Mutual Fund Embedded Compensation: The Expected, The Dramatically Unexpected And What's Next?

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As expected, on September 13, 2018, the Canadian Securities Administrators (the CSA) published draft rules intended to implement the policy direction reached earlier this year on mutual fund fee reform, also known as the "embedded compensation" project. The draft rules are written as amendments to National Instrument 81-105 *Mutual Fund Sales Practices,* together with related amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* and National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations.*

The draft rules are intended to have two primary effects once adopted:

- Mutual fund managers will no longer be able to pay dealers any form of sales commission at the time of acquisition of mutual fund securities. This is intended to wipe out the "deferred sales charge", "low load" and "level load" methods of acquiring mutual funds. Instead clients will agree with their dealer and individual advisor, whether or not they will pay any form of commission to the dealer/individual advisor.
- Mutual fund managers will no longer be able to pay discount brokers (as well as any other dealer that is not required by securities legislation to make a suitability determination in respect of the client) any form of trailing commission. Instead, discount brokers, and the other dealers that provide no advice, will be expected to charge their clients directly for the services they provide.

Implicit in this policy development (but largely unstated) is the expectation that mutual fund fees will be reduced and clients will take back the power to make decisions about what they will pay dealers and advisors.

However, also on September 13, 2018, the Ontario Minister of Finance released a dramatically unexpected press release. The press release stated simply that the Ontario government "does not agree" with the CSA proposals relating to the ban on DSC purchase options "as currently drafted". It is widely understood that the Ontario government was objecting to the proposed ban on DSC sales of mutual funds explaining that this payment option has allowed Ontario families and investors to save towards retirement and other financial goals and should not be interfered with. The

Ontario government's views on the CSA's proposals regarding trailing commissions paid to discount brokers and others remain unknown at this time.

Implications for Industry Participants

Notwithstanding the end of summer drama in Ontario regulatory circles, it is clear that the CSA, including the Ontario Securities Commission, are continuing with the consultation on the draft proposed amendments. Comments on the proposed amendments to NI 81-105 are due on December 13, 2018. We consider it important to provide input to the CSA, not just on what is proposed (and readers should note that there are other more technical amendments proposed to NI 81-105), but also on what is not proposed, but questioned. In addition to publishing draft rules designed to achieve the significant mutual fund fee changes, the CSA are asking for input into a number of modernization amendments to NI 81-105, including folding the concepts behind NI 81-105 into NI 31-103. In our view, modernization of NI 81-105 is long overdue, given that it was written for a specific time and to address specific issues inherent in the mutual fund industry practices of the late-1990s. If nothing else, much guidance has been provided by the staff of the CSA since the adoption of NI 81-105 and we consider it high time that that guidance be published for comment by way of CSA policy.

It is also vital that industry participants consider carefully the "client focused" reforms published in June 2018, and the commentary and guidance around payment of trailing commissions by fund managers and the conflicts of interest inherent on dealers accepting payment of such commissions. We consider that it will be very difficult indeed to put into practice some of the guidance of the CSA around firms addressing conflicts of interest in the best interests of clients. What does this really mean when a dealer firm wishes to accept trailing commissions in respect of its distribution of mutual fund securities? What must a dealer and an individual advisor do to avoid or manage these conflicts of interest, particularly given statements about the difficulties of managing conflicts of interest through disclosure alone? Collectively, the client focused reforms and the NI 81-105 amendments will result in a significant transformation of how managers and dealers, as well as other industry participants, manage their business relationships. Comments on the client focused reforms are due by October 19, 2018.

We urge firms to consider the proposed transitional provisions, as we expect there will be considerable challenges in operationalizing the following proposed rule changes:

- A year transition from adoption of the rule until the effective date
- No new DSC sales after the effective date
- DSC schedules may continue to run down
- No trailing commissions payable to discount brokers on and after the effective date (discount brokers will be expected to "move" clients to a trailing commission-free class of securities of the applicable funds, although no guidance is provided on how this could be accomplished).

Finally, we consider it important to question the CSA's proposals to ban trailing commissions to be paid to "other" dealers that are not required by securities legislation to make a suitability determination in respect of the client, given the considerable lack of clarity as to the meaning and application of that concept.

What's Next

Following the close of comment periods for both the client focused reforms and the mutual fund fee proposals, we expect there to be a further period of regulatory introspection — one that involves governments, at least in Ontario, but also potentially elsewhere. All that can be said about "what's next" is that this period of intensive regulatory consideration of Canada's financial services industry is definitely not over.

We would be pleased to discuss the ways you can learn about and analyze the collective reforms inherent in the client focused reforms and the mutual fund fee reforms. We plan to provide our comments on both proposals and would be pleased to work with you on providing comments.

For further information, or to better understand the direct impact these proposals will have on your business, please contact any of the authors of this bulletin, or any member of BLG's Investment Management Group.

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