Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels

Contact: Ken Woodard
Director, Communications & Membership Services
Phone: (416) 943-4602
E-mail: kwoodard@mfda.ca

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MFDA Bulletin

Policy

For Distribution to Relevant Parties within your Firm

MFDA Bulletin #0748-P Discussion Paper on Expanding Cost Reporting – Summary of Comments

On April 19, 2018, the MFDA published, for a 90-day public comment period, a Discussion Paper on Expanding Cost Reporting, the purpose of which was to promote further discussion in respect of expanding cost reporting requirements under MFDA Rule 5.3.3 (see Bulletin #0748-P). The 2018 Discussion Paper follows up on the initial Consultation Paper, published in 2015 (see Bulletin #0671-P), and a related review performed by MFDA staff in 2017 (see Bulletin #0740-C).

The MFDA received 27 submissions in response to the request for comments. A summary of comments received and next steps is attached as Schedule "A" to this Bulletin.

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SCHEDULE "A"

MFDA Bulletin #0748-P *- Discussion Paper on Expanding Cost Reporting*

Background

On December 3, 2014, MFDA Members approved MFDA Rule 5.3.3 (Report on Charges and Other Compensation), which requires Members to provide each client with an annual summary of charges paid by the client and compensation received by the Member. Rule 5.3.3 directly adopts expanded client reporting obligations made under National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("NI31-103"), which came into effect on July 15, 2016.

Since that time, Members, Approved Persons and other stakeholders have asked the MFDA to consider expanding requirements under Rule 5.3.3 to include costs/charges which are not paid to the Member (e.g. management fees and fund operating costs). On December 18, 2015 the MFDA issued Bulletin #0671-P: Report on Charges and Compensation – Consultation Regarding Cost Reporting for Investment Funds (the "Initial Consultation Paper"), the purpose of which was to seek stakeholder input on expanding requirements under Rule 5.3.3.

The majority of comments received from the initial consultation supported expanding cost reporting to include total costs paid by clients, including costs and compensation paid to other parties. However, commenters also suggested that the MFDA wait to determine the outcome of the CRM2 amendments before proposing further changes. Additionally, commenters advised that the expansion of cost reporting would require amendments to NI31-103 and, as a result, should be proposed by the Canadian Securities Administrators ("CSA") and not the MFDA.

Second Consultation Paper

On April 19, 2018, the MFDA published Bulletin #0748-P: Discussion Paper on Expanding Cost Reporting (the "Second Consultation Paper"), the purpose of which was to build on the 2015 consultation by providing examples of expanded cost reporting to promote further discussion on this initiative. The Second Consultation Paper also provided results of the MFDA's review of the charges and compensation reports of integrated Members, and identified costs incurred by investors which are not currently required to be reported in the Report on Charges and Other Compensation ("RCC").

MFDA CRM2 Review of Integrated Members

Prior to the implementation of CRM2, certain stakeholders raised concerns that unfairness in cost/compensation disclosure could arise where dealers are affiliated with fund companies and dealer compensation is not earned directly from sales activity, but is, instead, obtained from internal transfer payments ("integrated dealers").

Based on such feedback and given that integrated dealers account for a significant portion of mutual fund assets within the MFDA, the MFDA determined that it would be appropriate to review the RCC of integrated Member firms to understand their cost/compensation disclosure practices. As such Member firms earn a combined revenue stream for fund manufacturing and distribution activities, staff was of the view that they would be in a better position to provide client reporting on a total cost basis. The MFDA review, however, found that the majority of integrated Members did not report on a total cost basis but rather estimated the amount of commissions that they would have received had they acted at arms' length. A few integrated Members did disclose total costs paid by clients to invest and hold mutual funds, and, since our review, other integrated Member firms have indicated that they are considering moving to total cost reporting.

Costs Not Currently Disclosed to Clients

The RCC requires disclosure of cost and compensation received or earned by dealers. Cost and compensation earned or received by other parties are not required to be disclosed to clients but may have a material impact on client returns. The MFDA identified costs in the following four areas that are not currently required to be disclosed in the existing reporting requirements:

1. **Ongoing costs of owning investment funds**, including those related to fund management fees and fund operating costs;

2. **Transactional costs charged by investment funds**, including redemption fees and short term trading fees;

3. **Costs paid by clients directly to third parties for account administration**, including custodial or intermediary fees taken directly from a client's account; and

4. **Costs related to other investment products**, including other types of securities or investment products where investors pay ongoing management and operating costs.

Summary of Comments

Support for Expanded Cost Disclosure

Commenters expressed support for expanding cost reporting for investment funds and other products (including banking and insurance products), noting that CRM2 changes address only part of the total cost equation, and that expanded cost reporting would enable investors to have a more complete understanding of investment returns relative to the costs associated with the investment. Commenters encouraged the CSA to work with other regulators to establish more harmonized investment product disclosure, to achieve a more level playing field and to mitigate the risk of regulatory arbitrage.

Commenters also noted that expanding reporting for products other than investment funds might be more difficult to achieve due to issues associated with how such products are offered, and a lack of infrastructure.

MFDA Response:

We acknowledge and agree with the comments raised.

<u>*Expanded Disclosure for Investment Funds*</u>

Commenters emphasized the need to adopt a consistent methodology for calculating costs, noting that this would facilitate compliance with any expanded requirements, and better ensure a level playing field.

The Second Consultation Paper noted certain charges that could be included as part of expanded cost disclosure (i.e. MER, short-term trading fees, redemption fees, and client costs paid directly to third parties). Commenters expressed support for the inclusion of such charges. While mention was made of the Trading Expense Ratio (TER), concerns were raised regarding how the TER would be more difficult to calculate at an account level compared to the MER, and opposing views were also expressed as to its materiality and usefulness.

A few commenters noted that the costs set out in the Discussion Paper are already reported / available to clients, although not in a consolidated manner. These commenters indicated that any initiative to provide expanded cost disclosure should take into account existing cost and compensation reporting and ensure that duplicative reporting is eliminated. A few commenters indicated that the existing reporting and availability of cost and compensation information is sufficient and that expanded disclosure is unnecessary.

MFDA Response:

For those costs not currently disclosed in the RCC, disclosure is only available on a non-consolidated basis. Investors receive different pieces of information at various times in different reports, or must obtain information by going to different documents or websites. Having to receive/obtain information in this manner makes it unnecessarily difficult for investors to understand the aggregate impact of costs and compensation on their investments. The purpose of the present initiative is to explore options for addressing this issue by providing easy to understand information which is presented in a consolidated format.

We acknowledge all other comments received with respect to cost disclosure and agree, in particular, with comments respecting the need to consider duplicative reporting and to have a consistent methodology for calculating costs.

<u>*Comments on Reporting Examples*</u>

Commenters generally noted that the format of any expanded reporting should be simple and flexible, in order to minimize confusion, increase comprehension, and accommodate different business models. It was noted that CRM2 requirements should be reconsidered, so that registrants can create an all-inclusive report that better illustrates performance in relation to the total costs of investing.

The Second Consultation Paper presented possible changes to the Account Statement and RCC. Commenters supportive of including cost information on the account statement noted that such disclosure would be clear, concise, and likely the least costly statement modification for most dealers. Some commenters sought additional information regarding how cost information would be presented for fee-based accounts, with others noting that disclosure to explain the new information should be clear.

Commenters who were not supportive of the account statement changes noted the lack of a total account or total portfolio cost figure, and also indicated that the proposed inclusion of MER might not be representative of the client's specific MER, as it would not include rebates and/or fee reductions.

Concerns were raised with the pie-graph presentation of individual MER components, noted in Figure 2. Commenters indicated that the presentation is unnecessarily complex, does not provide any more information than Figure 1, gives clients details which they do not need, would have higher production and delivery costs, and would be difficult to implement and incorporate into account statement reporting.

Commenters noted that the annual Cost and Compensation Report (Figure 3), duplicates information, which could lead investors to double-count certain costs, suggested revisions to simplify and clarify the presentation, and also encouraged the MFDA to develop a single disclosure format to be used by all Members, whether they sell proprietary or third party funds.

Some commenters provided examples to illustrate their views and comments.

MFDA Response:

We agree that reporting should be simple, clear and concise, and should allow an investor to easily understand account performance, and costs of investing, in conjunction with their investment objectives. The comments and alternative examples submitted were appreciated and will be helpful when considering potential revisions.

With respect to comments regarding Figure 3, we agree that a more simplified approach would be preferable. However, the duplication and client confusion issues arise because of the deferred sales charge ("DSC") fee structure. When we created Figure 3, we had to consider how to distinguish between DSC compensation paid by the fund and earned by dealers at the time of purchase (currently required to be disclosed on the RCC), and redemption charges paid by the client to the fund at the time of redemption (not currently required to be disclosed on the RCC). These two amounts can be confusing to clients but both are important for clients to understand. In order to differentiate between compensation earned by the dealer and cost paid by the client, we proposed a "Cost Report" which aggregated all costs paid or incurred by the client and a separate "Compensation Report" outlining compensation earned by the dealer. The Compensation Report does repeat some of the same information in the Cost Report. While we agree this approach is not ideal, it was proposed to address existing complexity within the DSC fee structure. If DSC was no longer an available purchase option or where dealers do not trade in

DSC funds, Figure 3 could be simplified into one Cost and Compensation Report, which would avoid client confusion and unnecessary duplication.

Implementation Comments

Several challenges were noted with respect to the time and effort required to change current infrastructure to allow for the calculation and tracking of costs at the account level. Specifically, it was noted that IFMs currently calculate MER at the fund/series level, and that it will be a challenge to translate this information into a personalized account or individual amount. It was also noted that dealers will need to enhance systems in order to accept and verify information provided to them by IFMs, program that information for inclusion in the annual reports and/or train and oversee a third party service provider that assists the dealer with these requirements.

Commenters indicated that other investment products would be confronted with challenges similar to those noted above, and additional challenges particular to those product types. For example, IFMs can use FundServ to facilitate the transmission of data between the IFM and the dealer. However, no equivalent infrastructure exists for ETF providers. As a result, implementing expanded cost reporting for ETF funds might be a more complex and longer process.

Commenters noted that extensive programming and systems changes would be required to meet any expanded cost disclosure requirements, and that such changes would be based upon (i.e. operationalized from) rule provisions. As a result, rule certainty/stability would be required before any such programming/systems changes could be fully developed and implemented. Commenters recommended transition periods ranging from 1-4 years from the adoption of final rules. Most of those who provided input on this question expressed a preference for a 3 year transition period.

Given the significance of this initiative, commenters also noted that any proposed changes should be developed through a coordinated effort between the various regulatory bodies and industry stakeholders. Commenters also suggested that a cost/benefit analysis be performed to better assess the impact on the industry of any such proposed changes.

MFDA Response:

We appreciate and acknowledge input and related concerns respecting the need for new infrastructure builds and other implementation concerns.

Need for Investor Research

Commenters also indicated the need for research to gain insight into: (i) the impact of the CRM2 initiative for investors; and (ii) what additional cost information would be of value to them.

MFDA Response:

We agree with the need for investor research and believe it is an integral next step in proceeding with this initiative.

Next Steps

Total cost reporting, provided on a consolidated basis, will be more helpful to investors, and coordination between regulators and stakeholders will be an important part of exploring options and developing potential future directions for this initiative.

We anticipate that there will be a role for market research with investors as concepts (e.g. disclosure options and calculation methodologies) are further discussed and refined.

The MFDA will be sharing the results of this consultation with other regulators for the purpose of advancing the discussion on this initiative, exploring the viability of available options in conjunction with input received during the consultation, and considering implementation and other related matters.