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The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

RE: CSA Consultation Paper 81-408; Consultation on the option of discontinuing embedded commissions

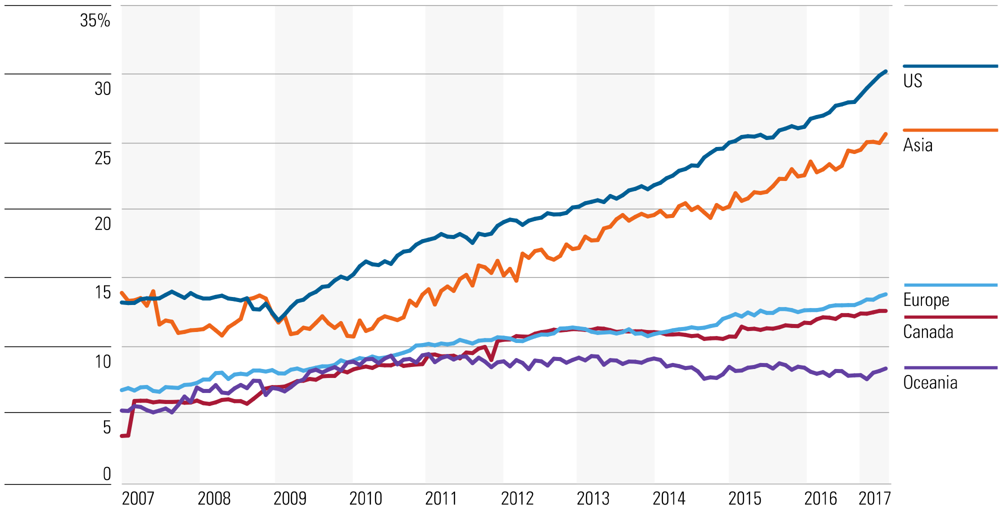
Ladies and Gentlemen:

Morningstar Research, Inc. welcomes the opportunity to address the questions posed in the CSA's January 10, 2017 paper discussion the proposed discontinuation of embedded commissions. Morningstar Research, Inc. is a leading provider of independent investment research, and our mission is to create products that help investors reach their financial goals. Because we serve individual investors, professional financial advisors, and institutional clients, we benefit from a broad perspective on the impact of the proposed rule and its possible effect on the advice investors receive.

Morningstar believes the embedded commissions should be discontinued because they align the financial interests of advisors with asset managers rather than with individual investors seeking advice. While clients' best interests are served by holding lower-cost funds, asset managers have an incentive to promote higher-cost alternatives from which they generate more revenue from fees. Asset managers use embedded commissions to incentivize advisors to favour higher cost funds, creating a conflict of interest. For example, the commission paid to actively-managed funds typically is at least twice that for passively-managed funds.

As a result, advisors in Canada overwhelmingly favour actively-managed funds: Index funds comprised 1.3% of commission-based assets as of March 2017, virtually unchanged from January 2007. By contrast, total Canadian indexed assets overall grew from 3.4% to 12.4% over this stretch, thanks mainly to the use of exchange-traded funds by fee-based advisors, institutions, and do-it-yourself investors. Index funds also made inroads in most other major markets, especially the United States, as Exhibit 1 (next page) illustrates.

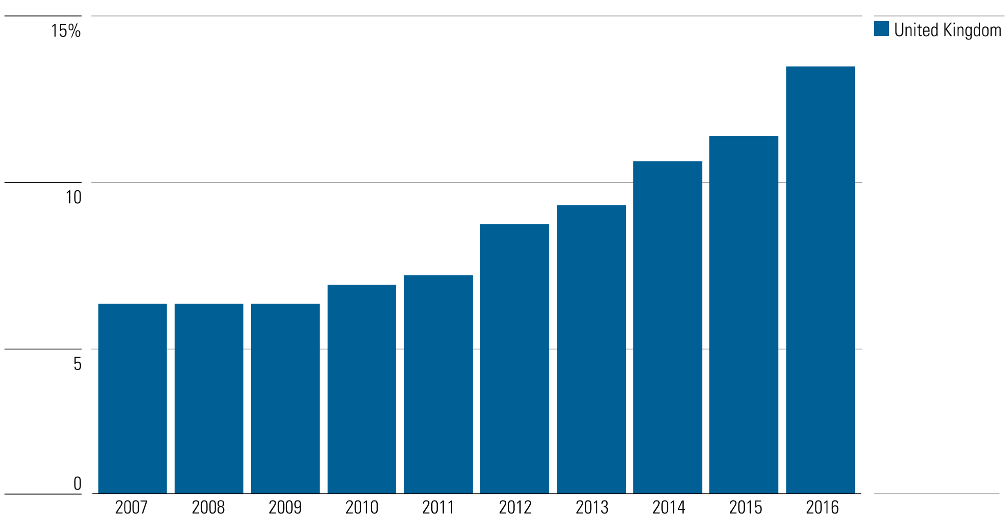
Exhibit 1 Index Fund Share Across Major Markets, 2007-Present



Source: Morningstar. Data as of March 31, 2017.

Morningstar expects discontinuing embedded commissions would accelerate flows into lower cost active funds and index funds. After the United Kingdom introduced new rules outlaw trailing commissions in December 2011, index funds' market share rose sharply after years of stagnant growth, as Figure 2 indicates. Index fund assets grew from 6.9% to 13.5% of industry assets from January 2012-December 2016. When asset managers could no longer incentivize advisors to favour more-expensive active funds, fewer advisors chose them. We welcome such competition from cheaper passive alternatives not to displace active managers but to pressure them to become cheaper.

Exhibit 2 Index Fund Market share, United Kingdom, 2007-16



Source: The Investment Association, Data as of January 31, 2017.

Exhibit 3 Historical Management Expense Ratios, 2011-15

Category	Distribution Channel	2011	2012	2013	2014	2015	2016	Change (2011-2016)
Canadian Dividend & Income Equity	Commission–based	2.29	2.29	2.3	2.29	2.29	2.26	–0.04
	Fee-based	1.22	1.22	1.22	1.22	1.2	1.16	-0.06
Canadian Equity	Commission–based	2.21	2.2	2.3	2.24	2.22	2.18	–0.03
	Fee–based	1.17	1.2	1.26	1.17	1.15	1.1	–0.07
Canadian Equity Balanced	Commission–based	2.32	2.32	2.34	2.31	2.3	2.29	–0.02
	Fee–based	1.26	1.29	1.27	1.24	1.21	1.21	–0.05
Canadian Fixed Income	Commission–based	1.53	1.56	1.55	1.55	1.54	1.53	0
	Fee–based	0.94	0.94	0.92	0.91	0.89	0.87	–0.07
Canadian Fixed Income Balanced	Commission–based	1.95	1.94	1.93	1.94	1.93	1.92	–0.03
	Fee–based	1.03	1.04	1.03	1.02	1.01	0.99	–0.04
Canadian Focused Equity	Commission–based	2.46	2.44	2.45	2.43	2.44	2.41	–0.06
	Fee–based	1.27	1.29	1.3	1.3	1.29	1.28	0.01
Canadian Neutral Balanced	Commission–based	2.23	2.2	2.2	2.17	2.17	2.15	–0.08
	Fee–based	1.18	1.16	1.13	1.1	1.09	1.07	–0.11
Global Equity	Commission–based	2.59	2.54	2.55	2.53	2.54	2.52	–0.07
	Fee–based	1.43	1.37	1.38	1.35	1.33	1.32	–0.11
Global Equity Balanced	Commission–based	2.5	2.5	2.48	2.46	2.45	2.43	–0.07
	Fee–based	1.34	1.31	1.32	1.3	1.27	1.24	–0.09
Global Fixed Income	Commission–based	1.91	1.89	1.91	1.91	1.82	1.8	–0.11
	Fee–based	1.1	1.08	1.13	1.08	1.01	1.02	–0.08
Global Fixed Income Balanced	Commission–based	2.21	2.16	2.14	2.12	2.08	2.07	–0.14
	Fee–based	1.24	1.14	1.19	1.13	1.1	1.08	–0.16
Global Neutral Balanced	Commission–based	2.38	2.35	2.32	2.31	2.29	2.29	–0.09
	Fee–based	1.24	1.25	1.24	1.2	1.18	1.17	–0.07
International Equity	Commission–based	2.43	2.41	2.42	2.38	2.36	2.37	–0.06
	Fee–based	1.28	1.27	1.29	1.28	1.24	1.24	–0.04
US Equity	Commission–based	2.29	2.23	2.31	2.28	2.27	2.23	–0.06
	Fee–based	1.28	1.21	1.27	1.22	1.19	1.17	–0.11

Source: Morningstar, Data as of March 31, 2017.

It does not take an imaginative leap to envision what the post-embedded commission landscape could look like. With increasing numbers of advisors adopting fee-based business models, the proportion of Canadian funds sold without commissions has grown markedly in recent years. While fee-based share classes accounted for 3% of advised fund assets in 2011, they now account for 15%, according to Morningstar data. Price competition was stronger in the fee-based channel over the period. For example, the average fee-based Canadian Equity MER fell 7-basis points from 2011-16, versus 3-basis points for the average commission-based fund in the category. We observed similar patterns across most major CIFSC categories, which we depict in Figure 3 above. Without embedded commissions to attract assets, fund managers compete, at least in part, on cost. Removing financial incentives to favour some funds over encourages advisors to focus on investment quality, of which cost is an important indicator. This result is unambiguously good for fund holders: Lower management fees mean better returns for investors.

Proponents of embedded commissions often characterize the commissions as fees for advice. In most cases, however, these commissions are fees paid by asset managers in exchange for funds sold, not for advice. Under the embedded compensation model, investors receive varying levels of service but pay a single, set price. Costs may be transparent but what investors get in return is not. Unbundling administrative and operational fees makes the cost of advice explicit. We anticipate greater transparency will require advisors to offer services commensurate with the fees they charge.

Some have argued that discontinuing embedded commissions risks leaving investors with relatively small balances without access to advice. But rather than abandoning or de-emphasizing these investors, we anticipate that the delivery of advice for this segment will change and technological innovations in advice will serve this segment. These solutions, commonly referred to as “robo advisors,” fill the gap between no-frills discount brokerages and full service wealth managers. We view the rise of digital advice solutions as positive for investors as these solutions democratize sophisticated asset-allocation models that had been available only to large institutions.

By inducing competition and lowering costs, improving transparency and accountability, and driving technological innovation, Morningstar believes investors will be well-served by discontinuing embedded commissions.

Very Truly Yours,

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