

MFDA CLIENT RESEARCH REPORT

A DETAILED LOOK INTO

MEMBERS



ADVISORS



CLIENTS



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PART I: BACKGROUND

Data Request and Use

As part of its regulatory activities the MFDA gathers information regarding its Members' business on an ongoing basis in order to effectively achieve its regulatory mandate of protecting investors. In 2016, the MFDA decided to expand the depth of its information database and retained Strategic Insight¹ to assist in a "Client Research Project". In addition to using the data in our regulatory activities, the MFDA's objective was to further evaluate MFDA Members' business operations, their role in the wealth management industry and assess their value in providing advisory services to retail investors in Canada. The research included an analysis of the various business models within the MFDA membership with a focus on financial advisory firms², their advisors and the clients they service.

The mandatory questionnaire was issued on June 29, 2016³ and required Members to provide the following information for each client account or household:

- Client address information
- Client age
- Account type and identifier
- Advisor code (where applicable)
- Product code
- Market value of each position held

When the information was received, it was anonymized and validated against the MFDA's existing information database for accuracy and completeness. The final aggregated database contains over 500 million individual pieces of data in respect of:

- 91 MFDA Members⁴;
- 15.6 million client accounts;
- 8.86 million households;
- 37.7 million individual investment positions reported in client accounts; and
- over 61,000 different investment products held by clients.

¹ Strategic Insight (Canada), an AI Financial Information Canada Inc. business, is a leading research firm that specializes in the fact-based measurement and analysis of Canada's retail financial services and wealth management industry. (www.strategic-i.com)

² See definition under Section B – Distribution Models.

³ The MFDA coordinated with the Autorité des marchés financiers (AMF) on the MFDA Client Research Project. In this regard, the AMF required MFDA Members to provide the MFDA with the information requested for clients residing in the province of Quebec.

⁴ Does not include carrying dealers, or resigning and suspended Members.

The MFDA categorized the over 61,000 different investment products by type (e.g. mutual fund, segregated fund, deposit instrument, cash, etc.) and performed further extensive analysis where the investment product was a mutual fund. For mutual funds, the MFDA compiled a database that associates each mutual fund with its corresponding prospectus risk rating, asset category⁵, and load type. This detailed mutual fund data will be used to analyze existing compensation arrangements as well as enhancing the MFDA's risk based regulatory oversight. The MFDA will also be better able to assess the characteristics of mutual funds held within client accounts as compared to the household demographics and focus on such things as senior investor issues and higher risk investments and strategies. Further, the data obtained in this project may also be used to establish a baseline for future research. Future research will allow the MFDA to identify trends or changes in such things as client demographics, industry compensation structures and asset mixes within portfolios.

CSA Consultation Paper 81-408

On January 10, 2017, the Canadian Securities Administrators ("CSA") published, for a 150-day public comment period, CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions ("Consultation Paper").

The purpose of the Consultation Paper is to solicit stakeholder input on the potential option of discontinuing embedded compensation for investment funds (including mutual funds) and moving to direct pay arrangements. The Consultation Paper is intended to assess the potential effects of discontinuing embedded compensation, identify potential measures that could assist in mitigating any negative impacts, and obtain feedback on other options that could adequately address the investor protection and market efficiency issues identified.

Given approximately 95% of the MFDA Members' AUA is comprised of mutual funds and MFDA Members' primary line of business is offering advisory services to retail investors in Canada, the MFDA was of the view that additional research was needed to better understand the potential impact of such a ban on MFDA Members, their advisors and, most importantly, their clients. The information contained in this report is meant to further inform all stakeholders of the potential scope of impact of an embedded compensation ban. We acknowledge that there are other factors, not measured by the MFDA or contained within this report, which could influence a potential outcome. Although it is difficult to specifically predict the outcome of a ban, the information contained in this report illustrates those business models, advisors and clients that have the greatest potential to be impacted.

⁵ Based on the *Retail Investment Fund Category Definitions* issued by the Canadian Investment Funds Standards Committee.

PART II: RESEARCH RESULTS

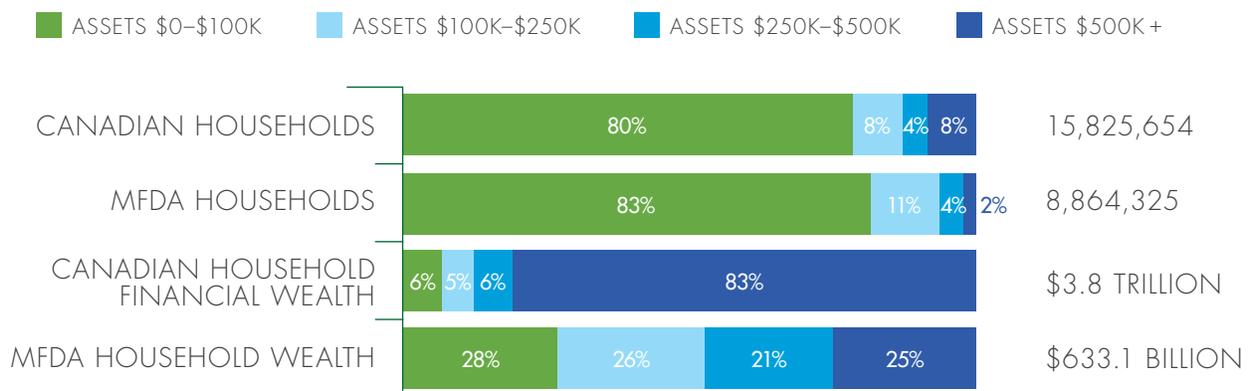
(A) Canadian Household Wealth and the MFDA Client Base

Households were categorized into the following financial wealth segments:

HOUSEHOLD CATEGORY	FINANCIAL WEALTH
MASS MARKET	< \$100K
MID MARKET	\$100K – \$250K
	\$250K – \$500K
AFFLUENT	\$500K +

Household financial wealth includes cash and investments. MFDA household wealth only includes cash and investments recorded on the books and records of MFDA Members.

(A.1) Comparing Canadian Households and the MFDA Client Base



As can be seen in figure A.1 above, the vast majority of households in Canada are mass market households (80%). However, these mass market households only own 6% of the \$3.8 trillion in financial wealth in Canada. Conversely, affluent households represent only 8% of all households in Canada but own 83% of the \$3.8 trillion of total financial wealth in Canada. Mid-market households represent 12% of all households in Canada and own 11% of total Canadian household wealth.

MFDA Members provide advisory services to 8.9 million Canadian households (or 56% of Canadian households) and manage \$633 billion in financial assets. Of the 8.9 million households serviced by MFDA Members, 83% (or 7.3 million households) are mass market households with less than \$100,000 in financial assets. While the number of households serviced by MFDA Members in the various wealth segments appears to be consistent with the Canadian demographic, the amount of assets managed by MFDA Members for each wealth segment is significantly different than the Canadian household distribution of wealth. All four wealth segments (mass market, lower mid-market, upper mid-market and affluent) contribute almost equally to the \$633 billion in MFDA Members assets under administration (“AUA”). Affluent households are only 2% of all households serviced by MFDA Members but they contribute almost the same amount (25%) to MFDA Member total AUA as the mass market households (28%). Even though only 6% of financial wealth in Canada is owned by mass market households, they are a significant segment of MFDA Members’ client base both in terms of assets and number of households.

The above data demonstrates that mutual fund dealers provide the most accessible advisory service to retail investors in the securities industry today. The fact that MFDA Members do not have minimum account sizes and the features of the mutual fund product itself aid in Member accessibility to retail investors. Mutual funds offer the average investor a professionally managed, diversified investment vehicle that can be purchased in small amounts to suit the client’s needs. Further, almost all MFDA advisors are dually licensed or employed in either the insurance or banking sectors thus offering broad access to a variety of financial services to Canadians.

(B) Distribution Models

There are various business models that operate within the MFDA membership. They vary by size, nature of employment of their sales force, and affiliations with fund manufacturers or other financial services entities. The MFDA segmented Member business models into the following three categories:

Direct Sellers

These firms are affiliated with fund companies and typically operate as call centers. Advisors are salaried employees of the affiliated fund company and only sell proprietary mutual funds. Advisors generally do not have their own books of business but instead service clients of the fund.

Deposit-Takers

These firms are affiliated with Canadian banks or credit unions. Advisors are generally salaried employees of the affiliated financial institution. Mutual funds are distributed through retail banking or credit union locations. While some deposit-takers do have advisors who are assigned clients and develop a client base, in general, most advisors with deposit-taker firms are not assigned to service specific clients. Rather, the advisors provide service to any client of the bank or credit union as needed.

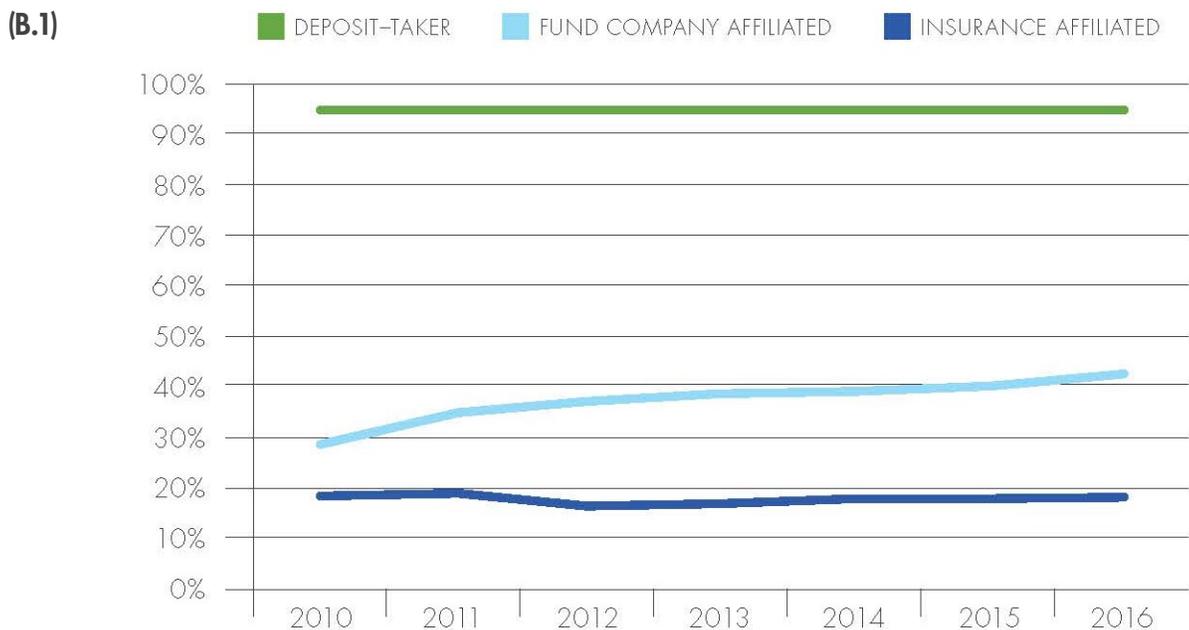
Financial Advisory Firms (“FA Firms”)

These firms almost exclusively employ advisors as agents and the advisors are responsible for developing their own book of business and financing their own business operations. These firms may be affiliated with an insurance carrier, fund manufacturer or completely independent of a product manufacturer. With one exception, all FA firms offer third party funds (or have “open” product shelves).

The following summarizes the MFDA membership using the distribution categories:

DISTRIBUTION MODEL	NUMBER OF FIRMS
DIRECT SELLER	9
DEPOSIT-TAKER	13
FINANCIAL ADVISORY	69
TOTAL	91

Percentage of Proprietary Mutual Funds by Distribution Model*



* INCLUDES ONLY FIRMS WITH OPEN PRODUCT SHELVES.

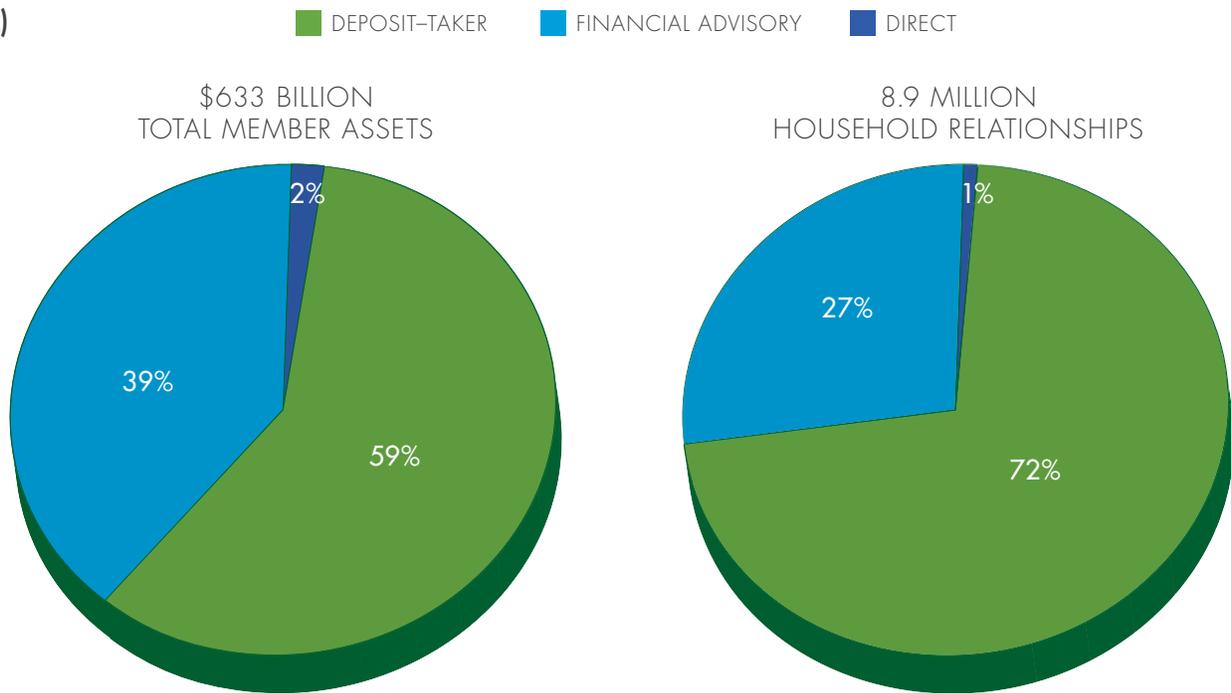
Figure B.1 charts the amount of proprietary mutual funds held within certain MFDA Member distribution models since 2010. Figure B.1 illustrates a key difference between the business models and in particular the insurance affiliated firms and deposit-takers. Insurance affiliated FA firms and deposit-takers are both affiliates of large financial institutions in a broad context. However, these firms operate very different business models within the MFDA.

For deposit-takers, approximately 95% of their mutual fund AUA is comprised of proprietary mutual funds. The client's primary relationship is typically with the bank or credit union and generally their advisors are not assigned to particular clients. A salaried workforce and what essentially amounts to a closed proprietary product shelf allow deposit-taker firms greater flexibility in determining how to finance mutual fund distribution.

In contrast, at FA firms, advisors are predominantly employed as agents and are responsible for establishing their own book of business and managing their own business operations. As evidenced in figure B.1, fund affiliated FA firms have just over 40% of assets in proprietary mutual funds and insurance affiliated firms have less than 20% of their AUA in proprietary mutual funds. Unlike the deposit taking firms, the FA firms do not have the same flexibility to restructure or manage revenue and costs between fund manufacturing and distribution.

MFDA Assets and Households by Distribution Model

(B.2)

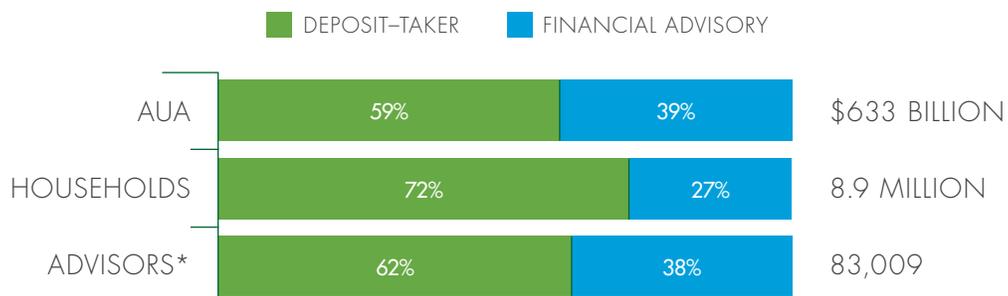


The deposit-takers have the vast majority of household relationships (72%) and assets (59%) in the MFDA membership. FA firms are the second largest category with 27% of households and 39% of membership assets. Direct sellers represent 1% of all household relationships and 2% of assets within the MFDA membership.

(C) Deposit-Taker and Financial Advisory Firm Comparison

Since the deposit-takers and FA firms are the two most significant business models within the MFDA membership, we performed a comparative analysis of these two categories.

(C.1)



* SOURCE: MFDA MEMBER FORM 1 FILINGS.

In terms of the overall membership demographics, deposit-takers have the greatest share of the \$633 billion of membership assets (59% or \$372 billion), 8.9 million household relationships (72% or 6.4 million) and 83,009 licensed advisors (62% or approximately 51,000).

(C.2) Asset Distribution by Household Asset Level – Deposit-Taker and Financial Advisory Firms

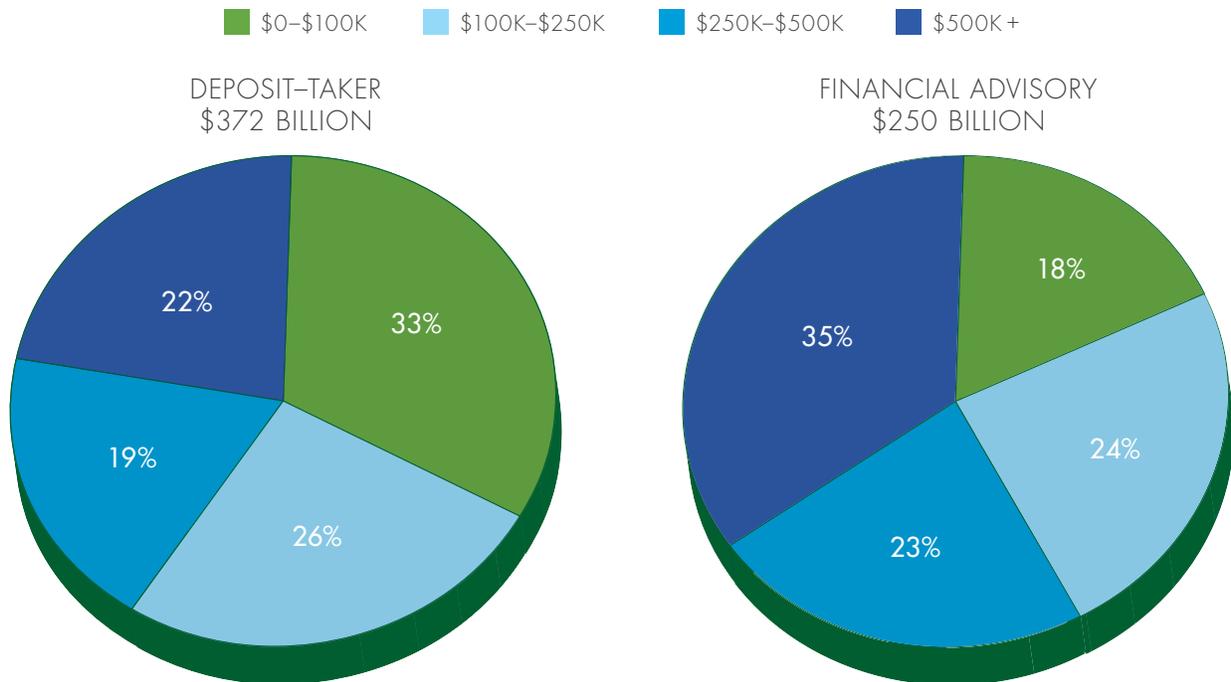


Figure C.2 provides an overview and comparison of the amount of assets that comprise deposit-taker and financial advisor AUA segmented by household wealth. As outlined in Figure C.2, 33% of deposit-taker AUA is from mass market households. In comparison, 18% of FA firms’ AUA is from mass market clients. Both distribution models have a comparable percentage of their assets with lower-mid market households with the deposit-takers having slightly less of their assets with upper mid-market households. FA firms have more assets with affluent households (35%) than the deposit-takers (22%). Deposit-takers have a lower percentage in the upper mid-market and affluent households as they typically refer clients that have accumulated over \$250,000 in financial assets to an affiliated investment dealer or portfolio manager.

(C.3) Deposit-Taker and Financial Advisory Firm Share of Total MFDA Member Households

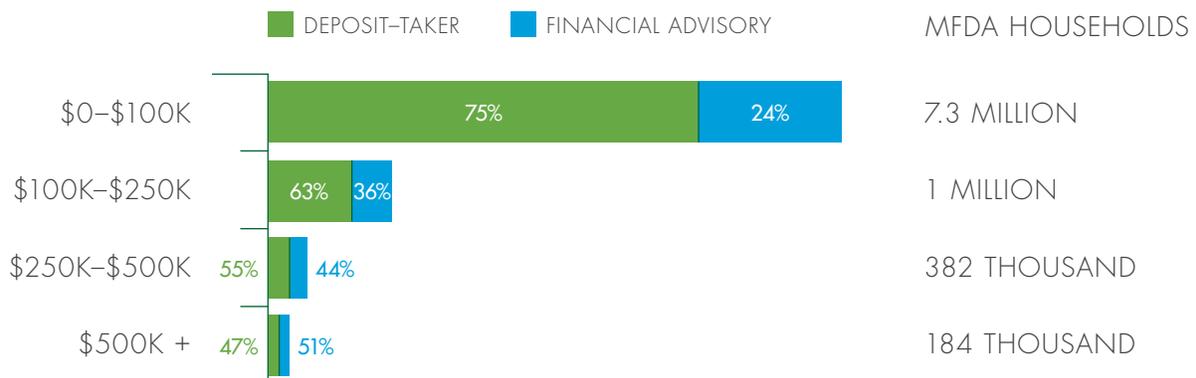


Figure C.3 compares the deposit-taker and FA firm share of household relationship segmented by household wealth. The deposit-takers service 75% (or 5.4 million households) of the 7.3 million mass market segment. FA firms gain market share in the mid-market segment with 36% in the lower mid-market (approximately 367,000 households) and 44% in the upper mid-market (approximately 167,000 households) categories. The FA firms slightly surpass the deposit-takers (51% or approximately 94,000 households) in the affluent household wealth segment.

(C.4) Household Distribution by Age Group – Deposit-Taker and Financial Advisory Firms

HOUSEHOLD AGE	DEPOSIT TAKER	FINANCIAL ADVISORY	CANADA*
0–24	2%	2%	6%
25–44	32%	28%	31%
45–54	24%	25%	19%
55–64	22%	23%	18%
65+	20%	22%	26%

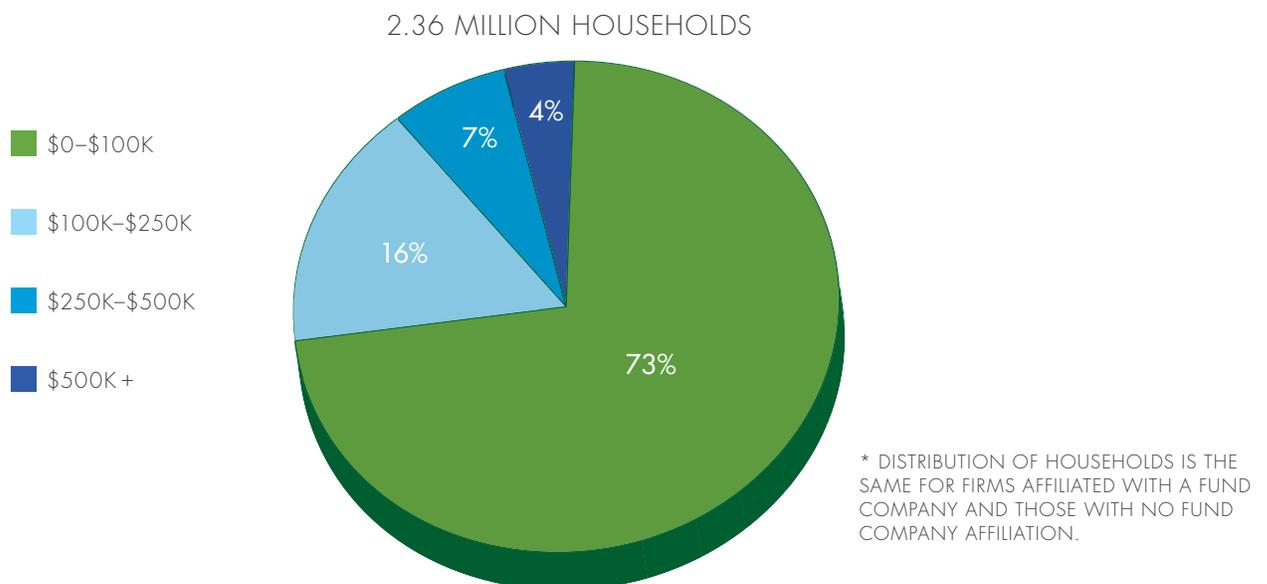
* SOURCE: STRATEGIC INSIGHT (CANADA).

Of particular interest to the MFDA was the age distribution of the MFDA client base. Age of the household was determined by the most senior person living in the household. As noted in the figure above, there is a similar distribution by age between households serviced by deposit-taker and FA firms.

(D) Financial Advisory Firms

Further analysis was performed specifically relating to FA firm clients, mutual fund assets by load type and advisor book size and composition.

(D.1) Household Distribution by Household Asset Level – Financial Advisory Firms*



As demonstrated in Figure D.1, there are 2.36 million households serviced by FA firms. Of those 2.36 million, 73% or 1.7 million households are mass market households with less than \$100,000 in financial assets. Those 1.7 million households own 18% of assets managed by FA firms (Figure C.2). The remaining 23% of mid-market households and 4% of affluent households own 47% and 35% of the assets managed by FA firms respectively.

The MFDA investigated whether there was a difference in household wealth segments serviced by independent FA firms and FA firms affiliated with a fund manufacturer (including both fund company and insurance carrier affiliated firms) and determined that affiliated and independent FA firms have the same distribution of households by wealth segment.

Age of Mass Market Households Serviced by Financial Advisory Firms

As FA firms are most likely to be impacted by a ban of embedded compensation and given mass market clients are less likely to be able to afford direct pay arrangements or less likely to be eligible for fee-based programs⁶, further analysis of the age of the 1.7 million mass market households was performed and is outlined below.

(D.2) Distribution by Age Group (Households <\$100K) – Financial Advisory Firms

1.7 MILLION HOUSEHOLDS

HOUSEHOLD AGE	HOUSEHOLD DISTRIBUTION
0–24	2%
25–44	35%
45–54	26%
55–64	20%
65+	17%

Of the 1.7 million mass market households serviced by FA firms, there are 638,000 households (or 37%) where the most senior client in the household is approaching or in retirement (i.e. over 55 years of age).

⁶ Members that offer fee-based programs set minimum account sizes starting at \$100,000 in assets. Existing fund administered fee-based programs tend to be targeted towards higher net worth clients.

Financial Advisory Firm AUA by Load Structure

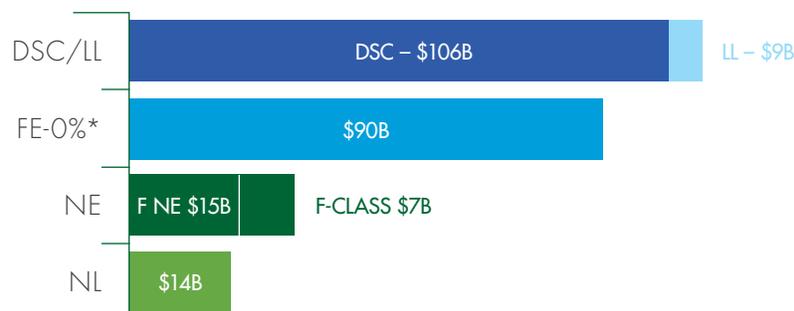
Mutual fund assets were segmented into the following load structures:

	DSC DEFERRED SALES CHARGE	FE FRONT-END LOAD	LL LOW-LOAD	NE NON-EMBEDDED	NL NO-LOAD
POINT OF SALE COMMISSION	EMBEDDED	CLIENT PAID	EMBEDDED	NONE	NONE
TRAILER FEE	EMBEDDED (30–50bps)	EMBEDDED (60–100bps)	EMBEDDED (40–70bps)	NONE	EMBEDDED (50–100bps)
COMMENTS	Up-front commission paid by issuer 5–7 year redemption schedule	Commission paid by client at purchase (deducted from amount invested)	Lower up-front commission paid by issuer Shorter redemption schedule (e.g. 3 yrs)	No up-front commission No trailer commission	No up-front commission Pays a trailer commission

Trailing commissions vary depending on the asset class and load type. With respect to asset class for example, a front end load (“FE”) domestic equity fund may pay a 1% trailing commission and a FE domestic fixed income fund may pay a 0.65% trailing commission. In general, the trailing commission paid on a deferred sales charge (“DSC”) fund is approximately half that of the FE series of the same fund.

With respect to non-embedded (“NE”) funds, there are two types of funds within this category. First, there are F-class funds that are held within MFDA dealer administered fee-based programs. Typically, fees for existing dealer administered programs are calculated on a declining rate based on assets. Fee rates generally begin at 1.5% for accounts in the lowest asset tier and can decline as assets increase to as low as 0.50% to 0.25% in the highest asset tier. The second type of non-embedded funds are funds held within fund company administered fee-based programs (“F-NE”) where the fund redeems units and distributes the proceeds to the dealer to pay the advisory fee. The non-embedded funds in the fund company administered programs that exist today are generally wrap products or portfolio solutions with negotiable fees that tend to be marketed towards higher net worth clients.

(D.3) Distribution by Mutual Fund Load Structure – Financial Advisory Firms



* BASED ON MFDA INFORMATION, MUTUAL FUNDS SOLD ON AN FE BASIS ARE GENERALLY SOLD WITHOUT AN INITIAL SALES CHARGE.

DSC and low load (“LL”) funds make up the largest component of FA firm mutual fund assets comprising about 48% of mutual fund assets held by FA firms. The MFDA has, however, observed changes in the industry regarding the sale of DSC funds over the past year. First, MFDA Members have been conforming to the guidance outlined in the MFDA DSC Sweep Report published in December 2015. Members have established supervisory controls and procedures to oversee, and in some cases limit or restrict, trading in DSC funds. Certain fund companies have also decided to discontinue offering DSC as an option for their funds⁷. Further, since the implementation of CRM2, the MFDA has also observed a rise in fee-based platforms and accounts within the MFDA membership. DSC mutual fund assets within the MFDA membership, while material, appear to be declining.

FE funds comprise 37% of total FA firm fund assets. MFDA data indicates that the vast majority of FE funds were sold without an upfront charge (i.e. 0% front-end load).

There is \$14 billion (6%) in no-load funds and for NE funds, there is approximately \$7 billion (3%) in F class funds and the remaining \$15 billion (6%) in fund administered fee programs.

Financial Advisor Profile

Based on the advisor codes submitted to the MFDA, we were able to perform an analysis of advisor book size as outlined below:

(D.4) Assets, Households and Advisors by Book Size – Financial Advisory Firms

BOOK SIZE	ASSETS* (MILLIONS)	HOUSEHOLDS**	ADVISORS***	ADVISORS (%)
<\$500K	\$1,847	83,257	11,957	35.2%
\$500K-\$2M	\$7,495	196,030	7,064	20.8%
\$2M-\$10M	\$39,082	636,113	8,238	24.2%
\$10M-\$20M	\$42,872	438,706	3,099	9.1%
\$20M-\$50M	\$80,492	597,884	2,706	8.0%
\$50M+	\$69,198	348,901	903	2.7%
TOTAL	\$240,986	2,300,891	33,967	100%

* INCLUDES ONLY MUTUAL FUND ASSETS.

** EXCLUDES HOUSEHOLDS WITH NO ADVISOR CODE OR NO MUTUAL FUND ASSETS.

*** BASED ON ADVISOR CODES SUBMITTED TO MFDA.

Almost all advisors licensed with FA firms are dually licensed to sell insurance and therefore they are not necessarily relying solely on revenue from mutual fund activity to generate income. However, as indicated in the figure above, approximately 56% of advisors licensed with FA firms (or 19,021) advisors, have a book size of less than \$2 million. While the MFDA did not collect data on advisor revenue from insurance activity outside the MFDA Member, advisors with a book of business of less than \$2 million are likely not able to support themselves solely from their advising activity and may have other occupations.

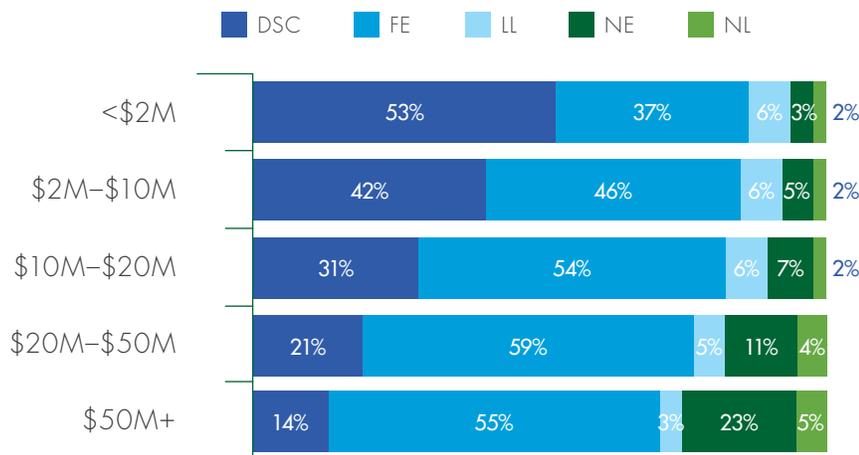
⁷ On September 19, 2016, Investors Group, a member of the IGM Financial Inc. group of companies announced plans to close the DSC purchase option of Investors Group’s funds for all new lump sum investments, effective January 1, 2017. On March 31, 2017, Dynamic Funds, announced plans to close the DSC purchase option of Dynamic funds for all new investments, effective June 30, 2017.

From the FA firm perspective, approximately 20% of advisors (6,708 advisors) or advisors with a book of business over \$10 million are responsible for 80% of the FA firms' AUA. In other words, 20% of FA firm advisors are responsible for driving 80% of the firms' revenue.

Mutual Fund Load Type by Advisor Book Size

Based on the advisor codes submitted to the MFDA, we were able to perform an analysis of advisor book size as outlined below:

(D.5) Asset Load Types by Advisor Book Size – Financial Advisory Firms*

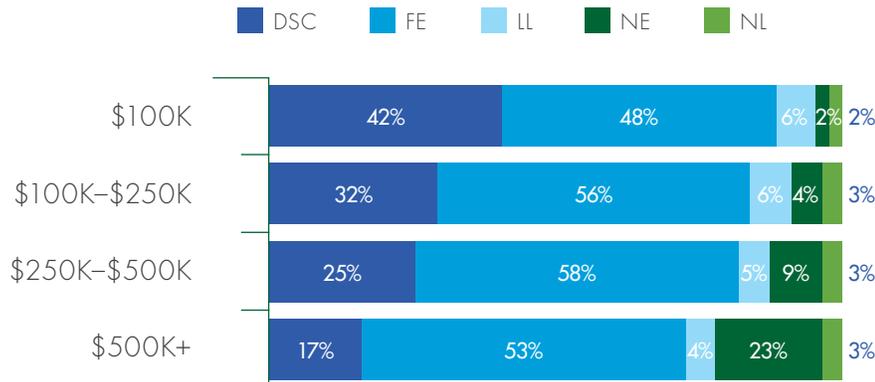


* INCLUDES ONLY FIRMS WITH OPEN PRODUCT SHELVES.

Figure D.5 outlines the percentage of funds by load type within FA firm advisors' books of business. Advisors with a book size of less than \$2 million are most reliant on DSC commissions to finance their operations with 53% of their book in DSC funds. As advisor book size increases, the amount of DSC within the book decreases and mutual fund assets shift to FE and NE funds. A mandatory switch to fee-based or direct pay arrangements will therefore have a greater impact on those smaller advisors who are more reliant on DSC commissions than those advisors who are currently predominantly earning trailing commissions.

Mutual Fund Load Type by Client Wealth

(D.6) Load Type Share by Household Asset Level – Financial Advisory Firms*



* INCLUDES ONLY FIRMS WITH OPEN PRODUCT SHELVES.

Mass market households have the greatest concentration in DSC funds and as household assets increase, they experience a shift from DSC funds to FE and NE funds. Advisors may be using the embedded DSC commission paid by the fund company upon purchase to finance the cost of offering advisory services to mass market clients. If so, a ban of embedded compensation would eliminate the DSC commission and may result in advisors having to charge clients an upfront fee to cover the cost of their services. As mass market households are less likely to be able to afford direct pay arrangements and are less likely to be eligible for fee-based programs, they would be the most impacted by a ban of embedded compensation.

It is the case, however, that mass market households serviced by advisors with larger books have materially lower levels of DSC than mass market households serviced by advisors with smaller books of business. It appears that as advisors grow their business, they reduce their reliance on DSC across the households that they service.

(E) Geographic Segmentation – Financial Advisory Firms

MFDA Members operate in all provinces and territories across Canada.

Figure E.1 provides a breakdown of MFDA Member households located in the various provinces and territories by client wealth segments.

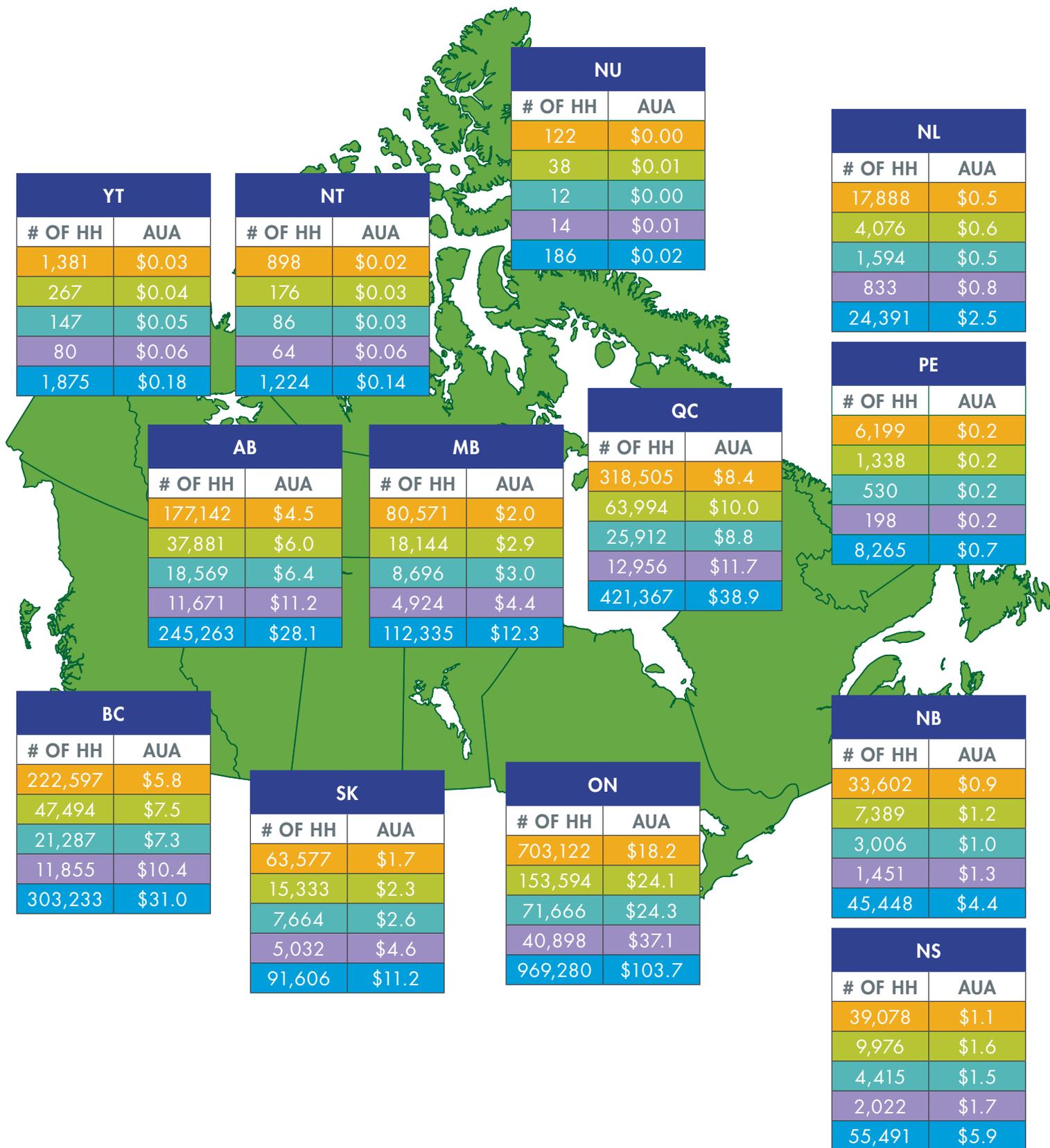
Figure E.2 provides a breakdown of the number of mass market households within each province and territory and further segments mass market households into urban and rural locations⁸.

Figure E.3 provides a breakdown of advisors licensed in the various provinces and territories segmented by advisor book size. The provincial segmentation was determined using provincial licensing and not by advisor residence. As advisors may be licensed in more than one jurisdiction, information for such advisors would be replicated in each jurisdiction of registration.

⁸ Urban and rural household locations were identified using postal code information as defined by the Canada Post Corporation.

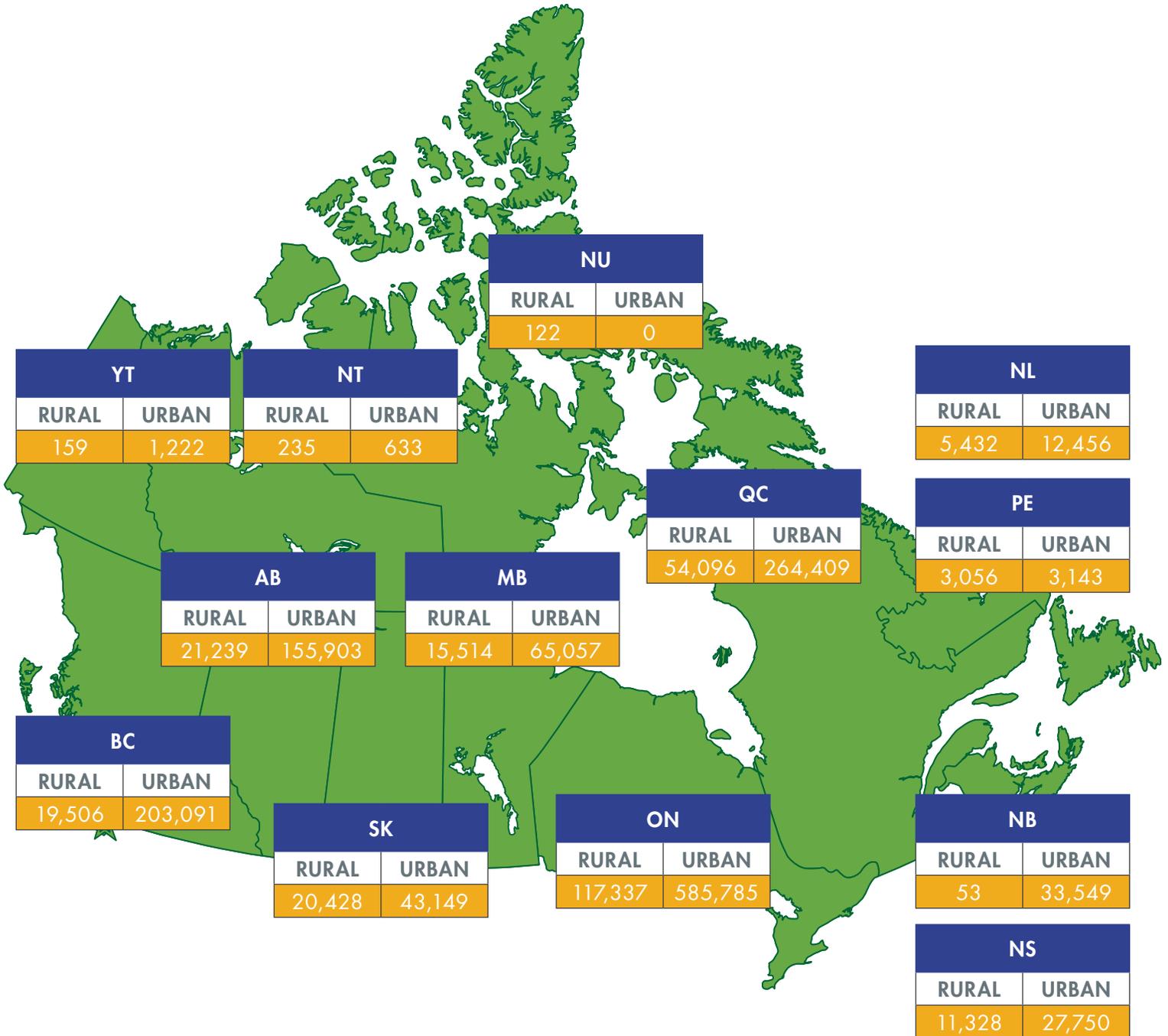
(E.1) Provincial Segmentation – MFDA Households and Assets by Household Asset Level – Financial Advisory Firms (AUA in Billions)

HOUSEHOLD ASSET LEVEL ■ \$0-\$100K ■ \$100K-\$250K ■ \$250K-\$500K ■ \$500K+ ■ TOTAL



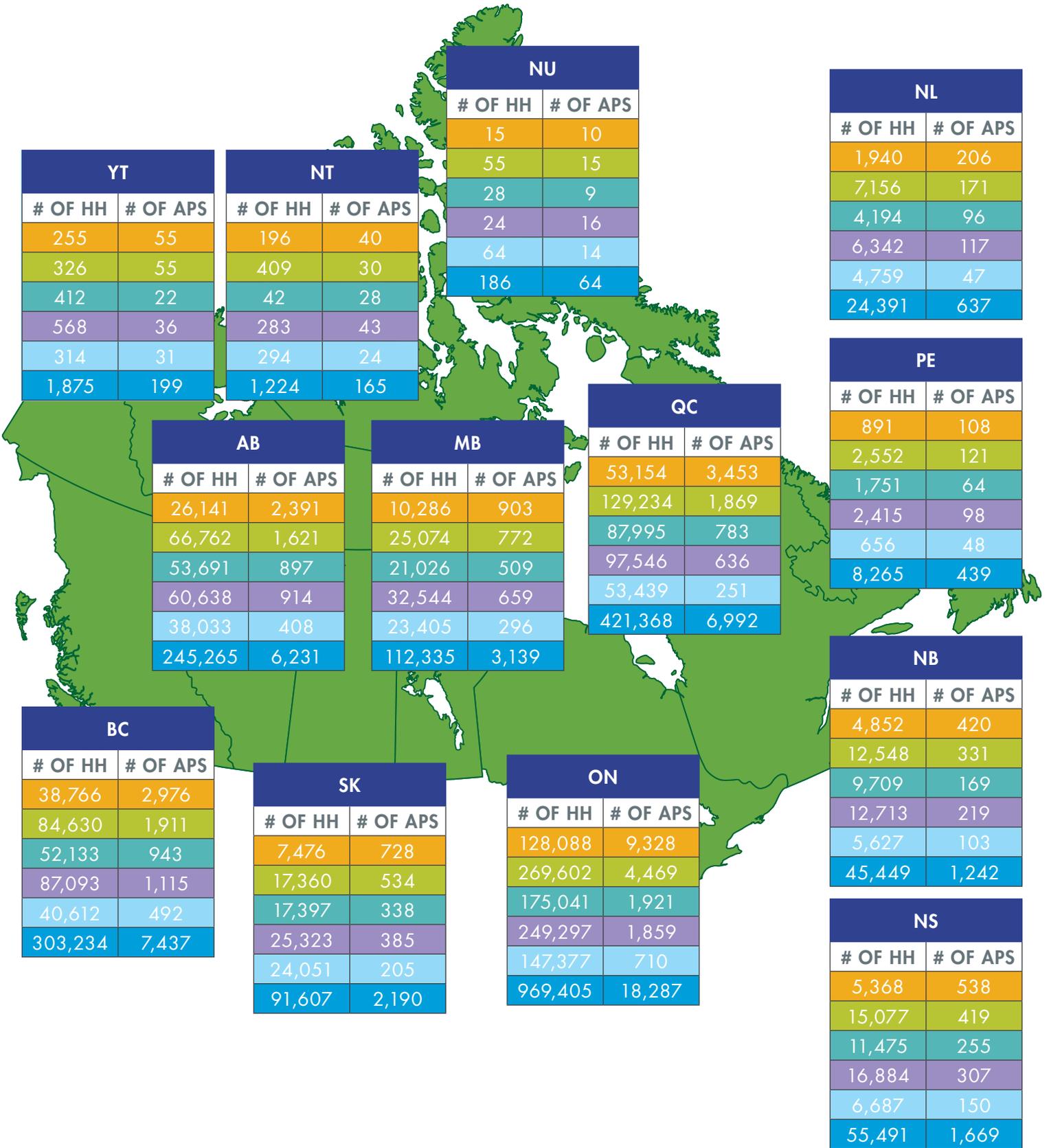
(E.2) Provincial Segmentation – Rural vs Urban Households – Financial Advisory Firms

HOUSEHOLDS <\$100K WEALTH



(E.3) Provincial Segmentation – MFDA Households and Assets by Advisor Book Size – Financial Advisory Firms

ADVISOR BOOK SIZE ■ \$0–\$2M ■ \$2M–\$10M ■ \$10M–\$20M ■ \$20M–\$50M ■ \$50M+ ■ TOTAL



PART III: SUMMARY REMARKS

Canadian Household Wealth and the MFDA Client Base

MFDA Members service more mass market households and license more advisors than any other category of securities registrant in Canada. Deposit taking firms are responsible for servicing the majority of MFDA Member households (72%) and licensing the most number of advisors (approximately 51,000) within the MFDA membership. However, FA firms form a significant part of the industry servicing 2.36 million households and licensing approximately 32,000 advisors within the MFDA membership.

The FA firms, and their advisors, are the most likely to experience an impact from a ban of embedded compensation. Approximately 56% (or 19,021) of advisors licensed with FA firms have small books of business and predominantly rely on DSC commissions to finance their operations. Mass market clients are more likely to purchase DSC funds and therefore are also more likely to experience an impact from a ban of embedded compensation.

In other countries where embedded compensation has been banned, concerns have been raised regarding the loss of advisors and inability of mass market clients to access advice. It is difficult to predict to what extent these outcomes will occur in Canada. One notable difference between the CSA proposal and the practices in the United Kingdom and Australia is that the CSA proposal would only apply to investment funds. In other countries, the ban of embedded compensation applied more broadly to other investment products. Given almost all licensed advisors with FA firms are dually licensed to sell insurance and the CSA proposal to ban embedded compensation would not apply to insurance products (such as segregated funds), clients may not in fact experience any change in their advisory relationship. Rather, advisors may decide to recommend products or services to their clients that are not subject to the same regulatory requirements.

Whatever course of action is ultimately proposed with respect to embedded compensation and investment funds, regulators will also need to be mindful of all conflicted compensation arrangements that raise similar or even greater regulatory concerns. In this regard, MFDA has identified regulatory and investor protection concerns with other compensation arrangements, and in particular, with the sale of exempt securities and referral arrangements with portfolio managers⁹.

Finally, we note that there are two components of embedded compensation: point of sale commissions (e.g. DSC) and trailing commissions. With respect to embedded point of sale commissions, MFDA has identified investor protection concerns with certain DSC trading activity, particularly involving senior investors. DSC trading has also been a focus of MFDA compliance examinations and the subject of investor complaints received by MFDA. With respect to a potential ban of trailing commissions, there may be additional implications beyond the scope of this report. Accordingly all such relevant factors, as well as alternatives to addressing the demonstrable investor protection issues, should be explored further to fully assess the costs and benefits of eliminating embedded point of sale commissions and/or trailing commissions.

⁹ MFDA Bulletin #705-C, *Review of Compensation, Incentives and Conflicts of Interest*.



**Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels**

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