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May 9, 2016

VIA EMAIL: rday@osc.gov.on.ca

Robert Day
Senior Specialist, Business Planning
Ontario Securities Commission
20 Queen Street West
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Toronto, ON M5H 3S8

Dear Mr. Day:

**Re: Ontario Securities Commission
Draft Statement of Priorities for 2016-2017**

On behalf of Advocis, The Financial Advisors Association of Canada, we are pleased to provide our comments to the Ontario Securities Commission ("OSC") in regards to its draft statement of priorities for 2016-2017 (the "SOP").

About Advocis

Advocis is the largest and oldest professional membership association of financial advisors and planners in Canada. Through its predecessor associations, Advocis proudly continues over a century of uninterrupted history serving Canadian financial advisors and their clients. Our 11,000 members, organized in 40 chapters across the country, are licensed to sell life and health insurance, mutual funds and other securities, and are primarily owners and operators of their own small businesses who create thousands of jobs across Canada. Advocis members provide comprehensive financial planning and investment advice, retirement and estate planning, risk management, employee benefit plans, disability coverage, long-term care and critical illness insurance to millions of Canadian households and businesses.

As a voluntary organization, Advocis is committed to professionalism among financial advisors. Advocis members adhere to our published Code of Professional Conduct, uphold standards of best practice, participate in ongoing continuing education programs, maintain professional liability insurance, and put their clients' interests first. Across Canada, no organization's members spend more time working one-on-one with individual Canadians on financial matters than do ours. Advocis advisors are committed to educating clients about financial issues that are directly relevant to them, their families and their future.

Comments on 2016-2017 OSC Priorities

Advocis continues to support the OSC's mandate of protecting investors from unfair, improper or fraudulent practices and fostering fair and efficient capital markets and confidence in those markets. We

believe this mandate must be exercised through the promulgation and enforcement of effective regulations that achieve policy objectives but which are not overly burdensome on market participants.

The year ahead will see a flurry of regulatory activity, including: the final stage of CRM-2; pre-sale delivery of Fund Facts; the development of ETF Facts; final rules for the proposed standardized risk classification methodology for investment funds; and the next stage of the mutual fund fee and best interest duty consultations. These are just some of the OSC's and CSA's active initiatives – simultaneously, other regulators will be pursuing their own projects. For example, the MFDA is working towards developing ETF proficiency and CE requirements, and there are regular changes to the anti-money laundering and anti-terrorist financing requirements of FINTRAC. Addressing each of these will require significant effort from advisors and dealers to ensure their successful implementation, and the collective burden can add up quickly.

We are encouraged that the OSC recognizes the challenge of this ever-increasing regulatory burden on market participants; the SOP reiterates the OSC's commitment to identifying opportunities to avoid or reduce undue burdens and seeking opportunities to streamline regulatory measures. As a core tenet of this commitment, we believe that every regulatory initiative should undergo a rigorous cost-benefit analysis to ensure their efficacy in producing the desired outcome, without hindering the competitiveness of Ontario's capital markets.

We now turn to comments on specific initiatives identified in the SOP. For convenience, the headings below reflect those used in the SOP.

Goal 1 – Deliver strong investor protection

- Reforms to NI 31-103, including a Statutory Best Interest Duty

The OSC is continuing its research into reforms to NI 31-103, including the possible imposition of a statutory best interest (or fiduciary) duty on advisors and dealers. Through the Canadian Securities Administrators, it launched the next phase of the consultation in April 2016.[1] We will continue to be an active voice in this dialogue, but we believe that it is important this debate be framed correctly: the question is not whether a client-advisor relationship *can* be a fiduciary one; it is whether all such relationships *must* be fiduciary, regardless of the circumstances surrounding that relationship.

We reiterate our position from our February 2013 submission:[2] a fiduciary relationship demands the highest standard of care in law, requiring the fiduciary to act solely in the beneficiary's interests, without regard to one's own. It is only appropriate where there is a significant imbalance of power between the parties: the beneficiary of the duty is characterized as vulnerable, there is significant information asymmetry and the fiduciary acts as a caretaker on the client's behalf.

The Supreme Court of Canada has stated that fiduciary obligations must be reserved for situations that are truly in need of the special protection that equity affords. These situations have been clearly set out by courts, through the articulation of key principles in case law by the nation's leading jurists. This

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[1] http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20160428_33-404_proposals-enhance-obligations-advisers-dealers-representatives.htm.

[2] http://www.advocis.ca/regulatory-affairs/RA-submissions/2013/Advocis-Response-to-CSA-Consultation-Paper.pdf.

common law approach strikes the right balance – it recognizes that retail investors in the securities marketplace are not homogenous and it gives clarity to the situations which invoke a fiduciary duty, all while protecting the most vulnerable that are in greatest need of its protections.

A statutory best interest duty would serve as a blunt instrument: by making all advisor-client relationships presumptively fiduciary, it would likely increase the volume of litigation brought against advisors and dealers (including nuisance claims), create enormous new compliance obligations that could overwhelm the industry and cause significant uncertainty regarding the interpretation of the duty. As a result, financial advice would become less accessible to consumers, which runs counter to the public policy objective of promoting personal financial independence and retirement readiness.[3]

Moreover, we urge the OSC to be cautious in using the phrase "best interest": we understand the populist allure of saying, colloquially, that an advisor should act in a client's best interests – no layperson could argue with a statement like that on its face. However, as you are aware, the legal interpretation of a best interest standard is not so simple. We all wish to improve the industry, including the enhancement of consumer protection – but we believe the way forward is through the professionalization of the advisory industry, with higher baseline and ongoing standards, rather than an overarching statutory duty.[4]

Further, we believe that the OSC's consultation on a statutory best interest duty is in direct conflict with the Government of Ontario's own active consultation. As you are aware, the government has commissioned an Expert Committee to review financial advisory and planning policy alternatives. Consideration of a statutory best interest duty is a core and fundamental part of the Expert Committee's deliberations. Following the release of the Expert Committee's final report, expected this fall, the government will determine its chosen policy direction.

As an agency of the government, the OSC should respect the government's wishes and the work of the Expert Committee. Consequently, it should suspend its own consultation until the Expert Committee process is completed and the government determines how it wishes to proceed. Ultimately, it is the

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[3] Time and time again, studies have proven that a key component of financial independence is working with a financial advisor. For example, in 2012, Professor Claude Montmarquette and Nathalie Viennot-Briot of the Centre for Interuniversity Research and Analysis on Organizations released Canada's largest and most scientific independent study to date on the value of financial advice, entitled *Econometric Models on the Value of Advice of a Financial Advisor*. The study provides strong evidence of the connection between financial advice and the accumulation of financial wealth. Amongst its findings:

(i) Advice has a positive and significant impact on wealth accumulation, relative to non-advised persons. Households with four-to-six year long advisory relationships accumulated 58% greater assets, and households with 15+ year advisory relationships accumulated 173% greater assets.

(ii) Advice is not exclusively for the wealthy. The median initial investment for the over 10,000 advised households in the study was only $11,000.

(iii) Advice positively impacts savings and retirement preparedness. Advisors played a key role in improving the savings behaviour of households in the study.

(iv) Advice positively impacts levels of trust, satisfaction and confidence in financial advisors. That is, by working with an advisor, households are able to see directly the value of advice.

We would be pleased to provide the OSC with copies of the study upon request.

[4] Our *Professions Model* (http://www.advocis.ca/raisethebar/) was launched in 2013, with the goal of increasing professional standards for financial advisors and planners. Since then, much debate has taken place about how the advisory sector should be reformed in the Province of Ontario. This includes the formation of an Expert Committee to Consider Financial Advisory and Financial Planning Policy Alternatives. Advocis remains an active participant in the ongoing dialogue.

government that sets policy direction and it is the role of agencies such as the OSC to serve the will of that government.

- <u>Embedded Fees in Mutual Funds</u>

The CSA-commissioned studies

The CSA has commissioned two research reports to help it assess whether regulatory changes are needed in connection with the embedded compensation option that currently exists for mutual funds.

The first report was completed by the Brondesbury Group in June 2015 (the “Brondesbury Report”). It asserts that mutual fund fees and commissions are negatively affecting investor returns, stating that there is “conclusive evidence that commission-based compensation creates problems that must be addressed.” Unfortunately, there is a near total lack of data in the Brondesbury Report on the Canadian mutual fund industry. Large parts of the report amount to a literature review of 12b-1 fees in the U.S., complemented by discussions of various international distribution trends – ranging from mutual fund sales by Spanish banks to the nature of advice provided by “commission-motivated” life insurance agents in India – but there is precious little data on Canadian fund distribution.

The second report is by Professor Douglas Cumming, Professor and Ontario Research Chair at the Schulich School of Business at York University (the “Cumming Report”). Released in October 2015, the Cumming Report found that sales and trailing commissions are positively correlated with mutual fund sales, and increasing levels of commissions are negatively correlated with future fund performance. While it is self-evident that fees reduce investment returns, the Cumming Report does not include any analysis of the value consumers receive in return for those fees, in the form of professional advice and investment management. Embedded fees allow millions of Canadians to access professional financial advice, and multiple studies have demonstrated that consumers who receive financial advice are better off than those that do not.[5,6]

What the Cumming Report does not do, and what policymakers must do, is study this issue from the consumer's perspective: how does the cost that consumers pay in the form of commissions compare to the value that consumers receive from accessing professional financial advice? If commissions were to be banned, what is the consumer’s willingness to pay, compared to the cost of providing that advice? Consequently, how many consumers will no longer be able to access advice, and what is the impact on their overall financial health? Only then can we understand how consumer outcomes would be truly impacted by the elimination of this important option.

The Cumming Report also does not take into account the fees paid by consumers directly to advisors in a fee-based arrangement, as the data comes directly from the managers; unlike embedded commissions, direct-paid fees are not deducted "at source" and therefore do not show up in the dataset. There is a cost to deliver any product, whether it be through an embedded cost or a fee-based arrangement, and

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[5] *Supra*, note 3.

[6] PricewaterhouseCoopers' 2014 study *Sound Advice: Insights into Canada's Financial Advice Industry*, which shows that advised households save up to 4.2 times more than non-advised households (http://www.advocis.ca/sareport.pdf).

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that would have to be accounted for in order to make a proper "apples-to-apples" comparison of the consumer's experience.

Moreover, policymakers must recognize that a fee-based arrangement could have a greater negative effect on consumers' investment returns compared to trailer fees, especially for consumers with relatively smaller amounts to invest. That is, for smaller portfolios, the aggregate fee in a fee-based arrangement could be greater than that resulting from a percentage trailer. Considering that 80 per cent of Canadian households have less than $100,000 in financial assets,[7] the typical one per cent trailer could be a more economical choice than paying several hundreds of dollars per hour on a fee-based model.

The key, though, is that this is a choice that should be left up to consumers: consumers should be able to choose the compensation model that is best suited for their financial needs and position. A heavy-handed outright elimination of the embedded fee option, ostensibly in response to consumer protection concerns, could make financial advice unaffordable for millions of Canadians and leave consumers worse off as a result.

New insights from Pierre Lortie

In April 2016, a new paper authored by Pierre Lortie, Senior Business Advisor at Dentons Canada LLP, and released by the University of Calgary's School of Public Policy asserts that banning embedded compensation from the sale of financial products would constitute "a massive setback for individual wealth accumulation and, ultimately, for the economy."[8]

Lortie notes that the United Kingdom, after banning third-party commissions under its Retail Distribution Review ("RDR"), must now address the unfortunate result: an "advice gap" in which fewer people can even afford professional financial advice. Predictably, the lower-income segments of the U.K.'s population – those who often need financial advice the most – quickly fell into this gap. More startling, however, is the fact that many middle-class British households soon followed them. By eliminating the bundling of product and advice, the commission ban also drove down the number of advisors, which made it even costlier to access advice.

Today in the U.K., the advice gap is so large and entrenched that it cannot be bridged by the natural operation of the market. Consequently, the U.K. government has been forced to get into the business of providing financial advice to its own citizens. At present, this takes the form of online advice services which have a dismal uptake rate among the general population; a government voucher system for advice has also been proposed.

Lortie's concern (which we echo) is that a commission ban could create a similar advice gap in Canada. Lortie notes that 80 per cent of Canadian households own less than $100,000 in investible financial assets – a fact which would effectively disqualify them as potential clients in the eyes of many U.K. advisors. Post-RDR, the compensation models in the U.K. mean that the average investable assets

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[7] *Ibid.*

[8] Pierre Lortie, "A Major Setback For Retirement Savings: Changing How Financial Advisers Are Compensated Could Hurt Less-Than-Wealthy Investors Most," University of Calgary, The School of Public Policy: SPP Research Papers, vol. 9, issue 13, April 2016, p. i.

required to engage an advisor has risen from £34,660 in 2010 to roughly £69,700 in 2015 (or about $135,500 Canadian).

In Advocis' view, the embedded compensation model should remain an option for those consumers who wish to access advice in that manner. Eliminating this option would cut off the ability of many consumers (particularly low-income consumers) to access professional advice and investing services. Concerns normally associated with embedded compensation, such as its potential to inappropriately influence the advice dispensed, can be effectively addressed by improving transparency and disclosure through CRM-2 and by increasing professional standards as envisioned in our *Professions Model*, a view echoed by Lortie. We encourage the OSC to keep open a dialogue with stakeholders, including Advocis, as this issue develops in the upcoming year.

- Completing the Risk Classification Methodology and ETF Facts initiatives

We are supportive of the CSA's efforts to complete its interrelated initiatives on i) a mandated CSA risk classification methodology to improve the comparability of risk ratings of investment funds; and ii) a summary disclosure document for ETFs.

Risk classification methodology

As we wrote in our March 2016 submission regarding the risk classification methodology,[9] we believe the revised proposal is a significant improvement over the initial 2013 proposal – particularly through the retention of the current five category structure and the adoption of the IFIC standard deviation bands, which will avoid the needless reclassification of thousands of funds that could render millions of client accounts offside when no actual changes have occurred to the funds themselves.

However, we caution that consumers should not be overly reliant on any one source of information before making an investment decision. We have long stated that the best role for a summary document such as Fund Facts is as a springboard to a deeper conversation between a client and his or her advisor about the opportunities and risks that a particular investment fund represents, and how that fund fits into the client's overall financial framework – being mindful of the client's particular financial position and objectives. It is through a holistic analysis, rather than the purchase of any one product, that sets consumers on the path to achieving their financial goals.

We express further concerns about (i) the limitations of using volatility as the sole measure of risk; (ii) the inappropriateness of historic volatility to measure the risk of bond funds; (iii) conflating the categorization computed by the proposed methodology with suitability, particularly when many advisors are constructing portfolios using modern portfolio theory; (iv) particular nuances of fund wraps; and (v) the proposed transition timeline. We ask that the OSC consider these concerns before promulgating the final rules for the risk classification initiative.

[9] http://www.advocis.ca/regulatory-affairs/RA-submissions/2016/160309-CSA-MF-Risk-Classification-Methodology-v4.pdf.

ETF Facts

We replied to the CSA's consultation on ETF Facts in September 2015.[10] In our view, development of ETF Facts is the logical next step in consumer protection, as ETFs have grown beyond their roots in institutional trading, gaining widespread interest from retail investors. This shift puts ETFs firmly in the mainstream – and their regulation should reflect the needs of today's users. We believe that ETF Facts will be an important tool for consumers, providing them with key information in an accessible format.

In developing the rules for ETF Facts, the OSC must be mindful of issues that are particular to ETFs and which are therefore not captured in the Fund Facts model that serves as the template for ETF Facts. These include dealing with odd lots, bid/ask spreads, premiums and discounts to net asset value, liquidity and distribution characteristics.

In regards to timing, we believe that it would be preferable to delay the implementation of the pre-sale delivery of Fund Facts until ETF Facts is launched and both are operating on a post-sale delivery basis. Once both Fund Facts and ETF Facts are established and functioning well, the CSA could select a uniform switchover date upon which both documents would require pre-sale delivery. Whenever possible, investor protection should not play out on an uneven playing field.

Goal 2 – Deliver responsive regulation

- Post-implementation analysis of POS and CRM-2

We fully endorse the OSC's plan of conducting a post-implementation analysis of the POS and CRM-2 initiatives. We have, as our collective goal, the improvement of the consumer's experience with the financial services industry, and it is through post-implementation analyses that we can determine whether the regulatory initiatives aimed at improving these experiences are actually accomplishing their intended goals.

We are particularly interested in the impact of CRM-2; the final phase of cost and performance reporting will usher in an unprecedented new era of transparency that will allow consumers to fully comprehend the fees that they pay, so that they can make their own judgment as to the value of the services they receive. This empowering of consumers will undoubtedly spark some sensitive conversations, but we believe this will be a boon for professional advisors who are able to articulate the unique value proposition they offer.

Our position has consistently been that before the OSC or CSA launch into disruptive initiatives such as the banning of embedded compensation or the imposition of a statutory best interest duty, they should first allow CRM-2 to be fully absorbed by the marketplace, analyze the behavioural changes that it will bring about (from both industry and consumers) and only then determine what further regulatory action is required.

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[10] http://www.advocis.ca/regulatory-affairs/RA-submissions/2015/150916-Submission-re-ETF-Facts.pdf.

Goal 5 – Be an innovative, accountable and efficient organization

- Cooperative capital markets regulatory system

We are pleased that the OSC has reiterated its support for the transition to the Cooperative Capital Markets Regulatory System ("CCMRS"). Advocis has voiced its support for this initiative as a long-anticipated and overdue restructuring of the securities regulatory landscape in Canada.[11]

However, we have voiced our concern that, based on the latest version of the draft legislation, the proponents of the CCMRS are leaving the door open to using regulations to enact major changes to well-established securities laws – such as in regards to the legal regime for segregated funds, or the duty of care applicable to registrants. These are fundamental matters and if they are to be changed, they should be done so only after considered debate, widespread stakeholder feedback, and ultimately, legislative amendment.

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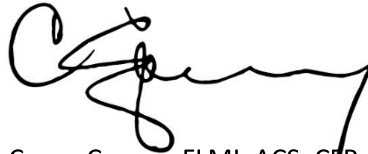
Advocis looks forward to working with the OSC as it works towards the objectives identified in the SOP for the coming year and beyond. We would be pleased to address any concerns or questions that you may have; please contact the undersigned or Ed Skwarek, Vice President, Regulatory and Public Affairs, at 416-342-9837 or eskwarek@advocis.ca.

Sincerely,



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[11] http://www.advocis.ca/regulatory-affairs/RA-submissions/2016/151223-Submission-to-CCMRS-re-Revised-Draft-CMA-v2.pdf.