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OSC proposes restrictions on use of DSC option in the sale of mutual funds

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Introduction

The Ontario Securities Commission (the OSC) has published for comment:

- proposed Ontario Securities Commission Rule 81-502 *Restrictions on the Use of the Deferred Sales Charge Option for Mutual Funds* (the Proposed Rule);
- proposed companion policy to the Proposed Rule; and
- certain proposed consequential amendments to National Instrument 81-105 *Mutual Fund Sales Practices*.

The Proposed Rule introduces restrictions on the use of the "deferred sales charge" (DSC) option in the sale of mutual funds, for investment fund managers (IFMs) and dealers. For the purposes of this Update, we will focus only on the Proposed Rule.

What's a deferred sales charge?

When an investor purchases mutual funds under a DSC option, he/she does not pay any upfront fees for securities purchased. Instead, the investor pays a redemption fee (i.e., the DSC) to the investment fund manager (the IFM) if the securities are redeemed before the end of a schedule. From an industry standpoint, this schedule generally ranges from five to seven years from the date of purchasing the securities, and gradually declines each year, thereby discouraging investors from redeeming their securities early. In order to incentivize dealers to sell securities of their funds to investors, IFMs pay commissions to those dealers, and the IFMs recoup such commissions by earning management fees and, if applicable, charging the DSC.

What are the DSC Restrictions?

The Canadian Securities Administrators (CSA) have taken the view that such commissions (as described above) encourage dealers to make self-interested investment recommendations to the detriment of investor interests, and intend to ban DSCs effective June 1, 2022 (as outlined in Multilateral CSA Notice of Amendments to National Instrument 81-105 *Mutual Fund Sales Practices*; Changes to Companion Policy 81-105CP to National Instrument 81-105 *Mutual Fund Sales Practices*; and Changes to Companion Policy 81-101CP to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* relating to Prohibition of Deferred Sales Charges for Investment Funds (the 2020 CSA Amendments)). The OSC also considers that there are

inherent conflicts of interest for registrants to accept upfront commissions associated with the sale of mutual fund securities under the DSC option; however, it has proposed "restrictions" on DSCs, due to the Ontario Ministry of Finance's interest in exploring alternatives to an outright prohibition.

Such restrictions (on IFMs and dealers) in the Proposed Rule are as follows:

a. Investment Fund Manager Restrictions (the IFM Restrictions)

The IFM Restrictions seek to mitigate some of the negative consequences of being "trapped" in an underperforming mutual fund. Specifically, an IFM must not pay commission to a dealer for a distribution of a security of a mutual fund, unless:

1. The maximum DSC redemption fee schedule is set at three years;
2. Investors can redeem up to 10% of the value of their investment, annually, without incurring any redemptions fees (on a cumulative basis); and
3. The security sold is in a separate DSC series or class of the applicable mutual fund.

b. Dealer Restrictions

The Dealer Restrictions seek to crystallize a dealer's KYC obligations in the context of selling a security under the DSC option to an investor. Specifically, a dealer must not accept a commission from an IFM for a distribution of a security of a mutual fund under the DSC option, if:

1. The investor is aged 60 and over;
2. The investor's account is valued over $50,000;
3. The investor's time horizon is shorter than the DSC schedule;
4. The dealer knew, or reasonably ought to have known, that the investor:
    1. borrowed money to purchase mutual funds with the DSC option;
    2. purchased the securities using money from the redemption of securities that had been subject to a redemption fee (or could have been subject, if the securities had been redeemed earlier);
    3. purchased the securities using money from the reinvestment of distributions received on securities that are subject to a redemption fee or had been subject to a redemption fee; and
5. The investor dies, involuntarily loses full-time employment, becomes permanently disabled or is critically ill, post-redemption.

What's next?

The Proposed Rule is an attempt to address the inherent conflicts of interest embedded in the DSC option, while also providing an additional option for investors to purchase mutual fund securities (who, under other purchase options, may not do so). While the Proposed Rule, if adopted, will keep the DSC option alive in Ontario, the additional restrictions may be so burdensome as to produce the same effect as the 2020 CSA Amendments. Whether or not the Proposed Rule will be able to balance the CSA's desire to "put clients' interests first," and the Ontario government's commitment to being "open for business," remains to be seen. We expect many industry participants to take the opportunity to comment up to May 21, 2020.