

# CUTTING OUT THE MIDDLE MAN – PROPOSED PROHIBITION OF EMBEDDED COMMISSIONS

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On September 13, 2018, the Canadian Securities Administrators (the “**CSA**”) published a notice and request for comment outlining Proposed Amendments to National Instrument 81-105 *Mutual Fund Sales Practices* (“**NI 81-105**”). The proposed amendments follow the CSA’s June 2018 policy response to concerns about investor protection and market efficiency, and seek to prohibit certain embedded commissions in the sale of mutual funds.

The proposed amendments intend to prohibit two types of payments made by mutual funds organizations: (1) upfront sales commissions to dealers and (2) trailing commissions to dealers who do not make a suitability determination.

The CSA intends to repeal section 3.1 of NI 81-105, which would prohibit funds from paying sales commissions to dealers out of their general revenue, and for sales made under the front-end load option which are deducted by the dealer from the investment amount at purchase. This change is intended to remove deferred sales charge (“**DSC**”) options, and drive compensation to be a direct matter between the client and dealer.

Under the proposed rules, only dealers who provide investors with advice arising from the suitability requirements will be allowed to receive trailing commission payments. As a result, order-execution-only and other similar dealers will no longer receive trailing commissions. The CSA proposes to define such commissions to mean any payment that is part of a continuing series of payments related to the ownership of securities of a mutual fund by a client of a participating dealer. This broad definition captures payments for all services of any kind to the client in connection with their ownership of mutual fund securities.

## **Transition**

The CSA proposed for a 365-day transition period before the amendments come into effect. During the transition period, existing mutual fund investments held under the DSC option will not have to be converted, though new mutual fund purchases will be expected to comply with the new rules.

The discontinuation of the DSC option will likely result in the increase of front-end load options or other direct-

pay arrangements with clients. Dealer firms may also have to reassess and adjust their internal compensation arrangements.

The 90-day comment period will close December 13, 2018.

### **Ontario government opposition**

The amendments face no small amount of difficulty ahead, as the Ontario provincial government has expressed its opposition to the Ontario Securities Commission (the “**OSC**”). On the same day the proposed amendments were released, Minister of Finance Vic Fedeli issued a statement that the “CSA and OSC’s proposed amendments result from a process initiated under the previous government and, if implemented, will discontinue a payment option for purchasing mutual funds that has enabled Ontario families and investors to save towards retirement and other financial goals,” and that the Conservative government “does not agree with this proposal as currently drafted.”

The OSC’s reaction has been restrained, with a spokesperson stating that they “are respectful of our government’s authority to decide whether any rules published for comment ultimately come into effect.” In contrast, the Alberta Securities Commission and British Columbia Securities Commission, while both declining to address the Minister’s statement, have expressed support for the comment and consultation process.

Minister of Finance Vic Fedeli subsequently stated that the Ontario government will work with other provinces and territories and stakeholders to explore other potential alternatives to ensure fair, efficient capital markets and strong investor protections. Given that the proposed prohibitions on embedded commissions are subject to government approval, it is unlikely that the changes in current form will be adopted across all CSA jurisdictions. Nonetheless, the consultation process is being carried out, so what changes will ultimately be made to the rules governing embedded commissions, if any, remains to be seen.

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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