFID II), expected to be implemented in 2015, proposes various reforms designed to enhance investor protection. These include a proposal for more stringent disclosure standards, which will require that advisors clearly explain to investors the existence, nature and amount of commissions at the point of sale, as well as enhanced obligations upon advisors to ensure product recommendations are suited to their clients' personal characteristics on an ongoing basis.

iii. ESMA Guidelines on remuneration policies and practices

On September 17, 2012, the European Securities and Markets Authority (ESMA) published draft compensation guidelines for firms in the European Union providing investment services, including investment firms, credit institutions and fund management companies.[135] The guidelines aim to prevent the use of distorting compensation incentives that can result in the mis-selling of financial products which are not appropriate for investors, or investment choices which are sub-optimal. The key elements of the guidelines include the following general obligations:

- Firms should design and monitor their remuneration policies and practices to take account of the conduct of business and conflicts of interest risks that may arise;
- Firms should set up adequate controls on the implementation of their remuneration policies and practices to ensure that they deliver the intended outcomes;
- Firms ensure that remuneration is not paid in a way that aims at circumventing the rules and guidelines.

The consultation period for the draft guidelines on remuneration closes on December 7, 2012. The final guidelines are expected to be published by the second quarter of 2013.

4. U.S.

i. Rule 12b-2 proposal

On July 21, 2010, the Securities and Exchange Commission (SEC) proposed new Rule 12b-2 under the *Investment Company Act of 1940* with the objective of reforming the payment of trailing commissions, currently known as "12b-1 fees" in the U.S. Rule 12b-2 would cap the aggregate sales charges that could be charged to an individual investor.

September 26, 2012, the European Parliament's Committee on Economic and Monetary Affairs voted to amend the October 2011 draft legislation which initially proposed a Europe-wide ban on third party commissions for advisors. The vote supported softer rules requiring disclosure of all inducements and commission.

[134] The European Economic Area consists of the 27 member states of the EU (Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom), as well as the three EEA/EFTA States, Iceland, Liechtenstein and Norway.

[135] European Securities and Markets Authority, *Consultation Paper: Guidelines on remuneration policies and practices (MiFID)*, (September 2012), ESMA/2012/570, available at: http://www.esma.europa.eu/system/files/2012-570_0.pdf

The proposal is borne out of a recognition that trailing commissions have gradually come to function like a sales commission that is paid to advisors over time.[136] Given this current use of trailing commissions, new rule 12b-2 proposes to permit a "marketing and service fee" of up to 0.25% to be charged on mutual fund assets to pay for distribution related activities, including the payment of trailing commissions to advisors for ongoing services and advice they provide to investors. Any amount charged in excess of 0.25% of mutual fund assets would be labelled an "ongoing sales charge", but rather than deducting this for as long as the investor holds the mutual fund shares, it will be subject to certain cumulative limits. The limit would be determined by reference to the front-end sales charge on the mutual fund described in the prospectus, or if none, the maximum sales charge allowed under Financial Industry Regulatory Authority (FINRA) limitations.[137] Upon reaching the maximum sales charge limit, the individual investor's shares would have to be automatically converted to a share class of the mutual fund without an "ongoing sales charge".

Rule 12b-2 would require disclosure of the "marketing and service fee" and "ongoing sales charge" as separate line items in the mutual fund prospectus, expressed as a percentage of net asset value. It would further require disclosure of such fees in the trade confirmation as follows: (i) annual amount of each fee, expressed as a percentage (%) of net asset value, (ii) the aggregate amount of the "ongoing sales charges" that may be incurred over time, expressed as a percentage (%) of net asset value, and (iii) the maximum number of months or years that the investor will incur the "ongoing sales charge".

Proposed Rule 12b-2 has been the subject of considerable industry comment and remains to be finalized at this time.

ii. SEC study on best interest standard for investment advisers and broker-dealers

As part of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (the Dodd-Frank Act), staff of the SEC released a report on January 21, 2011, summarizing the findings of a study[138] it conducted of the obligations of investment advisers[139]and broker-dealers[140]. Broker-dealers in the U.S. have similar duties and obligations as registered dealers in Canada, which we informally call "advisors" in this paper.

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[136] See Rule 12b-2 proposal at http://www.sec.gov/rules/proposed/2010/33-9128.pdf at p.37.

[137] Under section 2830(d)(2)(A) of NASD Conduct Rules, the front-end and deferred sales charges described in the prospectus of an investment company with an asset-based sales charge (i.e. trailing commission) must not exceed 6.25%.

[138] SEC, *Study on Investment Advisers and Broker-Dealers* (January 2011), available at http://www.sec.gov/news/press/2011/2011-20.htm

[139] An "investment adviser" is anyone who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. This excludes any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation as a result thereof.

[140] The *Securities Exchange Act of 1934* defines the terms "broker" and "dealer". A "broker" is anyone engaged, as agent, in the business of effecting transactions in securities for the account of others. A "dealer" is anyone engaged, as principal, in the business of buying and selling securities for a person's own account through a broker or otherwise. The term "broker-dealer" is often used because of the frequent overlap of their duties.

The study is meant to inform the SEC's decision whether to introduce a statutory, uniform best interest standard on broker-dealers and investment advisers when providing personalized investment advice about securities to retail investors.

Currently, all U.S. investment advisers are subject to a fiduciary standard under the *Investment Advisers Act of 1940* (the Advisers Act).[141] In contrast, broker-dealers are generally subject to a suitability standard, along with a broader duty of fair dealing and other requirements.[142] While broker-dealers are generally not subject to a fiduciary duty under federal securities laws, U.S. courts have found broker-dealers to have a fiduciary duty under certain circumstances. Generally, courts have held that broker-dealers that exercise discretion or control over client assets, or have a relationship of trust and confidence with their clients, owe clients a fiduciary duty.[143]

In the study, SEC staff notes that investment advisers and broker-dealers are regulated extensively under different regulatory regimes. However, many retail investors do not understand and are confused by the roles played by investment advisers and broker-dealers. SEC staff notes that many investors are also confused by the standards of care applying to investment advisers and broker-dealers when providing personalized investment advice about securities. The study further states that retail investors should not have to parse through legal distinctions to determine the type of advice they are entitled to receive. Instead, retail investors should be protected uniformly when receiving personalized investment advice about securities regardless of whether they choose to work with an investment adviser or a broker-dealer.

SEC staff recommends in the study that the SEC establish a fiduciary standard for broker-dealers that is at least as stringent as the current fiduciary standard applicable to investment advisers under the Advisers Act. Specifically, SEC staff recommends that the uniform fiduciary standard of conduct:

> "for all brokers, dealers, and investment advisers, when providing *personalized investment advice about securities to retail customers* (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer *without regard to the financial or other interest of the broker, dealer, or investment adviser* providing the advice." (italics added)

At the same time, however, SEC staff notes that retail investors should continue to have access to the various fee structures, account options, and types of advice that investment advisers and broker-dealers provide. SEC staff's recommendations are intended to minimize cost and

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[141] Although the Advisers Act does not use the word "fiduciary" or the phrase "best interest" to apply to the standard of conduct to which an investment adviser is held, the U.S. Supreme Court has held that an investment adviser in fact has a fiduciary duty. For additional detail, see Michael V. Seitzinger (Congressional Research Service), *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Standards of Conduct of Brokers, Dealers, and Investment Advisers* (August 19, 2010), available at: www.fas.org/sgp/crs/misc/R41381.pdf.

[142] SEC, *supra* note 138 at pages 46-83. We note that the fair dealing obligation on broker-dealers is not statutory in that it is derived from the antifraud provisions of the U.S. federal securities laws. This suggests that there are technically no equivalent statutory provisions to the statutory provisions currently in place in Canada.

[143] *Ibid*, pages 54-55.

disruption and assure that retail investors continue to have access to various investment products and choice among compensation schemes to pay for advice.

The SEC has not at this time released a draft fiduciary rule for comment.

iii. SEC study regarding financial literacy among investors

On August 30, 2012, staff of the SEC published the results of a study identifying the existing level of financial literacy among retail investors as well as methods and efforts to increase financial literacy of investors.[144] Mandated by the Dodd-Frank Act, the study also identifies methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products, including shares of open-end mutual funds.

The study finds that U.S. retail investors lack basic financial literacy, and are not fully aware of investment costs and their impact on investment returns. The study further identifies investor perceptions and preferences regarding a variety of investment disclosures. The study shows that investors prefer to receive investment disclosures before investing, rather than after, as occurs with many investment products purchased today. The study specifically identifies information that investors find useful and relevant in helping them make informed investment decisions. This includes information about fees, investment objectives, performance, strategy, and risks of an investment product, as well as the professional background, disciplinary history, and conflicts of interest of a financial professional. Investors also favour investment disclosures presented in a visual format, using bullets, charts, and graphs.

Possible methods to increase the transparency of expenses suggested in the study include disclosure in the trade confirmation of the composition of a financial intermediary's total compensation, including types of compensation, and an explanation in a point-of-sale disclosure of how the financial intermediary is paid in connection with the client's account. Possible methods to increase the transparency of conflicts of interests suggested in the study include disclosure of whether a financial intermediary stands to profit if a client invests in certain types of products, whether the financial intermediary would earn more for selling certain specific products instead of other comparable products, and whether the financial intermediary might benefit from selling financial products issued by an affiliated company.

VII. CURRENT REGULATORY INITIATIVES AND TOPICS FOR CONSIDERATION

1. Regulatory initiatives in Canada

To date, the CSA have focused on initiatives aimed at improving the transparency of mutual fund fees and embedded commissions, as a way to enable investors to better understand the costs of investing in mutual funds and to make more informed investment decisions. Key CSA initiatives

[144] SEC, *Study Regarding Financial Literacy Among Investors* (August 2012), available at: http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf

include point of sale disclosure for mutual funds and cost disclosure and performance reporting for advisors.

i. Point of Sale

The first stage of the CSA Point of Sale (POS) project, which was completed on January 1, 2011, requires mutual funds to produce and file a Fund Facts document and make it available on the mutual fund's or mutual fund manufacturer's website.

The Fund Facts improves fee transparency by disclosing, in summary form, the costs of buying, owning and selling the mutual fund. Under "Fund expenses", an investor will find disclosure of the fund's MER, trading expense ratio and fund expenses. Trailing commissions are also highlighted there, with an explanation of their purpose. The range of the rates of the trailing commissions must be shown for each purchase option in percentages, along with the equivalent dollar amount of such commissions on each $1000 investment.

The CSA expect the Fund Facts will more likely be read by investors than the current lengthy fund prospectus.[145] The short, easy-to-read and standardized format of the Fund Facts is expected to improve investors' overall awareness and understanding of mutual fund fees and ongoing costs. The Fund Facts should better enable investors to compare the costs of investing in one mutual fund over another, which should enhance investors' ability to manage the impact of fund costs on their individual returns. The CSA also anticipate that the heightened transparency of trailing commissions provided by the Fund Facts may cause investors to discuss with their advisors the services that their advisors provide in exchange for the payment of trailing commissions.

The CSA continue to move forward with a staged approach to implementation of the project. On June 21, 2012, the CSA published for a second comment period proposed rules that would implement Stage 2 of the framework, which would require delivery of the Fund Facts document instead of the prospectus within existing delivery timeframes under securities legislation.[146] As part of this publication, the CSA have proposed additional disclosure in the Fund Facts that identifies that trailing commission payments may create a conflict of interest by influencing the advisor to recommend the fund over another investment.

In Stage 3, the CSA will publish for further comment any proposed requirements that would require delivery of the Fund Facts document to the investor at the point of sale. As part of Stage

[145] Research on investor preferences for mutual fund information, including our own testing of the Fund Facts, indicates investors prefer to be offered a concise summary of key information. A list of the research, studies and other sources that the Joint Forum of Financial Market Regulators reviewed and relied on in developing the POS disclosure framework may be found in Appendix 4 to the proposed framework, published in June 2007. The proposed framework was published in the OSC Bulletin at (2007) 30 OSCB (Supp-4) and may be accessed at http://www.osc.gov.on.ca/en/13146.htm.

[146] See CSA Notice and Request for Comment: Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds, Proposed Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*, Form 81-101F3 and Companion Policy 81-101CP *Mutual Fund Prospectus Disclosure* and Consequential Amendments (2nd Publication) (21 June 2012). The publication is available on the websites of members of the CSA.

3, the CSA will consider the applicability of a summary disclosure document and point of sale delivery for other types of comparable investment fund products.

ii. Client Relationship Model (Phase 2)

The CSA, through their Client Relationship Model Project, phase 2 (CRM2), have a mandate to develop enhanced cost disclosure and new performance reporting requirements for advisors. Initial proposals were published for comment in June 2011, followed by a second publication for comment on June 14, 2012.[147] Among other things, the CRM2 proposals would require advisors to provide to each client:

- at account opening, a description of charges that the client might pay in the course of holding an investment, including trailing commissions, and
- annually, a summary of all charges incurred by the client and all the compensation received by the registered firm that relates to the client's account.

If the advisor received trailing commissions on mutual funds held by a client during the 12 month period, the CRM2 proposals would require the advisor to include in the annual summary of charges the dollar amount of trailing commissions received on those mutual fund investments held by the client during the year.[148] This disclosure would be accompanied by a statement that trailing commissions reduce the amount of the mutual fund's return to the investor.

The CSA expect that this trailing commission disclosure, if implemented, will help mutual fund investors understand and assess the costs and benefits of the services their advisors provide and in so doing, become more informed consumers of those services. This may in turn encourage more effective competition among mutual fund industry participants.

2. Topics for consideration

We intend to monitor the impact of POS and CRM2, and in particular in those areas still to be implemented, to determine whether these initiatives appreciably improve investors' awareness and understanding of mutual fund costs, make them more informed consumers of investment fund products and advice services, and promote effective competition among financial industry participants.

We will also closely monitor the global regulatory reforms discussed in Part VI and their practical effects on financial industry participants in those markets. We appreciate that the full effects of these reforms, particularly the ban on commissions set by financial product providers

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[147] See CSA Notice and Request for Comment on Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and to Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (2nd Publication) (June 14, 2012). The publication is available on the websites of members of the CSA.

[148] The cost reporting requirement proposed under CRM2 is not limited to mutual funds. The proposed disclosure would apply to all investment products that pay commissions that are similar in substance to trailing commissions. This would include advisor compensation on fixed-income securities.

in the U.K. and Australia, may not be known for several years. These will need to be fully understood and thoughtfully considered.

While this monitoring is underway, we intend to use this paper as a platform to begin a discussion on the current mutual fund fee structure with mutual fund industry participants and other financial industry stakeholders to determine whether regulatory responses are needed in Canada to enhance investor protection and foster confidence in our markets.

There may be some changes that mutual fund industry participants could initiate themselves to address the issues we have identified under Part V. There may be some changes that the CSA could initiate. Each of these changes would have a varying degree of impact on investors and the mutual fund industry. And while each of them would offer potential benefits to investors, we also recognize that they may at the same time give rise to practical implications and competing considerations.

Certain of the changes discussed below would impact the mutual fund and/or fund manufacturer directly, while others would impact those who sell the product. We anticipate that any initiative undertaken by the CSA would include a consideration of all investment funds and comparable securities products. We welcome views on these and other potential changes which are not discussed in this paper, including your thoughts on the practical implications and the potential positive and negative outcomes of each option.

Some possible changes include:

i. Advisor services to be specified and provided in exchange for trailing commissions

In order to more clearly align the payment of trailing commissions with the provision of specified services to investors, the purpose of trailing commissions could be defined and disclosed, and a minimum level of ongoing services that advisors must provide to investors in exchange for the payment of these commissions by mutual fund manufacturers could be established.

Under this option, an advisor would be prohibited from collecting a trailing commission if it was determined that the services were not being delivered to investors. In order to substantiate that the prescribed minimum level of ongoing service is being provided, advisors and their dealer firms would have to record and monitor the nature, extent and frequency of the services provided to mutual fund investors.

Such a change in expectations for advisors and their dealer firms would help a mutual fund manufacturer to show how the use of fund assets to pay trailing commissions to advisors benefits the fund and its investors, consistent with the fund manufacturer's duty to act in the best interest of the fund.

ii. A standard class for DIY investors with no or reduced trailing commission

Every mutual fund could have a low-cost 'execution-only' series or class of securities available for direct purchase by investors. The lower management fees of this series or class would reflect that no or nominal trailing commissions are paid to advisors, in light of the lack of advice sought by DIY investors who purchase and hold securities of this series or class. This low-cost series or class of securities could be made available to investors through a discount brokerage, or alternatively, be distributed directly by the mutual fund manufacturer, in which case the mutual fund manufacturer would need to be registered as a mutual fund dealer.

iii. Trailing commission component of management fees to be unbundled and charged/disclosed as a separate asset-based fee

The trailing commission component of a mutual fund's management fee could be "unbundled" and instead charged and disclosed as a separate asset-based fee to the fund. This would enhance transparency of the cost of distribution. In addition, it would make trailing commissions an expense of the fund and limit what it could be used for.

This would be similar to what is done in the U.S., where investment companies that pay trailing commissions to advisors bear an asset-based "12b-1 fee". This fee is distinct from the management fee and is intended to cover the cost of trailing commissions and other distribution-related services. Rule 12b-1 made under the *Investment Company Act of 1940* permits a "12b-1 fee" to be charged to an investment company subject to compliance with various requirements intended to address the conflicts of interest that arise between an investment company and its fund manager when an investment company bears its own distribution expenses. The rule requires that the investment company adopt a written 12b-1 plan describing all material aspects of the proposed financing of distribution and that this plan be approved initially by the investment company's board of directors and separately by the independent directors. The rule specifically requires that, in their consideration of the plan, the directors conclude "that there is a reasonable likelihood that the plan will benefit the company and its shareholders".[149] There is also a requirement that the board receive quarterly reports of all amounts expended under the plan and the purposes for which the expenditures were made. Plans and related agreements are subject to annual approval by the board/independent directors, and any material increase in amounts payable under a 12b-1 plan must be approved by the board, the independent directors, and the fund's shareholders.

This option would require that future increases in the separate asset-based trailer fee charged to a mutual fund be subject to security holder approval in the same way that an increase in the management fee is subject to such approval under current mutual fund rules.[150] Mutual fund manufacturers would then be required to explain to their investors the potential benefits to them of an increase in trailing commissions and allow them to vote on the proposed increase. There could be additional oversight and governance requirements similar to those in the U.S. Specifically, any increase to the trailer fee rate charged to the mutual fund would be subject to review by the fund's independent review committee.

iv. A separate series or class of funds for each purchase option

[149] Rule 12b-1(e).
[150] See note 80.

Either in conjunction with or as an alternative to option iii above, mutual funds could maintain a separate series or class of securities for each available purchase option (i.e. front-end sales charge, DSC, low-load, and no-load). The specific distribution costs incurred by each series or class of mutual fund securities would be allocated only to investors in that specific series or class rather than be borne equally by all investors in the mutual fund. The management fee of each series or class of a mutual fund would therefore be a reflection of each class' respective distribution costs. This would eliminate any cross-subsidization of commission costs by various investors within a mutual fund.

Under this proposal, the management fee of the DSC and low-load series or classes (each hereinafter referred to as a "DSC" class) should be highest as these classes incur the costs of financing the sales commissions the mutual fund manufacturer pays to advisors at the time of the investor's purchase. As the front-end load and no-load series or classes do not incur these costs, we would expect their respective management fees to be relatively lower.

Mutual funds could also provide for the automatic conversion of mutual fund securities held in a DSC series or class to securities of a lower-cost series or class at the end of the prescribed redemption schedule. The rationale for this is that by the end of the redemption schedule, the mutual fund manufacturer has sufficiently recouped the financing costs it incurred to pay the sales commissions to advisors at the time of the investor's purchase of those DSC securities. Accordingly, DSC investors who remain invested in the mutual fund at the end of the redemption schedule should, from then on, benefit from a reduced management fee on their invested assets.[151]

Unlike in Canada, U.S. investment companies are required by law to offer a separate class of securities for each purchase option in order to guard against cross-subsidization between various load-type investors.[152] Furthermore, each class bears its own distinct trailer fee, known as the "12b-1 fee", which is charged separately from the management fee for each class, and which reflects the distinct distribution costs attributable to each class. Because the DSC and low-load sales charge classes in the U.S. bear financing costs, they charge a higher 12b-1 fee, part of which is typically used to defray those financing costs, while the remainder is paid to the advisor. The 12b-1 fee for each of those two back-end classes is typically 1.0%, while the 12b-1 fee for the front-end load class is typically around 0.25%. U.S. regulation effectively caps the 12b-1 fee that may be charged on load classes to 1%[153]and the 12b-1 fee that may be charged on a no-load class to 0.25%.[154]

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[151] The CSA note that there are currently at least two Canadian mutual fund manufacturers that offer a separate series of mutual fund securities for each purchase option, and further automatically switch investors in their DSC series to a lower-management fee series after the expiration of the redemption fee schedule.

[152] Under rule 18f-3 under the *Investment Company Act of 1940*, an open-end investment company may issue more than one class of voting stock, provided that each class has a different arrangement for shareholder services or the distribution of securities or both, and pays all of the expenses of that arrangement. The classes of securities typically offered by U.S. investment companies include Class A (front-end sales charge), Class B (DSC) and Class C (low-load/"level-load" sales charge).

[153] Under sections 2830(d)(2)(E) and 2830(d)(5) of NASD Conduct Rules, an advisor is prohibited from offering or selling the shares of an investment company if the trailing commission (known in the U.S. as the "12b-1 fee"), as

As a result, each class of investment company shares in the U.S. bears a different MER, with the varying 12b-1 fee accounting for the difference in MER. The no-load and front-end load classes have the lowest MERs, while the DSC and low-load sales charge classes have the highest MERs.

U.S. investment companies also must automatically convert an investor's DSC class securities to the lower-cost front-end load class at the end of the redemption schedule.[155] This automatic conversion recognizes that the financing costs associated with the payment of commissions to advisors have been recouped by that time and that investors should no longer be made to indirectly bear those costs. This action is also consistent with the fiduciary duty that applies to the directors of the board of the investment company under the *Investment Company Act of 1940*.[156]

v. Cap commissions

There could be a maximum limit set on the portion of mutual fund assets that could be used to pay trailing commissions to advisors as a way to mitigate the perceived conflicts of interests and the lack of alignment of advisor compensation and services described in Part V. This could be achieved by imposing a cap on the separate asset-based fee discussed in option iii above. Trailing commissions could further be plainly labelled or described as "ongoing sales commissions" in mutual fund disclosure documents, thus providing greater transparency for investors of their main purpose.

In addition or as an alternative to a cap on trailing commissions at the mutual fund level, there could be a cap imposed on the aggregate sales charge, that is, the sum of any initial sales charge and "ongoing sales commission" that could be paid by an individual investor at the account level over the length of a mutual fund investment. Once the cap is reached, the investor's holdings could be automatically converted to a series or class of securities of the mutual fund not bearing an ongoing asset-based sales charge. This would bring certainty to an investor as to the maximum sales commission payable.

The U.S. imposes caps on commissions paid by mutual fund investors. These caps are imposed through a prohibition on advisors who are members of FINRA from offering or selling shares of any investment company if the sales charges described in the prospectus are excessive. "Excessive" is determined by reference to specific sales charge limits prescribed under FINRA's

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disclosed in the prospectus, exceeds a total of 1% per annum. This 1% cap includes a cap of 0.75% on distribution reimbursement fees and a cap of 0.25% on service fees.

[154] Under section 2830(d)(4) of NASD Conduct Rules, an advisor may not describe an investment company as being "no-load" or as having "no sales charge" if the investment company has a front-end or deferred sales charge or pays a trailing commission exceeding 0.25% per annum.

[155] Under rule 18f-3 under the *Investment Company Act* of 1940, an investment company may offer a class with a conversion feature providing that shares of one class of the company will be exchanged automatically for shares of another class of the company after a specified period of time, provided that no sales load, fee or other charge is imposed and the total expenses, including 12b-1 fees, for the target class *are not higher* than the total expenses, including 12b-1 fees, for the purchase class.

[156] Section 36 of the *Investment Company Act of 1940*.

business conduct rules.[157] Those same rules similarly impose limits on trailing commission rates for both load[158] and no-load investment companies.[159]

vi. Implement additional standards or duties for advisors

To assist in mitigating the actual or perceived conflicts of interests that exist in the embedded advisor compensation system and that can result in a misalignment of advisors' interests with those of investors, the CSA could impose a duty on advisors requiring them to put their clients' best interests first, among other things.

As already discussed, investor research shows that most investors assume advisors already have a legal duty to act in their best interests.[160]However, the prevalent regulatory standard in the Canadian common law jurisdictions is that an advisor "shall deal fairly, honestly and in good faith with his or her clients".[161]

The CSA are currently consulting on the appropriateness of introducing a statutory best interest duty for advisors to address potential investor protection concerns regarding the current standard of conduct that advisors owe to their retail clients. We refer you to CSA Consultation Paper 33-403 for a full discussion of the key investor protection concerns that the CSA have identified with the current standard of conduct for advisors in Canada, along with a discussion of the potential benefits and competing considerations in imposing a statutory best interest standard for advisors.[162]

vii. Discontinue the practice of advisor compensation being set by mutual fund manufacturers

In order to address the actual or perceived conflicts of interest that embedded advisor compensation gives rise to, and at the same time improve the transparency, negotiability and fairness of ongoing advisor service costs for investors, measures could be adopted, similar to those being implemented in the U.K. and Australia, under which the payment to advisors of sales and trailing commissions set by mutual fund manufacturers would no longer be permitted. Advisor compensation would no longer be embedded in the management fees charged on mutual funds. Instead, advisors would need to discuss with their client how they will be paid for the sale and ongoing servicing of mutual fund investments and obtain the client's agreement to the proposed fee-for-service model.

Under this model, charges for a mutual fund purchase transaction could be paid in the form of a deduction from the client's investment or separately. Ongoing charges should only be levied where a client is paying for ongoing service, such as a performance review of their investments,

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[157] See note 137.
[158] See note 153.
[159] See note 154.
[160] See note 106 and discussion in Part V under "**2. Potential conflicts of interests at the mutual fund manufacturer and advisor levels** – *ii. Advisor*".
[161] See notes 101 and 102 and the related discussion in Part V under "**2. Potential conflicts of interests at the mutual fund manufacturer and advisor levels** – *ii. Advisor*".
[162] See CSA Consultation Paper 33-403, *supra* note 100.

or where the client makes ongoing pre-authorized purchases. In each case, the client would be clear on what services he or she is entitled to in return for the agreed upon payment.

Under this option, the MER of a mutual fund would represent the operational costs of the fund independent of advisor compensation costs. Investors could then more easily assess and compare the sales and service costs of advisors and the operating costs of mutual funds.

While this option would have the greatest impact on current business models, it would also be the most straightforward way to align the interests of both the mutual fund manufacturers and the advisors with those of investors. Commissions would no longer be a consideration in the sale of the mutual fund product.

VIII. COMMENT PROCESS

We welcome feedback on the issues raised and the potential regulatory options discussed in this paper. We invite all interested parties to make written submissions. Submissions received by April 12, 2013 will be considered.

While the focus of this paper is on mutual funds, the issues we have identified are not unique to mutual fund products. Consequently, we anticipate that any regulatory options the CSA may consider would include a consideration of all investment funds and comparable securities products. Therefore, we encourage comments from participants in the broader investment fund and financial product industry, and not only the mutual fund segment.

Because of the importance of the issues raised in this paper and their implications, the CSA intend to convene a roundtable or technical conference to discuss the issues and the submissions received. The discussion will help the CSA to determine what, if any, regulatory options we may proceed with.

Submissions we receive are not confidential. All comments will be posted on the Ontario Securities Commission website at www.osc.gov.on.ca. Thank you in advance for your comments.

Where to Send Your Comments

Please address your comments to all CSA members, as follows:

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island

Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Please send your comments only to the addresses below. Your comments will be forwarded to the remaining CSA member jurisdictions.

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Annex I

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

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

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

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

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

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

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

typically incur more of these basic costs and therefore have a relatively higher MER than a fund that primarily serves institutional and/or higher net worth investors;

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

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

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

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

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

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

Canada:

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

U.S.:

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[1] See notes 4 and 5 in the Discussion Paper.

[2] Source: Investor Economics. Investment by mutual fund-of-funds, segregated funds, insurance company pools and private investment counsel into mutual funds has been removed.

[3] Source: Investor Economics.

[4] Source: Investor Economics, *ETF and Index Funds Report*, Q2, 2012.

[5] According to the Organization for Economic Co-operation and Development (OECD) Global Pension Statistics, defined contribution plans made up only 3% of total pension plan assets in Canada in 2011. By contrast, defined contribution plans in the U.S. and Australia made up 39.4% and 89.1%, respectively, of total pension plan assets in those countries.

[6] Source: Benefits Canada 2011 CAP Suppliers Directory. Private sector defined contribution plan assets reported.

[7] Not all of the assets in group RRSPs and defined contribution plans would be invested in investment funds though the majority would be.

[8] Source: OSC calculations based on data from Benefits Canada *2011 CAP Supplier Directory* and Investor Economics *2012 Household Balance Sheet*.

- The U.S. mutual fund market, with $12.8 trillion (CAD) in assets under management at year-end 2011, remains the largest in the world, accounting for 49% of mutual fund assets worldwide;[9]
- It has the largest number of mutual fund manufacturers, of which the 10 largest hold 53% of all U.S. mutual fund assets under management;
- U.S. mutual funds are on average very large (average size is $1.58 billion CAD);
- Distribution of U.S. mutual funds is less reliant on advisors than in Canada:
    - Employer-sponsored retirement plans (401(k) plans/defined contribution plans) figure significantly in the distribution of mutual funds to investors. Mutual funds distributed through this channel are typically no-load mutual funds.[10] As at the end of 2011, 21% of U.S. mutual fund assets were held by investors through defined contribution plans;[11]
    - In 2011, of the U.S. households owning mutual funds outside employer-sponsored retirement plans, 54% owned mutual funds purchased through an advisor, and 32% owned mutual funds purchased through the direct market channel (i.e. from the mutual fund manufacturer directly or through a discount broker);[12]
- Outside of employer-sponsored retirement plans, 11% of mutual fund assets as at year-end 2011 were held by institutional investors;[13]
- Trailing commissions (12b-1 fees) on U.S. funds are capped by law to no more than 1% per annum and trailing commissions on no-load funds are capped by law to no more than 0.25% per annum;[14]
- Money market funds (which have low MERs) weigh considerably into the overall asset mix of U.S. mutual funds, accounting for 23% of mutual fund assets under management as at the end of 2011. Equity funds and balanced funds (which have higher MERs) accounted for 54% of mutual fund assets under management at the end of 2011;[15]
- Index funds (which tend to have lower MERs than actively managed funds) accounted for approximately 9% of mutual fund assets under management.[16]

U.K.:

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

[9] Investment Company Institute, *2012 Investment Company Fact Book*, 52nd Edition.
[10] No-load mutual funds in the U.S. are typically less expensive than no-load mutual funds in Canada as their trailing commissions (12b-1 fees) are capped by law to no more than 0.25% per annum (see note 155 in the Discussion Paper), whereas Canadian no-load funds may pay trailing commissions of up to 1.50%,
[11] Investment Company Institute, *supra*, note 9.
[12] Investment Company Institute, *Profile of Mutual Fund Shareholders, 2011* (February 2012). Note that mutual funds acquired directly from the mutual fund manufacturer or through a discount broker are typically no-load funds whose trailing commissions (12b-1 fees) are capped by law to no more than 0.25%.
[13] Investment Company Institute, *supra*, note 9.
[14] See notes 153 and 154 in the Discussion Paper.
[15] Investment Company Institute, *supra*, note 9. Note that in the U.S., balanced funds are called hybrid funds.
[16] *Ibid.*
[17] The U.K. fund market is open to foreign domiciled UCITS funds subject to compliance with UCITS regulation.

- Distribution of U.K. mutual funds is less reliant on advisors than in Canada:
  - Fund platforms[19] accounted for 41% of gross retail fund sales in 2011.[20]
  - Direct distributions to investors by mutual fund manufacturers accounted for 13% of gross retail fund sales in 2010.[21]
- Pension funds are the largest U.K. institutional client category, accounting for 50.3% (£1.2 trillion) of U.K. institutional client assets. Defined contribution plans account for approximately 36% of those pension fund assets, and play a role in the distribution of mutual funds;[22]
- Trailing commissions on U.K. mutual funds (pre-RDR reforms) typically don't exceed 1% per annum;[23]
- While equity funds accounted for 53% of U.K. mutual fund assets under management as at the end of 2011, approximately 11% of those equity fund assets (or 6% of all U.K. mutual fund assets under management) were held by passively managed index funds (which tend to have lower MERs).[24]

Australia:

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

UCITS funds can be marketed to retail investors within any European Union member state.

[18] European Fund and Asset Management Association (EFAMA), Investment Fund Industry Fact Sheet, December 2011.

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

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

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

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

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

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

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

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

- Superannuation funds drive growth in the Australian fund management industry, accounting for approximately 70% of mutual fund assets under management;[27]
- The fund market in Australia is open to foreign-domiciled funds.[28]
- More than half of Australian funds are classified as no-load funds (which generally have lower MERs than load funds);[29]
- Trailing commissions on Australian funds (pre-FoFA reforms) typically don't exceed 0.50% per annum[30], and are the lowest of the four countries featured in the table.

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

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

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

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

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

Notes:

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