No advice on mutual fund investing? No trail after June 1, 2022, but challenges ahead

September 30, 2020

On September 17, 2020, the Canadian Securities Administrators (CSA) released final rule amendments prohibiting the payment of trailing commissions by fund managers to dealers that do not provide advice to investors in publicly offered mutual funds, such as discount brokers (order execution only (OEO) dealers) and dealers that transact in publicly offered mutual funds with certain "permitted clients" and hence do not provide advice to those clients. The trailing commission ban also prohibits affected dealers from soliciting and receiving such payments. The final rule amendments will come into force on December 31, 2020 (subject to government approvals) and will be effective on June 1, 2022. The effective date is intended to give industry participants time to carry out the necessary actions and systems changes to ensure compliance, some of which are described below.

The amendments were made to National Instrument 81-105 *Mutual Fund Sales Practices* and its Companion Policy, with related amendments made to National Instrument 41-101 *General Prospectus Requirements* and National Instrument 81-101 *Mutual Fund Prospectus Disclosure.* Together with the enhanced conflict of interest provisions included in the client focused reforms to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* coming into force on June 30, 2021, these amendments are the CSA's policy response to the regulatory concerns they have expressed regarding the payment of commissions to dealers who do not provide advice to investors in mutual funds. They represent the final chapter in the CSA's "embedded fees" project, although we await the Ontario Securities Commission's final rules in respect of distribution in Ontario of deferred sales charge securities of mutual funds.

What does the CSA expect before June 1, 2022?

Securities regulators have reached out to many fund managers in connection with the release of the final amendments to provide notice of the changes and to encourage registrants to take steps to address the implementation of the ban in advance of June 1, 2022. Some fund managers are also being asked to respond to certain questions by December 2020, which appear designed to enable the CSA to understand any implementation issues.

Regulators have indicated they expect OEO dealers and other dealers that do not provide advice, along with fund managers, to facilitate all necessary switches, conversions and/or redemptions of trailing commission-paying mutual fund securities, without cost to the investor (such as the payment of a deferred sales charge (DSC)), to comply with the ban. The CSA suggest that affected dealers can also comply with the ban by working with their clients who hold trailing commission securities to move those securities to an account with a dealer that does provide advice, in which case the trailing commissions can continue to be paid. Investors may continue to hold these investments in such circumstances, if trailing commissions are paid to the dealer who provides advice and not the OEO dealer after the effective date of the ban.

Regulators have also encouraged managers and dealers to consider how to change pre-authorized purchase plans at OEO dealers that provide for the periodic purchase of mutual fund securities subject to a trailing commission.

To facilitate switches out of trailing commission series of funds, the amendments include a welcome exemption from the Fund Facts delivery and ETF Facts delivery requirements by dealers in respect of those switches. The exemption from the Fund Facts delivery and ETF Facts delivery requirements comes into effect on December 31, 2020, to facilitate switches well in advance of the effective date for the ban.

It is clear that regulators expect fund managers to determine which investors in their funds acquired those securities from dealers that do not provide advice and once the ban is effective, cease to pay trailing commissions to those dealers. The CSA has acknowledged, at least in part, the difficulties facing fund managers in making this determination. In response to comments that fund managers may not know whether a suitability determination was required to be made in connection with a mutual fund purchase, the amendments include a knowledge qualifier clarifying that the prohibition against the payment of trailing commissions by managers to dealers only applies if the fund manager knows, or ought reasonably to know, that the dealer was not required to make a suitability determination.

As an example, the CSA note that there may be circumstances when multiple affiliated dealers, including a full-service dealer and an OEO dealer, use a single dealer code to place orders for mutual funds with fund managers. In these circumstances, fund managers may not be able to determine whether a mutual fund purchase order originates from the full-service dealer, who was required to make a suitability determination, or from the affiliated OEO dealer, who was not required to make a suitability determination.

Managers will need to take reasonable steps in order to ensure that trailing commissions are only being paid to dealers in accordance with the ban, including the implementation of applicable policies and procedures. The inclusion of the knowledge qualifier will provide some protection for managers who unknowingly pay a trailing commission to a dealer who was not required to make a suitability determination, despite taking reasonable measures.

Challenges for dealers and fund managers to be addressed before June 1, 2022

A number of challenging issues remain to be navigated by managers and dealers, alike. We anticipate that many of these issues cannot be resolved by a simple "one-time" fix and processes will need to be put in place to deal with this issue on an account-by-account basis until the effective date of the ban. Preliminary considerations include:

- Many fund managers created Series D securities, with lower trailing commissions, for their funds that would be available for OEO dealer platforms. Given Series D securities were generally distributed by OEO dealers only, we expect that the amendments will mean the end for these Series D securities, unless they are amended to switch off payment of trailing commissions. Dealers and fund managers will likely be able to identify and address existing client holdings in Series D securities, including whether to simply cease trailing commission payments in respect of these securities or to switch investors to a no-trailing commission series. Fund managers may wish to consider terminating Series D securities by way of a redesignation into another series, which does not pay a trailing commission. Fund managers will need to determine when to cease distribution of Series D securities and to consider disclosure about the changes they propose to make before the implementation date.
- Challenges will arise for managers while identifying and addressing what to do about Series A securities (as well as other similar trailing commission series) held with an OEO dealer. In particular, when the OEO dealer has executed those trades through its affiliated full service dealer or the OEO dealer is part of the same entity as the full service dealer and therefore the fund's records show the full service dealer as the dealer of record (without distinction).
- Can a fund manager determine which full service dealer dealt with the investor as a "permitted client" and therefore did not make a suitability determination? It may be decided this will be the sole responsibility of the dealer to identify these clients and give instructions to the fund manager in respect of that client.
- Which mutual fund series will be appropriate for OEO dealer platforms – the manager must not pay a trailing commission, but what will be the right fee structure for such securities and does the manager have non-trailing commission paying series of its funds to make available on OEO platforms?
- Will OEO dealers modify their fee structures in order to receive fees directly from their clients who wish to invest in mutual funds to reflect that there is a cost to the OEO dealer in making such securities available on their platforms?
- How can switches or conversions be carried out – with client consent, on notice to clients or in some other way? Fund and account documentation will need to be examined to determine the ability to make these changes. Who will initiate the switch or conversion – the client, the dealer or the fund manager or a combination?
- It is clear that clients cannot be charged for the costs of any change out of trailing commission series, however, what arrangements can be put in place for sharing the implementation costs between dealers and fund managers?
- Is the CSA's suggestion for OEO dealers to work with clients to move their mutual fund holdings to a full service dealer practical? This means the client will hold a higher fee series of the fund and trailing commissions will be paid, but that advice will be given to the client. Under what circumstances will this be a viable option?

The amendments raise significant operational and implementation challenges for both dealers and managers that will need to be addressed before the ban comes into force

on June 1, 2022. We expect that many managers will begin thinking about whether any of these changes should be implemented in connection with their next prospectus renewal, as some changes will likely involve changes to prospectus disclosure. The fund managers who received an email from their provincial regulators with questions must provide the information to the CSA by December 16, 2020. The answers to the questions may not be straightforward and managers may need to correct their answers once they have more practical experience in working to implement the ban before June 1, 2022.

Please contact your usual BLG lawyer or any of the listed below if you have any questions about the implications of the rule amendments for your firm and its operations, including how you should answer the CSA's questions.

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