Kenmare Associates
Investor Education and Protection

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Discussion Paper on Expanding Cost Reporting BULLETIN #0748–P
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Kenmar Associates appreciates the opportunity to comment on this Discussion paper. Kenmar is an Ontario- based privately-funded organization focused on investment fund investor education via on-line research papers hosted at www.canadianfundwatch.com.Kenmar also publishes *the Fund OBSERVER* on a monthly basis discussing investor protection issues primarily for investment fund investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused investors and/or their counsel in filing investor complaints and restitution claims.

We applaud the MFDA for its proactivity in advancing the issue of mutual fund investing cost reporting. It is clear that CRM2 is not an adequate disclosure. We note that the MFDA is inviting meetings with individual investors and advocates which is a very positive action. Ideally, what investors need is a breakdown of the total investing costs per account with a specific breakout of the amount they are paying for personalized investment advice.

Mutual funds are the foundation of Canadian investors' saving and retirement plans. Their dependency on these products gives rise to concerns about retail investor vulnerability. There is an asymmetry in knowledge, information and experience between retail investors and their financial advisor; in fact, many investors do not know how their advisors are paid. Moreover, there is a loose correlation between the fees charged and the advice or services provided. Mutual funds are Canadians' most commonly held investment product. The average Canadian household holds about 40% of all its investable assets in mutual funds. Nearly two thirds of Canadians hold mutual funds in their investment portfolios totalling about $1.48 trillion. A significant number of all mutual funds are held by Canadians who are approaching or already in retirement. Mutual funds are thus particularly important to Canadians for their retirement income security.

Background

The Discussion paper examines whether the disclosure that clients now receive should be expanded to cover costs that aren't currently captured in the client relationship model

(CRM2) requirements, which focus on charges that are paid to investment dealers. According to the paper, expanded reporting could include: the impact of mutual fund expenses (not just embedded commissions); transaction costs that are not currently reported (such as redemption fees and short-term trading fees); and account administration costs that are not paid to dealers, but may be paid directly by clients for custody (and other administrative) services. For the purposes of the Discussion Paper, "Investment Funds" would include mutual funds, exchange traded funds, labour-sponsored funds and commodity pools.

There are costs associated with owning investment funds that are not currently required to be reported under CRM2. As a result, "cost reporting to the client is incomplete and this may prevent clients from fully understanding their total costs of investing," the Discussion paper says. To be sure, more inclusive cost reporting makes it possible for investors to better understand investing costs and assess value for money which is a positive.

The purpose of added cost reporting should be to make people more aware of what they are actually paying for the services they receive. The cost of personalized investment advice [separating Parts and Labour in John DeGoey parlance] is a particularly important component in the context of embedded commission products like A series mutual funds.

However, the Bulletin states that the MFDA will be mindful of dealer business models in deciding on how to present the added information. That is very pragmatic of the MFDA but in the end , from an investor viewpoint , any dealer who has a business model that is structured such that it cannot provide a detailed accounting of the fees it is charging to clients is a business model that is incongruent with the transparency associated with the contemporary *wealth management industry*. An integrated firm that only sells their own products and does not receive distinct and separate compensation for financial advice and fund management should be required to restrict their advisors to calling themselves "salespersons". If organizations structure themselves so that fund manufacturing and distribution are "one" operation (i.e. there is no separate compensation for financial advice), then the firm is selling and <u>not</u> advising. The focus is on asset accumulation with advice incidental to the transaction.

Integrated firms charge one fee for all services and then internally split it amongst their affiliated entities based on their own internal cost/revenue sharing agreements. They do not have multiple fee structures like third party arrangements such as DSC, FEL, switch fees and operational charges. These firms only sell their own funds and have integrated fund manufacturing and distribution to maximize cost efficiency and optimize profitability (albeit with some unavoidable conflicts-of-interest). Integrated firms that do not receive trail/commissions do not explicitly charge clients for advice and do not earn specific compensation for advice.

For the integrated firm example in Figure 4 of the Bulletin, trailer commissions aren't listed separately from ongoing costs, since some of these firms may derive compensation through some sort of internal cost transfer payment system or in the case of some firms, no trailers are paid. In the example we are explicitly told:" *This sample report contains a*

combined cost and compensation section as the Member does not receive sales or trailing commissions". The product is sold totally bundled with the advice with no carve out of the "advice" portion. This means to us that those providing "advice" under such an arrangement, must be titled salespersons not "advisor". It should also be noted that one key finding of the CSA sponsored Cumming Report on fund fees was that affiliated dealer flows showed no flow-performance sensitivity at all which was found to be relatively more detrimental to investors relative to all trailing commission paying purchase options for non-affiliated dealer flows.

The regulated "advice" provided is limited to ensuring the product being sold by the Member is suitable for the client per KYC in accordance with MFDA rules. The regulated advice is not the broad personalized advice depicted in marketing brochures or industry-funded research studies. It is to enable the distribution of product. The financial advice actually provided may or may not extend beyond the dealer's and salesperson's registration depending on the individual concerned.

That being said, if an A series mutual fund is sold under Fund Facts disclosure [*The trailing commission is an ongoing commission. It is paid for as long as you own the fund. It is for the services and advice your representative and your representative's firm provide to you. Your representative's firm may pay part of the trailing commission to its representatives*], an implied contract, , we would expect the 1% trailer charge (typical trailer commission rate for an equity fund) to show up as an isolable cost on client statements and reports independent of internal accounting or other structural impediments . One large integrated bank told us that they do pay the trailer directly to the affiliated dealer, so cost breakout would not be an issue. This isolation of advice from product sale is the fundamental issue investor advocates have been trying to resolve with the CSA for over 20 years.

Over the past two decades the financial services industry has rebranded itself from a transaction business to an advice business and more recently to a Wealth management business but remained anchored in a transaction-based regulatory environment due to CSA disengagement. Corporate culture has remained tied to a sales and marketing mindset rather than as a trusted provider of unbiased personalized investment advice as a distinct service. The CSA have allowed this disparity between reality (the suitability standard, embedded commissions) and advertising and marketing to persist by permitting dealers and salespeople to hold themselves out to Canadian consumers as trusted "advisors" despite significant conflicts- of- interest and compensation practices that independent research has shown, adversely affects the integrity of the advice provided. In addition, some dealing representatives purport to provide financial planning services without the necessary qualifications. Only Quebec has provided legislation to provide some regulation of financial planners.

If no compensation is earned distinctly for advice, then the MFDA want the whole fee charged to be disclosed and it has to be clear what the compensation covers (fund management and financial advice) .For certain firms ,the MFDA must unfortunately work within the business framework that the CSA has allowed to develop . A key goal, disclosure of total investing costs, is nevertheless achieved.

The importance of total costs

The importance of investing fees to overall investor returns, especially in the context of long-term investing like retirement accounts, is frequently overlooked by retail investors. But there is convincing evidence that many investors are paying unduly high investing fees. The MFDA is looking at making these cost presentations more fulsome and visible. The additional disclosure builds on CRM2 disclosure and would allow investors, at least in principle, to make cost comparisons across firms and permit investors to weed out unsatisfactory relationships. It does not appear that, given the different business models, that cost reporting across firms will be consistent.

Critical observers of CRM2 have stated that the primary weakness of that disclosure is that it only provides information on about half the costs of owning a mutual fund. The proposed MFDA augmented fee disclosure would paint a more complete picture. . Morningstar's Director of Mutual Fund Research has observed, *"If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision."* In order to make a truly informed investment decision, investors another piece of information – details of the services and investment advice that they will be provided for the fees paid. The product may be fine but the advice provided may not be.

It should be noted that CRM2 is credited with causing IIROC dealers to come clean on double billing and overcharging for a decade or more. This resulted in regulatory actions requiring them to return over $300 million to investors. Similarly, it is quite possible that expanded cost reporting, and the visibility it provides clients, will inspire fund dealers and fund salespersons to seek out lower cost funds and products for their clients.

One of the challenges in evaluating investor responses to cost/fee information is to understand why investors so frequently overlook fee information, and what kinds of interventions might make fees more salient. In our experience we have found that retail investors downplay the importance of investing costs because (a) they do not know them because some costs are embedded in the product cost (b) fees in percentage terms appear to be so inconsequential; (c) they assume their "advisor" is working in their best interests; (d) they lack the financial literacy and numeracy to assess the impact of fees on annual and especially long-term returns and (e) they are not aware of competitive products.

Response to the questions posed by the MFDA

Expanding Cost Reporting

1. *Should regulators consider expanding cost reporting for Investment Funds?*

Yes, the CRM2 reporting is limited to dealer costs which does not present the full picture. The added reporting would provide the total cost of investing and thus investors would be able to make more informed investment decisions. Disclosure and reporting is not the same as transparency, .If salespersons have meaningful conversations on investing costs

with clients, the MFDA initiative will achieve its full potential. That being said, other supporting regulatory initiatives would amplify the value of better reporting. These include reforms on title inflation, a Best interest standard for advice givers, increased dealer Rep proficiency, the elimination of embedded commissions and a plain language disclosure of the services and advisory functions related to each fee. Educational initiatives should focus on the de-compounding effect of fees over time and the valuation of advice. See for example our piece *Decompounding- the tyranny of fees* http://www.canadianfundwatch.com/search?q=decompounding

2. *Should regulators consider expanding cost reporting for other investment products?*
There are other investment products that are currently not included in the annual charges and compensation report. Bond pricing transparency is an area that merits increased regulatory effort as bonds are a critically important portfolio component in RRIF's and RRSP's. As for GIC's, these are bought primarily on the guarantee return. Clients look at the guarantee (always stated after fees) - the shopping process consists of seeking out the highest return. If investors are satisfied with the guarantee return, they make the purchase. For PPN's and index-linked GIC's, we feel that the embedded commissions should be disclosed but the first priority should be mutual funds. Note that such products do not make any assertions regarding advice or services to be provided and hence are different than mutual funds (A series) that do make POS and continuing after-sale service and advice claims.

Costs Considered for Expansion

3. *Do you agree that the costs considered in this Discussion Paper (i.e. MER, short-term trading fees, redemption fees and client costs paid directly to third parties) should be disclosed to clients?*
Of course. They are material costs that impair long –term returns. Fees are a crucial element of overall portfolio return. These costs are already factored into account performance calculations so the investor would now finally be able to match total investing costs to account performance . There is research showing that mutual fund investors tend not to review disclosure documents for cost information and instead primarily rely on advisors to tell them about costs .Further research indicates that many advisors do not tell their clients about costs and CRM2 fails to provide adequate disclosure. With lower expected market returns going forward, the MFDA emphasis on expanding and highlighting investing cost reporting is particularly timely and relevant. We believe this added visibility on total cost will improve will improve the client-salesperson relationship and ultimately lead to better client outcomes.

4. *Are there any other costs that should be reported to clients?*
We recommend the inclusion of mutual fund trading costs (the TER). For some funds they can be material and act as a de-compounding force on long-term returns. The interest costs should be included if an investor has been advised to use leveraging. We do not have adequate information on referral fees received by dealers. We leave it to the MFDA to decide whether such fees should appear on client cost reports.

Cost Reporting

5. *What are your views on the reporting examples provided in this Discussion Paper?*

With some provisos and changes, we believe the examples given could increase investor knowledge and sensitivity to investing costs. We like the table on MER's (Figure 1) but accommodation needs to be made for ETF's which we expect to become increasingly popular in MFDA dealer accounts .The MER should be defined as annual cost to remind clients of its ongoing nature . By having account statements include an accounting of fund MER's, the investor awareness of the ongoing costs related to fund ownership will be continually refreshed. The MFDA should consider reporting the MER in $'s per $1000 invested instead of in percentage terms for greater retail investor comprehension. It would be a big plus if fees in dollars could be added (see Steadyhand client statement sample) to provide a total for each account. In Figure 2, the trailer is depicted as 100% *advice* related- in reality it is more like 50%. We like the brief plain language explanation of the services provided-most people do not have a clue about the services provided (and industry itself is all over the map in revealing what is included). The fund's trading expenses (TER in dollars and cents) which are not part of the MER or CMR2 would have to be added in. We have a concern that the Figure 2 pie chart format may be overwhelming as we've seen clients with 15 and 16 different funds and in the end it doesn't tell the investor that much implementable information. Figure 3 appears to us to be well laid out but investors may not interpret trailing commissions as the cost for services and investment advice with the asterisk note .Perhaps after trailing commissions add a bracket viz. (services and investment advice). Note 1 should read *investment advice* not *financial advice.* We definitely want the cost of services and advice depicted as a stand-alone cost. There should also be a line for borrowing costs since some fund salespersons recommend leveraging .If the figure is not known ,the report should state that the investor should add the interest expense in to his/her total investing cost.

6. *Are there better ways to report the costs of investing to clients?*

We leave this to human factors and behavioural finance professionals. Any changes to disclosure should be fully tested with investors before implementation to ensure its effectiveness. The key success criterion is that the reporting engages the investor so that he/she understands total investing costs and can act on the information.

7. *What challenges or issues do you foresee in obtaining and reporting expanded cost information to clients?*

The terminology used to describe costs must be standardized to achieve investor comprehension. NOTE: When assessing CRM2 disclosure, the MFDA Bulletin 0740-C http://mfda.ca/bulletin/bulletin0740-c/ found some firms used different terms for trailer commissions, which impedes clients' ability to make comparisons between firms. Firms that are truly in the wealth management business should not find providing this basic information to clients a huge burden.

Conclusion

We have identified a number of issues but we clearly support the initiative of more fulsome disclosure of total investing costs on monthly (or quarterly) client statements and annual cost reports despite the shortcomings discussed. The ability to match total investing costs to account performance empowers the investor. Increased cost visibility may cause investors to ask why they have been sold a DSC fund, why the fees they pay approximate their returns or why lower cost alternatives, such as Index funds or actively-managed ETF's , are not being put forward. We recommend that the initiative should be

accompanied by a retail investor laser- focused financial education initiative on investing costs.

Financial confidence plays a greater role than financial knowledge when it comes to developing healthy financial behaviour, according to a new report released from The Financial Consumer Agency of Canada (FCAC).FCAC's *Progress Report on Canada's National Research Plan on Financial Literacy 2016-2018* was developed to share important findings with financial literacy practitioners and researchers in order to improve the financial well-being of Canadians.https://www.canada.ca/en/financial-consumer-agency/programs/research/progress-report-national-research-plan-2016-2018.html The MFDA can play a key role in building financial confidence among Canadians. We recommend that the MFDA partner with the FCAC on such investor education programs and their promotion. We also recommend that the MFDA provide a tool or link to a tool that would help retail investors better understand. the long term impact of fees. The one provided here allows for adding periodic payments rather than just a lump sum at the beginning. http://saviifinancial.com/seg-funds/m-e-r-fee-calculator/

It seems particularly appropriate to cite the words of former OSC Commissioner Glorianne Stromberg who has been a trailblazer over the past two decades in identifying the need for reform of Canadian mutual funds. In her classic 1998 report she stated, *"Permitting these capital-eroding fees will impact the need for social support systems that we simply don't have and probably won't be able to afford given the erosion of the tax base as the population ages".* With the decline of DB pension plans, more Canadians than ever now depend on their own investments for their retirement. Cost reporting is therefore a socio-economic issue and this MFDA initiative helps reduce the chances of retirement portfolio erosion due to excessive investing costs.

Kenmar hope this feedback is useful to you.

We look forward to working collaboratively and assisting, where possible, with some of the goals of the consultation.

Kenmar Associates agree to public posting of this Comment Letter.

We would be pleased to discuss our comments and recommendations with you in more detail at your convenience.

Respectfully,

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A supporting guideline from the MFDA would be needed to ensure fund salespersons take the time to walk clients through these costs reports.
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Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds
http://www.ncbi.nlm.nih.gov/pmc/articles/PMC2872995 ABSTRACT: We conduct an experiment to evaluate why individuals invest in high-fee index funds. In our experiments, subjects allocate $10,000 across four S&P 500 index funds and are rewarded for their portfolio's subsequent return. Subjects overwhelmingly fail to minimize fees. Search costs for fees matter, but even when we eliminate these costs, fees are not minimized. Instead, subjects place high weight on annualized returns since inception. Fees paid decrease with financial literacy. Interestingly, subjects who choose high-fee funds sense they are making a mistake.[The composition of their subject pool , college staff/MBA students made it more likely that they would find support for rational theories; given the dismal results it is thus no surprise that ordinary Canadians have trouble figuring out fund fees]

Exhibit 1 The BCSC study
https://bcsc.bc.ca/News/News_Releases/2017/76_Significant_improvements_in_investor_knowledge_following_new_fee_disclosure_documents__BCSC_study_finds/
Last fall, the British Columbia Securities Commission (BCSC) published a report that outlined the results of an survey that examined the impact of the new annual investment reports had on those individuals working with a salesperson In addition, the BCSC rolled out an educational online tool to help investors navigate and understand the new reports, including a short video and an improved fee calculator. In the report, it stated that 52 % of investors who had expressed less confidence and investment knowledge at the outset of the study increased their general understanding of fees after receiving CRM2 reports. Other findings included:

- Half of all respondents always read statements
- Nearly all respondents confident in their understanding of their statements and bills
- Slight majority feel they know how to compare investment advisors, products
- 57% are familiar with the two types of fee they pay.

The report also showed that while there was an overall increase in fee knowledge among less-confident investors, that knowledge was short-lived. The report states that while "many" of those investors surveyed in March and then again in June saw their knowledge level increase upon receiving their CRM2 reports, that knowledge later declined during a follow up study several months later. "Clearly, knowledge fades," the BCSC says in the note.

Of 400 respondents who answered questions on specific fees, such as the total amount of fees paid, investor knowledge improved among 34 % of survey participants, but 35 % saw no change. Curiously, 31 % said it actually worsened.

The research shows that there is an overall positive effect on investor knowledge and behaviour; but what we would also want to see is whether the fee reports will cause investors to have a conversation with their Reps about the fees they pay, is there a different mix of products that could work for them, or would they consider changing their firm or advisor. . And while that 52 % learned more – which is great – they didn't do anything with that knowledge. The MFDA initiative should aim to greatly improve on that.

Per FCAC research, evidence demonstrates that financial decisions are influenced by a wide-range of related factors such as:

- financial confidence (and its cognitive cousin self-efficacy)
- executive functioning (e.g., self-control, working memory, problem solving)
- attitudes towards money (e.g., time-orientation)
- behavioural habits

What we are learning is that, on top of the financial knowledge it takes to make a decision, many psychosocial factors relate to the degree to which consumers persist through a problem to find the right solution for them. Some factors also relate to the required abilities to plan out financial behaviours and then to stick to that plan. Better cost reporting is one aspect of better decision making.

EXHIBIT 2 Why investing costs are not top of mind for retail investors

Notwithstanding any regulator mandated disclosure there are other powerful influencers on investor decision making. These include trust-inducing “advisor” titles , creative , glitzy brochures with images of a happy retirement, attention grabbing websites, biased investment calculators,“ free lunch “ seminars , controversial industry financed investor polls , mind -capturing celebrity speakers , portfolio manager's appearances on television expounding their smarts (but not the fees) and of course an advice-skewing distribution system addicted to opaquely disclosed (and poorly understood by retail investors) sales commissions and trailers. These have the undesirable effect of diverting investor attention from the regulated disclosures and incentivizing advisers more toward sales volume, than the investors' best interests. We add parenthetically, that most Canadian mutual fund advisers do not have a fiduciary duty to clients, yet trust in the advice provided by advisors is generally very high especially among the elderly .Even when a disclosure is available, regulator finds significant deficiencies and non-compliance yet does nothing more than issue a Staff Notice detailing the shortcomings and suggesting how improvements can be made. This cycle goes on, year after year, with little sign of progress. One need only look at the recent double dipping scandal involving all of Canada’s leading investment dealers as evidence. Better regulatory enforcement is required to support an expanded cost reporting initiative.

Exhibit 3 The trailer commission- what exactly is it"

Per Fund Facts *The trailing commission is an ongoing commission. It is paid for as long as you own the fund. It is for the services and advice your representative and your representative's firm provide to you. Your representative's firm may pay part of the trailing commission to its representatives.*

There does not appear to be a definition of trailer commission in securities legislation. Unlike Fund Facts, IFIC's articulation of the trailer's services and advice content is forthright - it does not leave the impression that the trailer is all about the investor. It describes the trailing commission as a distribution charge that rightfully includes compensation for the overhead and direct costs of distributing the mutual fund and provides the profit associated with being a registered distributor. It also takes a stab at defining some of the tasks the Dealing Rep should (but may not) be providing. It is this side of the disclosure equation that is missing. We add parenthetically, that we believe that in most cases, those tasks are associated with selling a mutual fund rather then providing the trusted personalized financial advice depicted in fund industry marketing promotional materials. The old mutual fund industry quote "Mutual funds are sold, not bought" rings true today. Essentially, this is what most independent academic research finds. This is not to say that some professional advisors do not go beyond the basic KYC parameters but it does mean that these extra services are (a) not contractually required to be provided or (b) if provided ,do not have to be provided in the client's best interests.

A significant issue, however, is that trailers apparently are not used primarily for the direct benefit of the investor. An April 12, 2013 letter https://www.ific.ca/wp-content/uploads/2013/09/IFIC-Submission-to-CSA-–-Discussion-Paper-81-407-Mutual-Fund-Fees-April-12-2013.pdf/5514/ from IFIC to the CSA says that *"trailing commissions are paid to the dealer firm to cover a whole host of regulatory and supervisory functions and services in addition to advisor compensation. The dealer may retain one half **or more** of the trailing commission to pay for, for example: tier 1 and tier 2 supervision and the systems that support it, regulatory costs including fees to fund the SROs, OBSI, and securities commissions, client complaint handling processes, advisor investigation and enforcement requirements, general compliance obligations of the SROs, OBSI, and securities commissions, client reporting, due diligence on products, etc."* This seems like a stretch. Why on earth should an investor's payment for a mutual fund be directly tied to a dealer's legal obligation to be a Participating firm in OBSI?

The IFIC paper also says "The portion of the trailing commission that goes to the advisor also benefits clients through the provision of client services. These services include but are not limited to: suitability reviews, reviews on transfers, reviews of material changes of client circumstances, responses to client questions, general financial advice that can be unrelated to mutual funds, the rebalancing of portfolios, advice on registered products, Setting up a savings programs and the encouragement of good investment behaviors". If done professionally, these tasks can add value to the relationship.

A 2014 IFIC document titled Paying for Advice: Why Options are Important, says that,

"on average, 0.78% of the assets invested in a long-term fund are paid annually by the fund to the dealer, of which approximately two-thirds may go to the representative for advisory services and the rest kept by the dealer to pay for administrative, compliance and regulatory oversight functions."

Unlike IFIC, individual firms suggest a list of other services provided to the investor. These firms state that trailing commissions support :Printing and mailing of disclosure documents (prospectuses, Fund Facts, other shareholder communications, including proxy material); Processing of corporate events and distributions (Since mutual funds held by investment dealers are typically registered in nominee name, the dealer takes on responsibility for updating client account records for things such as mutual fund reorganizations and client payments of interest, dividends, etc.); Preparation and distribution of tax reporting information such as annual trading summaries, and, in some cases, T3 and T5013 tax slips; Provide the widest selection of mutual funds from multiple fund families (This requires efforts by the dealer/advisor to conduct extensive product due diligence and legal documentation before making these funds available to clients.); Custody services; Portfolio monitoring of margin requirements (as applicable); Clearing and settlement of purchase and sales through FundSERV and/or CDS.

It should be no surprise that retail investors don't know exactly what they are getting for paying the trailing commission. One thing however is clear – 0.78%* of $1.48 trillion equals about $11 billion in trailers paid by investors every year. Even half that amount is a lot of money for printing, mailing, tax slips, etc., and the laundry lists the industry enumerate seems to confirm the CSA's and investor concerns that trailer commissions create conflicts-of- interest causing investor costs to unduly add up.
* Average trailer commission

The root problem in the investment industry seems to be the variable definitions applied by various stakeholders (seemingly to serve their respective interests at any given time) to the same term. Our favourite example of this is the term "services" as it is used throughout the mutual fund industry. It is interpreted differently by different investors, different advisors, full service brokers, discount brokerages regulators and lobbyists. We've asked these stakeholders to provide us with a definition for services and they have all responded with a different one. We are dumbfounded to learn that billions of dollars a year are moving from mutual fund trusts to dealers based on the terms "service" and "advice" and no one can agree on what these terms mean. If stakeholders are not speaking the same language, how can anything get resolved? (Or maybe that was the intention all along?)