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BY E-MAIL

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumers Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Dear Canadian Securities Administrators:

Re: Comments on proposed Total Cost Reporting for Investment Funds

Thank you for providing us with the opportunity to comment on the proposed amendments (the **Proposed Amendments**) to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) and Companion Policy 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* published by the CSA on April 28, 2022 to introduce total cost reporting (**TCR**) for investment funds.

Our comments below reflect the views of the authors of this letter and certain other individual members of our firm that participated in the preparation of this letter. Our comments do not necessarily reflect the views of our firm or of our clients, and are submitted without prejudice to any position that may in the future be taken by our firm on its own behalf or on behalf of any client.

Background to our comments

Fasken Martineau DuMoulin LLP (**Fasken**) is a leading Canadian law firm that provides advice to investment fund managers, portfolio advisers, dealers and service providers across Canada. Currently, eleven partners at Fasken devote a substantial portion of their practice to advising clients on structuring, offering and managing investment fund products and related services, and are supported by further partners with expertise in specific fields including tax, derivatives and

financial institution regulation. Fasken is one of the largest Canadian legal practices in the investment products and wealth management area. Our client base includes managers of retail mutual funds, exchange-traded funds, alternative mutual funds, closed-end funds, hedge funds, pooled funds, segregated funds, private equity funds and separately managed account services. We regularly assist clients with developing innovative investment products including, where necessary, obtaining novel discretionary relief under Canadian securities legislation and advance tax rulings to accommodate those products.

Our comments below are based mainly on our experience advising clients in the investment funds industry. Prior to submitting this letter, we also consulted with a number of industry participants specifically about the Proposed Amendments. Though the comments in this letter are those of Fasken alone, we have taken into consideration the feedback we received from those we consulted.

Substantive Issues

Below are certain fundamental questions regarding TCR that we believe should be addressed before the Canadian Securities Administrators (the **CSA**) proceed further with this initiative.

1. ***Please clarify why TCR is needed.***

It is unclear to us from the CSA's notice (the **Notice**) accompanying the Proposed Amendments what is the policy objective of the CSA behind TCR, and whether TCR is the best course of action for achieving that objective. The Notice states:

> Research carried out by the Ontario Securities Commission (**OSC**) Investor Office and the Behavioral Insights Team in connection with the adoption of CRM2 shows that Canadian investors presented with a sample annual charges and compensation report, assumed that it included embedded fees associated with investment funds, when it does not include such fees.
>
> We believe it is important that investors and policyholder be aware of all of the costs associated with the investment funds and segregated funds they hold as these fees can impact their returns and have a compounding effect over time.

TCR disregards the existing securities regulatory framework and the protections it provides for investors

Investment funds and the distribution channels through which they are made available are complex products and services. It is not surprising that there are aspects of these products and services that are not fully understood by retail investors. This is why investment funds and the firms and individuals that distribute them are subject to perhaps the most extensive regulation under Canadian securities laws. The default expectation of Canadian securities laws is that every retail investor will purchase investment funds based on the advice of a registered dealing representative who must satisfy extensive proficiency requirements, and comply with ongoing obligations to recommend only investments that are suitable for their clients. These obligation were recently enhanced by the Client Focused Reforms which (among other matters) expressly added (i) a "know-your-product" obligation on dealing representatives that includes understanding the

embedded costs of the investment funds they recommend, and (ii) the cost structure of an investment fund as a factor of suitability.

In light of this regulatory framework and the specific protections it provides to investors, it is not clear to us why TCR is needed. We suggest that it is unrealistic to expect that retail investors, through TCR, will achieve the same level of understanding as dealing representatives regarding the cost structures of investment funds. We believe that the CSA's concern regarding the misunderstanding of some retail investors is adequately addressed simply by providing the narrative disclosure contemplated by proposed section 14.14(5)(h), rather than the numerical data contemplated by TCR (most of which is not explained). Investors also can be directed to contact their dealing representative should they wish more information regarding fund expenses.

The CSA's concern with "competition" is not explained

The Notice also states:

> Furthermore, transparency about costs may encourage more competition, which would benefit investors and policyholders.

The foregoing statement suggests that current fund expenses are higher than necessary due to a lack of competition. We are unaware of a basis for this concern, and would ask the CSA to provide data regarding such a concern. Further, we believe that any change in the future selection of investment funds based on cost structures is likely to result from dealing representatives taking into account the cost structures of investment funds under the enhanced obligations summarized above, rather than the actions of individual retail investors. Dealing representatives do not require TCR in order to perform such an analysis.

2. ***Please clarify the behavior to be modified by TCR.***

The Notice cites the previous research carried out by the OSC Investor Office and the Behavioral Insights Team. However, it does not identify whether the misunderstanding of some retail investors regarding fund expenses has resulted in inappropriate investment decisions. Behavioral science seeks to identify impediments causing irrational decision-making and remove those impediments. Often, those impediments arise from the manner in which information is presented which, if corrected, will lead to more rational decision-making. The Notice does not indicate how TCR is intended to change investor behavior.

In fact, TCR may make no difference to the investment funds selected by investors who focus primarily on past performance (after deduction of fund expenses) when making their investment decisions. In this respect, we analogize to real estate investment trusts (**REITs**) and mortgage investment corporations (**MICs**) which are popular alternate investments for retail investors. We suggest that, for both such types of issuers, investors focus their decision based almost entirely on the returns generated by the issuer and the volatility of the trading price of its securities, rather than the operating expenses incurred by the issuer that reduce its returns, even though in many cases such issuers are charged management fees similar to investment funds. We believe that investors use a similar approach when assessing the merits of investment funds such that fund

expenses are largely irrelevant to their investment decisions. The higher fund expenses of an investment fund are likely to be disregarded by investors where the performance of the investment fund exceeds that of its peers. We therefore question whether TCR will change investment decision-making.

Before proceeding further, we suggest that the OSC Investor Office and the Behavioral Insights Team conduct further research to confirm whether TCR will change investment decision-making patterns by retail investors.

3. ***Please clarify whether the CSA have identified and considered possible unintended consequences from TCR.***

As noted above, it is unclear what investor behavior the CSA seek to change through TCR. If the CSA's expectation is that TCR may lead investors to select investment funds with lower fund expenses, this also could lead to undesirable changes in investor behavior. For example:

(a) Investors may begin selecting investment funds with lower fund expenses without taking into account the effect of the selection on the risk-return profile of the investor's portfolio.

(b) Investors may shift in greater numbers to order execution only dealerships simply to purchase series of securities which do not include a cost of compensation to the dealers and dealing representatives that provide investment advice.

(c) Investors may reallocate assets from investment products to savings instruments which, to the investor, have no embedded costs since the opportunity cost of savings instruments is not disclosed to, or understood by, retail investors.

We suggest that each of the foregoing could be an undesirable consequence of TCR. Before proceeding further, we suggest that the OSC Investor Office and the Behavioral Insights Team conduct further research to assess whether TCR could cause retail investors to make undesirable changes to their investment decision-making.

4. ***Please clarify the CSA's view on the potential benefits of TCR compared to its anticipated costs.***

The Notice does not state whether the CSA believe the anticipated benefits of TCR will exceed its anticipated costs

Implementing TCR will result in significant costs to the investment funds industry. We anticipate that there will be both initial transition costs to set-up new systems for calculating and communicating the additional data contemplated by TCR, as well as ongoing costs to maintain those systems. The Notice did not state a view of the CSA on the anticipated benefits relative to the anticipated costs. We believe that the CSA objective of reducing unnecessary regulatory burden on market participants includes determining whether new regulatory requirements are proportionate to the benefits sought.

Absence of a quantitative analysis by the OSC

As well, we did not identify in Appendix I to the Notice a quantitative analysis by the OSC of the anticipated costs and benefits of TCR as required section 143.2(2)7 of the *Securities Act* (Ontario).

Accordingly, we recommend that TCR not proceed further until these views and analysis are provided, and affected parties are given an opportunity to review them.

5. ***Please reconsider the proposal to impose TCR on investment funds that are not reporting issuers under Canadian securities laws.***

We are concerned that the proposal to require TCR for Canadian investment funds that are not reporting issuers (**pooled funds**) is unduly onerous and uncertain, which may lead dealers to discontinue offering pooled funds to their clients. This will be particularly true for pooled funds of managers with smaller amounts of assets under management that may not have the same resources as larger investment fund managers to build and maintain the support for dealers to provide TCR regarding their pooled funds. Given that investors in pooled funds must be accredited investors or satisfy other criteria permitting them to invest in pooled funds without a prospectus, we do not see a policy imperative for extending TCR to pooled funds. Our comments above regarding the policy objective of TCR, the anticipated costs and benefits of TCR, and possible unintended consequences resulting from TCR are particularly relevant in the context of pooled funds.

Likewise, we are concerned that the proposal to require TCR for non-Canadian investment funds (**foreign funds**) can be equally onerous and uncertain if the non-Canadian managers of those foreign funds do not build and maintain support for Canadian dealers to provide TCR regarding their foreign funds. This too could lead dealers to discontinue making foreign funds available to their clients. Foreign funds can be purchased by retail investors in certain Canadian jurisdictions only if there has been no active solicitation of retail investors in that jurisdiction[1]. Imposing TCR on those foreign funds expects a level of local activity by managers of foreign funds that is inconsistent with the unsolicited basis on which their foreign funds are available. Here too, our comments above regarding the policy objective of TCR, the anticipated costs and benefits of TCR, and possible unintended consequences resulting from TCR are particularly relevant in the context of foreign funds.

Technical Issues

In addition to the comments of a fundamental nature provided above, below are our comments of a more technical nature on the wording of the Proposed Amendments.

6. We note that "direct investment fund charges" are defined in the Proposed Amendments as amounts charged by the fund or its manager to the investor.

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[1] Section 3(b) of Multilateral Instrument 32-102 *Registration Exemptions for Non-Resident Investment Fund Managers.*

(a) Other provisions in the Proposed Amendments refer to amounts charged by the fund, its manager "or any other party"[2]. Please clarify whether amounts charged by other parties such as dealers, registered plan administrators and custodians are intended to be included since those "other parties" are not included in the definition of "direct investment fund charges".

(b) If the response to the foregoing comment is positive, then we recommend that the definition of "direct investment fund charges" be amended to include "other parties", and also provide clarification of any "other parties" not intended to be included.

7. We note that the amounts reportable under proposed section 14.17(1)(j) are described as direct invest investment fund charges charged "in relation to securities of investment funds owned by the client".

(a) Please clarify whether this wording is intended to exclude amounts charged to the client's account as a whole (such as fees of registered plan administrators and custodians).

(b) If the response to the foregoing comment is positive, please also clarify that such fees may be proportioned based on the value of investment fund securities versus non-investment fund securities in the account.

8. Please clarify whether the carve-out in the definition of "direct investment fund expenses" for amounts included in "the investment fund's fund expenses" is intended to be the same as amounts included in its fund expense ratio (i.e., its management expense ratio plus trading expense ratio). If yes, then we recommend changing the words "investment fund's fund expenses" (which are not defined) to the words "fund expense ratio" (which are defined).

9. Proposed section 14.17(6) prescribes the methodology for calculating the total fund expenses as the daily cost factor [MER+TER X NAVPU] X number of units.

(a) Please clarify whether this calculation is intended, as stated, to apply to all of section 14.17(1)(i), or only to the calculation in section 14.17(1)(i)(b). We note that section 14.17(6) provides a formula to be used where "A" cross-references section 14.1.1(2) which only includes the fund expense ratio. This would provide an accurate calculation for the amounts in section 14.17(1)(i)(b), but we do not believe it would be correct for expenses charged directly to the investor described in section 14.17(1)(i)(a). If the intention is to cover both items of section 14.17(1)(i), we suggest a formula equivalent to section 14.1.1(2) may need to be added for the portion of the total amount of fund expenses derived from direct investment fund charges.

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[2] See proposed sections 14.17(1)(i)(a) and 14.17(1)(j).

(b) Please also clarify whether sections 14.17(1)(i)(a) and (b) are intended to be conjunctive ("and" versus "or")? As currently drafted, it appears that the total amount of fund expenses is one or the other item, rather than the sum of both items.

(c) We note that section 14.17(6) states that these amounts are to be "added together … for each day that the client owned" the investment fund. For greater clarity, we suggest that the Proposed Amendments include a defined term for such daily amounts, such as a "daily total fund expense", and reword section 14.17(6) to refer to the sum of all the daily total fund expenses.

10. The prescribed narrative disclosure in proposed section 14.17(1)(n) regarding deferred sales charges cross-references the redemption fee schedule in the investment fund's prospectus or fund facts. However, the current simplified prospectus and fund facts will not include this disclosure now that deferred sales charge options are no longer offered. As well, deferred sales charge schedules sometimes change. We recommend that this section instead cross-reference the prospectus or fund facts "at the time you purchased your units or shares".

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Thank you in advance for your consideration of the above commentary. Should you have any questions or wish to discuss the above commentary, please contact the undersigned.

Yours truly,

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