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June 9, 2017

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Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer 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
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Dear Sirs/Mesdames:

Re: Canadian Securities Administrators Consultation Paper 81-408
Consultation on the Option of Discontinuing Embedded Commissions

On behalf of Advocis, The Financial Advisors Association of Canada, we are pleased to provide our comments in regards to the Canadian Securities Administrators' ("CSA") Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions* (the "Consultation Paper").

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1. INTRODUCTION AND EXECUTIVE SUMMARY

The CSA is contemplating bringing about nothing short of devastating change to the investment funds industry. Let us be clear in our position: we are opposed to the CSA's proposal to ban the embedded compensation option for retail investment funds. This is fundamentally an issue of consumer choice and fairness. We believe that the elimination of commissions by regulatory fiat would cripple the ability of low- and middle-income consumers to access financial advice.

Financial advice is of tremendous value to clients. Multiple studies have proven this fact conclusively. But to understand its value, the CSA must look not to traditional metrics such as *alpha*, the chasing of excess returns, or *beta*, portfolio construction and asset allocation. The value of advice is about *gamma*, the ability of an advisor to transform clients' ingrained savings apathy towards a forward-looking mindset of long-term investments. Despite the CSA's apparent dismissal of this skill based on the tone of its commentary on behaviour modification in the Consultation Paper, changing clients' predilections is an extraordinarily difficult task that the vast majority of investors cannot achieve alone.

Because of embedded commissions, financial advice is currently available to all investors, large and small. This is evidenced by data that shows the modest size of new advised investment accounts. It is true that not enough small investors are seeking advice, even when they feel they should; so the CSA should enact policies that would expand access, rather than restrict it. Advisors are currently willing to serve these small investors because of the cross-subsidization that embedded compensation allows, as well as the promise of growing future income streams that is only realized if the investor is successful as well.

The fact is that most low- and middle-income consumers are not willing to pay for advice directly. Without the benefit of the cross-subsidy, investors will be facing charges that effectively equate to hundreds of dollars per hour. Even if small investors are able to pay these fees, they would have to understand the value of financial advice to be willing to do so. But financial advice is a credence good by nature, so its value is not easily discernible to an individual investor – particularly as its benefits cannot be nailed down at any particular moment in time and only become apparent, in hindsight, after years or decades of committed use. So eliminating commission compensation means that these investors will not have access to advice, and will miss out on the benefits of the gamma factor.

So the elimination of commissions will orphan millions of small consumers. The CSA should not count on banks or fintech filling in the gap. And the CSA's fixation on passive investment strategies based on low costs alone evinces its outdated emphasis on alpha as the value of advice; its desire to

see a wholesale shift to passive products could create serious implications for the capital markets, including in regards to market efficiency and price discovery.

The CSA should also be cognizant that direct-pay arrangements are no panacea. No compensation scheme is behaviourally-neutral: they each carry their own set of challenges. We have recently seen an outcry in popular media against the questionable sales techniques of employees at large, vertically-integrated firms incented by proprietary product sales targets and the constant threat of dismissal for failure to hit revenue targets. Yet the elimination of commissions would suffocate the independent channel that competes with, and counter-balances the influence of, vertical firms and it would give even more leverage to the latter.

Ultimately, we understand that the CSA is motivated by its honest and forthright goal of improving investor protection. But the CSA's focus on commission compensation, and the deleterious effects it can have, is too narrow and its proposed solutions would cause more harm than good. At the same time, we recognize that the gamma factor is grounded in the trust clients place in their advisor – so advisors must be worthy of that trust, and it is our collective responsibility to ensure that is the case.

We believe the better way forward is to professionalize advice so that consumers can be assured that their trust is well-placed. Financial advisors are most consumers' sole interface with the entire financial services sector. So they are also the key consumer safeguard. It is time to elevate financial advice to a profession – by raising proficiency standards across the board and re-aligning the regulation of advice so that it accords with the modern consumer's perspective, we could solve more consumer protection issues, more dynamically and effectively than prescriptive regulation ever could.

Professional advisors must be involved in their own regulation and, as professionals, must be subject to the highest of standards – including a duty to act in their clients' best interests. In doing so, we can preserve choice and access to advice for all investors, regardless of their wealth, while increasing the quality of the advisory relationship that is so critical to achieving financial independence.

2. ABOUT ADVOCIS

Advocis is the association of choice for financial advisors and planners. With more than 12,000 members across the country, Advocis is the definitive voice of the profession, advocating for professionalism and consumer protection. Our members are provincially licensed to sell life, health and accident and sickness insurance, as well as by provincial securities commissions as registrants for the sale of mutual funds or other securities. Members of Advocis are primarily owners and operators of their own small businesses and create thousands of jobs across Canada. Advocis

members provide advice in a number of key areas, including estate and retirement planning, wealth management, risk management, tax planning, employee benefits, critical illness and disability insurance.

Professional financial advisors and planners are critical to the ongoing success of the economy, helping consumers to make sound financial decisions that ultimately lead to greater financial stability and independence both for the consumer and the country. No one spends more time with consumers than financial advisors, educating them about financial matters and helping them to reach their financial goals. Advocis works with decision-makers and the public, stressing the value of financial advice and striving for an environment in which all Canadians have access to the advice they need.

3. A LOOMING RETIREMENT CRISIS

Canadians are living longer, but they are not saving sufficiently

As the CSA is aware, Canada faces a looming retirement crisis. By 2031, life expectancy is expected to be about 82 years for men and 86 years for women,[1] up sharply from 69 and 76 years, respectively, in 1970.[2] But only about 70 to 80 of those years are expected to be in "good health",[3] meaning that private spending on medical and home care services are poised to skyrocket. At the same time, there has been a major drop off in the proportion of the public that is covered by a workplace pension: now, only about 25% of private sector employees have a workplace pension,[4] with defined contribution plans being the dominant option for new entrants.

These demographic and structural changes mean that consumers will need to rely on the accumulation of voluntary savings, in greater amounts and for a longer duration than ever before. Consumers now bear the challenge of market, inflation and longevity risks. But consumers are ill-equipped to deal with these challenges alone, as financial literacy is poor amongst the general public – which is a problem that is not unique to Canada.[5] Public financial education is helpful, but it is clear that educational campaigns alone will not suffice.

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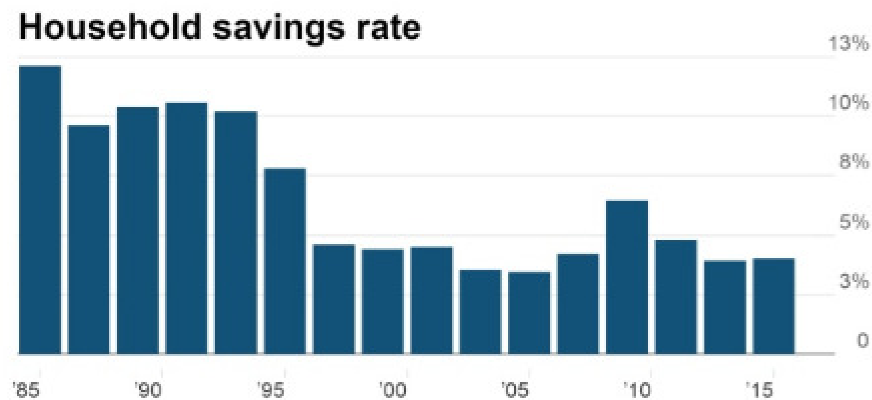
[1] Statistics Canada, Canadian Demographics at a Glance. Catalogue 91-003 Ottawa: 2008.
[2] Statistics Canada, CANSIM Table 102-0512 and Catalogue no. 84-537-XIE.
[3] Statistics Canada, CANSIM Health-adjusted life expectancy, at birth and at age 65, by sex and income group, Canada and provinces.
[4] Statistics Canada, Pension plans in Canada. Available at: http://www.statcan.gc.ca/daily-quotidien/110509/dq110509a-eng.htm.
[5] Surveys conducted in OECD countries and some non-OECD economies show that not only do consumers have low levels of financial literacy preventing them from making good and informed financial decisions, but they also often overestimate their

On the whole, Canadians have demonstrated poor financial discipline: according to Statistics Canada, the national saving rate is just 4.5%, which is near 30-year lows. At the same time, debt levels have reached record levels, exceeding $2 trillion nationally, mostly consisting of mortgage loans and consumer credit.



Source: Statistics Canada

As a result, most Canadians are alarmingly ill-prepared for retirement. A recent Broadbent Institute study found that nearly half of Canadians aged 55 to 64 who are without an employer pension plan have accumulated a "wholly inadequate" amount of retirement assets.[6] Specifically, retirement assets amounted to only $250 on average for those earning between $25,000 and $50,000, and $21,000 for those with incomes in the $50,000 and $100,000 range. Across the whole group, the median level of savings was only $3,000. Fewer than one in five people who do not have an employer pension have enough to live in retirement for five years or more.

It is plainly obvious that regulators and policy makers must contemplate action that can reverse this disturbing trend and set Canadians on a path towards greater wealth accumulation.

<u>Retirement wealth is built on investments, not savings alone</u>

The traditional line of thinking is that saving for retirement means just that – starting early and putting little by little into "safe" deposit accounts or GICs. Retirement funds are thought to be a nest egg that should largely be shielded from market risk. But this cannot be the case in a sustained

financial skills, knowledge and awareness. See: *Financial Literacy and Consumer Protection - Overlooked Aspects of the Crisis*, OECD 2009.

[6] Richard Shillington, *An Analysis of the Economic Circumstances of Canadian Seniors*, Broadbent Institute, February 2016.

low interest rate environment. Instead, to achieve retirement savings targets, consumers must have an appetite for bearing some risk. After all, the real risk facing most Canadians is not losing money from investments over a long time horizon, but running out of money in retirement.

Average Real Return from 2005-2014			
	Nominal Return	**CPI (Inflation)**	**Real Return**
1-Year GIC	1.40%	1.81%	-0.41%
3-Year GIC	1.85%	1.81%	0.04%
5-Year GIC	2.28%	1.81%	0.47%

Source: Ratehub.com

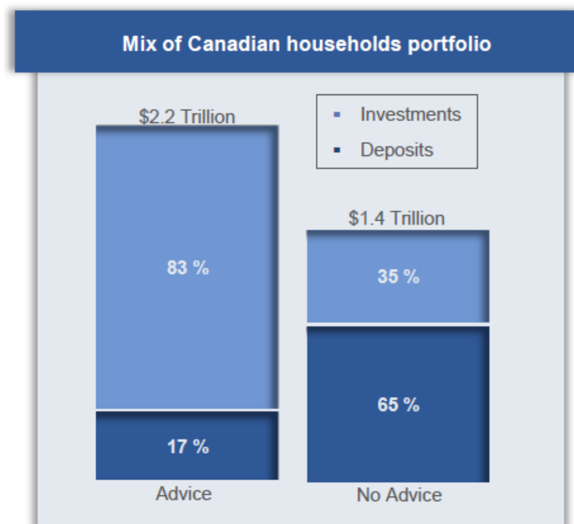
Recent studies have established that the causal factor for rising wealth is the rising value of investments, not income from labour.[7] When it comes to the success of those investments, the key driver is the allocation of savings between "riskless" assets (such as treasury bills, government bonds or GICs) and "risk bearing" assets (such as mutual funds): it is the choice of risk bearing assets that is responsible for higher returns in investor portfolios.[8]

Consumers are risk averse

The problem is that, generally, people are naturally risk averse and are prone to weigh potential losses more than gains.[9] They are reticent to wade into the capital markets alone: without professional assistance (particularly as financial literacy levels are so low), uncertainty and potential losses are magnified. Downside risk looms large over the benefits of investing in the market, the latter of which are only realized years and decades later, which leads to the further discounting of its potential benefits when investing decisions are made today.

This is evidenced in a recent Pollara report that indicates investors would have very limited confidence choosing mutual funds without the help of an advisor. The majority (56%) say they would feel "not very confident" or "not confident at all" without professional assistance.[10] Consequently, it is no surprise that non-advised consumers hold a disproportionate share of their assets in deposit instruments rather than investments, relative to consumers receiving financial advice.

[7] Thomas Piketty, Emmanuel Sary, Gabriel Zucman, *Distributional National Accounts: Methods and Estimates for the United States*, NBER Working Paper no. 22945, January 2017.
[8] Thomas Piketty, *Capital in the Twenty-First Century*, Harvard University Press, 2014.
[9] Ito, T. A., Larsen, J. T., Smith, N. K., & Cacioppo, J. T. (1988). *Negative information weighs more heavily on the brain: The negativity bias in evaluative categorizations*, Journal of Personality and Social Psychology.
[10] *Infra*, note 15.



Source: Investor Economics, 2015 Household Balance Sheet Report

This is disastrous to wealth accumulation in the long run. By keeping such a large proportion of their assets in low-return deposit instruments, non-advised consumers are poised to see the value of their savings eroded by inflation and they will miss out on the critical investment growth that is needed to sustain their lifestyles in retirement.

Only professional financial advice can stem the crisis

Given the facts above, we believe it is unreasonable to expect most consumers to manage their retirement needs by themselves. In fact, research estimates that only 6% of Canadian investors meet the criteria required to be successful at being their own financial advisor.[11] At the same time, there is clear proof – detailed in Section 5 below – that accessing professional financial advice materially improves investor outcomes, which includes providing investors with the confidence that is necessary to invest in the risk-bearing assets that are crucial to wealth accumulation. **Therefore, to enact a regulatory regime that deprives consumers of professional assistance in managing their financial affairs is nothing short of putting the public's retirement security at risk.**

High net worth investors have the means to access professional financial advice, regardless of what compensation structure is mandated by regulators. Those consumers at the very lowest levels of

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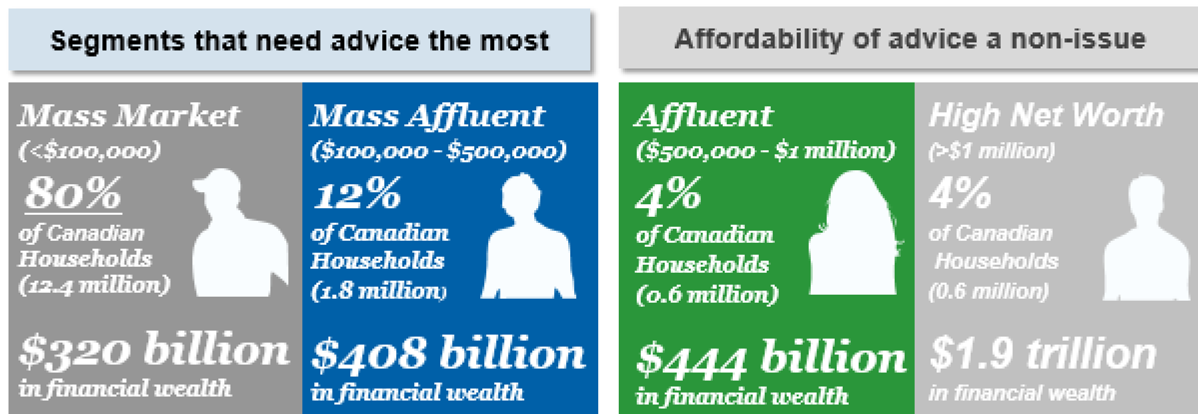
[11] Claude Montmarquette and N. Viennot-Briot, *Econometric Models on the Value of Advice of a Financial Advisor*, Le Centre interuniversitaire de recherche en analyse des organisations, July 2012 (hereafter, "2012 CIRANO Report"). In the 2012 CIRANO Report, investors meeting this criteria are described as those who identify themselves as their own main source of investment information and capable of self-managing their investments by exhibiting greater levels of education, income and financial literacy.

income and wealth are reasonably covered by social programs, such as CPP/QPP, OAS and GIS,[12] which largely replace their levels of pre-retirement income – although they too would benefit from professional advice. But the cohort most at risk of poor post-retirement financial outcomes are those with middle- and upper-middle levels of earnings and wealth.[13]

In the face of this looming crisis, it is clear that Canadians need more and better access to professional financial advice, not less. Regulatory policy must reflect this.

4. A SNAPSHOT OF THE MARKET TODAY

Let us provide a snapshot of what the market for financial advice looks like today. Of about 15 million Canadian households, about 80% have less than $100,000 in investible assets – this segment is commonly referred to as the “mass market”. Despite representing the vast majority of households by number, they represent only about 10% of Canadian household financial wealth.



Source: Strategic Insight

Advice is accessible to small investors today

Today, mass market households that seek financial advice are able to obtain it. In fact, according to The Investment Funds Institute of Canada (“IFIC”), half of all mutual fund investors have less than $25,000 when they first engage an advisor.[14] And one third of all clients with advisors start with less than $10,000 to invest.[15] According to Strategic Insight, small-business financial advisors have

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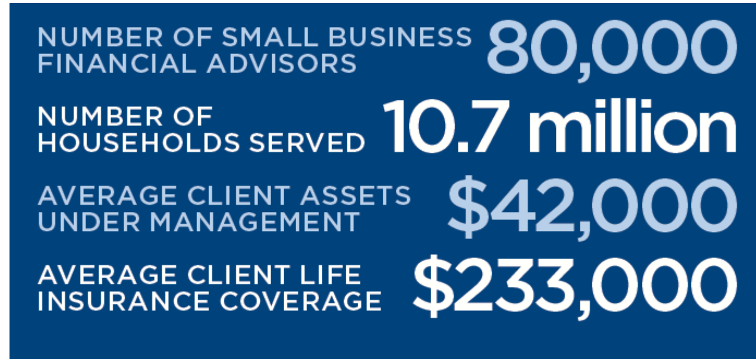
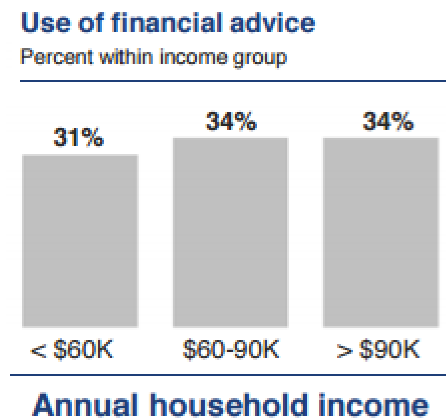
[12] Stephen Gordon, *If it isn’t broken…*, National Post, June 21, 2016.
[13] Bob Baldwin, *Assessing the Retirement Income Prospects of Canada’s Future Elderly: A review of Five Studies*, C.D. Howe Institute, September 2016.
[14] The Investment Funds Institute of Canada, *Industry Statistics*, available at: https://www.ific.ca/en/stats/.
[15] Pollara Research, *Canadian Mutual Fund Investors’ Perceptions of Mutual Funds and the Mutual Fund Industry 2016*.

tremendous reach: they serve nearly 11 million households and the average client asset balance is only $42,000. This is in large part due to the ability of consumers to choose the advisory business model that works for them, which often includes the embedded compensation structure.



Source: Strategic Insight

From the advisor's perspective, the embedded compensation structure promises a continuing income stream which will grow as clients accumulate assets over time. Although smaller investors are not usually profitable to advisors at the initial stages of the relationship, the cross-subsidization allowed by embedded compensation (discussed further in Section 6 below) makes it viable for the advisor to invest resources in taking on the client and fostering a relationship. This arrangement allows for a salutary alignment of interests, as both the client and the advisor benefit from the growth of the portfolio and both have an interest in a stable, long-term successful relationship.



Source: Ipsos-Reid survey, 2014

There is tremendous value in financial advice. We will discuss this value in detail in Section 5. But as we do so, we ask the CSA to consider that, given the tremendous value of advice, isn't the 1% trailer

commission of a typical equity mutual fund[16] (or about $420 a year for the average client, based on the $42,000 average account size) that covers *both* dealer and advisor compensation a tremendous bargain for professional advice?

Despite its accessibility, not enough consumers access advice today

In a survey by the Financial Consumer Agency of Canada,[17] 27% of consumers did not seek financial advice even though they felt that they should have. Only 8% reported always seeking financial advice when they felt it was needed. This is an alarming result which suggests that policymakers should foster an expanded role for professional advice, not less.

In the Consultation Paper, the CSA acknowledges that those with less than $100,000 to invest are already underserved in the market, and concedes that "independent fund dealers may choose not to continue to service these households" if commissions are eliminated.[18] Given the tremendous value of advice that is detailed in the next section, we urge the CSA to be very careful in considering whether the elimination of commissions is in the best interests of mass-market consumers.

5. The Value of Financial Advice

What modern financial advisors do (and don't do)

In participating in many consultations with regulators, politicians and consumer groups, what we have come to realize is that there is a misunderstanding of what exactly it is that modern financial advisors actually do.

Traditionally, financial advisors were seen as providing two key services for their clients:[19]

Seeking *alpha*, excess returns relative to a benchmark. Described in a layperson's terms, this is stock picking. Outdated depictions portray individual stockbrokers as the go-to person for insights on the next "sure thing", but this just doesn't happen today. The search for superior returns

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[16] Investor Economics, *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives*, September 2012.
[17] Financial Consumer Agency of Canada, *Payday Loans: Market Trends*, October 25, 2016. Available at: https://www.canada.ca/content/dam/fcac-acfc/documents/programs/research-surveys-studies-reports/payday-loans-market-trends.pdf.
[18] Consultation Paper at p.62.
[19] Henri-Paul Rousseau, *Why Banning Embedded Sales Commissions Is a Public Policy Issue*, The New Paradigm of Financial Advice Conference: Toronto, March 31, 2017.

through active means is now an incredibly complex matter, built on research reports, quantitative analysis and sophisticated algorithms, with the data parsed by entire teams of analysts.

Asset allocation and portfolio construction. This is a technical task to ensure that an investor's portfolio is adequately diversified in line with the investor's risk tolerance, liquidity needs and long-term financial goals. Portfolio optimization work is also largely the domain of computer automation today.

So neither of these traditional services are particularly dependent on the advisor any longer. Instead, the key value that advisors create has to do with **behaviour modification**: advisors can create a real and measurable shift in client behaviour towards prudent long-run financial planning, saving and (critically) investing that sets clients on the right path towards retirement readiness. This view is borne out by a 2015 survey of investors working with a financial advisor, which found 88 per cent of respondents see their advisors more as advice and guidance providers than as salespeople.[20]

This behavioural change has been called the *gamma factor*[21] by commentators. It is not one single action, but the culmination of day-to-day behaviours driven by a holistic and mutually accountable relationship between the client and advisor over the course of many years. The gamma factor is not an effect that is observable instantly, but one that strengthens over course of time, and it is difficult to capture the impact of any one particular action at the time it is undertaken. But the sum of these shifts brought about by the advisor's work creates **real and significant** benefits to client welfare.

The CSA seems reticent to acknowledge the value of behaviour modification in the Consultation Paper; in casually dismissing the CIRANO Studies,[22] the CSA states that the superior outcomes enjoyed by advised clients are "not [brought about] by better returns due to advisor skill".[23] This is a very unfortunate and narrow view, exposing the regulators' improper focus on alpha as its chosen, yet flawed, metric to judge value.

We firmly argue that behaviour modification is a skill, and a very difficult one to achieve at that. Changing the public's natural disposition from apathy and present consumption and convincing them to delay gratification, save and invest for the future is a daunting task – particularly when the benefits of doing so are decades down the road and are not guaranteed. We note the OSC itself has recently published Staff Notice 11-778 *Behavioural Insights: Key Concepts, Applications and*

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[20] Advocis, *Investor Insights on the Financial Advice Industry*, November 2015. Available at: http://www.advocis.ca/pdf/Consumer-Voice-2015.pdf.

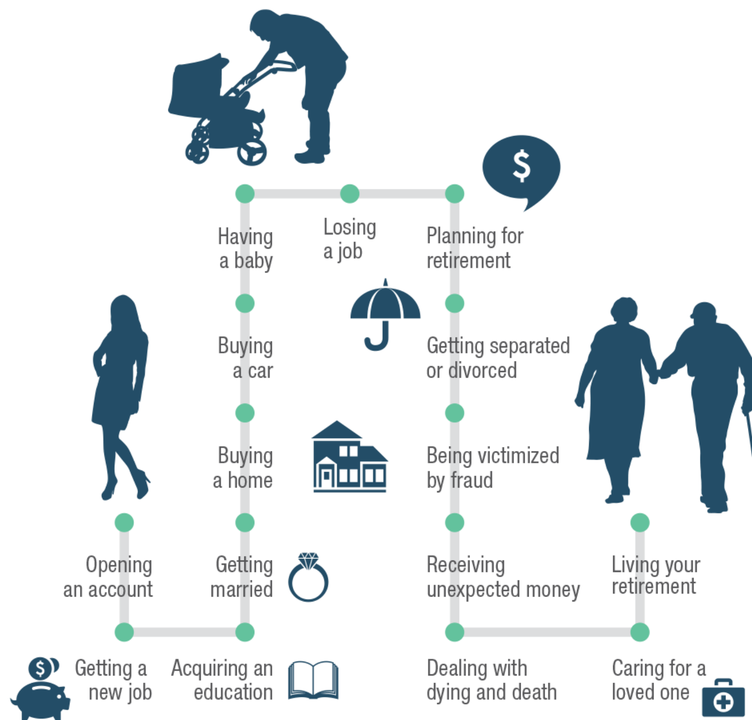
[21] See, for example, Morningstar Investment Management, *Alpha, Beta and now…Gamma*, 2013.

[22] *Infra*, note 39.

[23] Consultation Paper at p. 126.

Regulatory Considerations,[24] a report detailing how leading practitioners and regulators around the world are using behavioural insights to address capital markets issues and improve outcomes for investors. The report highlights how investors are prone to make irrational decisions based on emotions and other psychological factors.

This includes the common problem of recency bias, the assumption that what has occurred recently will continue to do so indefinitely; this bias causes ill-advised investors to liquidate their portfolios at the bottom of a financial crisis, buy individual stocks at a market peak after they've become popularized 'media darlings', or assume that certain asset prices (such as housing) will rise forever. We know how disastrous irrational emotion-driven investing decisions can be, and how many investors will never recover from them.



Financial advisors help clients ensure they are financially prepared for life's events.

The authors of *Nudge*, a leading book on behavioural economics, opine that standard theories about retirement savings are based on two incorrect assumptions: that investors are able to calculate how much they need to save for retirement, and that they have the willpower to stick to

[24] OSC Staff Notice 11-778, *Behavioural Insights: Key Concepts, Applications and Regulatory Considerations*. Available at: https://www.osc.gov.on.ca/documents/en/Securities-Category1/sn_20170329_11-778_behavioural-insights.pdf

their plan – day to day, and even in the face of crisis. They argue that neither is generally true.[25] An advisor's ability to overcome these real, and major, behavioural deficiencies and set investors on a steady path towards retirement security is the key component of the gamma factor.

Trust drives the gamma factor

What drives advised consumers to overcome their natural predisposition against long-term thinking and complex-sounding risk-bearing assets? It is the trust forged between client and advisor. In fact, consumers cite 'trust' as the most important factor in seeking a financial advisor,[26] with evidence showing that households with lower financial capability need to trust their financial advisor in order to invest in risky assets.[27] Further, the level of trust consumers express about advisors increases after actually working with an advisor by about 30%,[28] demonstrating the positive outcomes that consumers enjoy from the experience.

Trust can only be forged between an advisor and client through a holistic relationship – not a transactional one. Perhaps once, advisors were primarily seen as a gateway to product. But today, if access to product is all that consumers are looking for, it is far easier to simply transact directly with a manufacturer on the internet.

Indeed, the primary role of the *modern* advisor is to offer holistic financial guidance to clients through relationships that last years or even decades. These relationships ensure clients' financial preparedness for life's major events – such as marriage, home ownership, the raising of children, and even death, through trust and estate matters, and it is through these experiences, shared over many years, that trust is created. Without trust, the gamma factor cannot be realized.

The CSA's focus on alpha is wrong

Part of the CSA's reasoning behind its proposal is based on the impact of embedded commissions on alpha as suggested by the Cumming Report.[29] We have attempted to make clear throughout this submission that regulators' focus must not be on seeking alpha, which is not the value of the

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[25] Richard H. Thaler and Cass R. *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Sunstein, Penguin Books, 2009.
[26] Jeremy Burke and Angela A. Hung, *Trust and Financial Advice*, RAND Corporation, January 2015.
[27] Dimitris Georgarakos and Roman Inderst, *Financial Advice and Stock Market Participation*, Goethe University, 2014.
[28] 2012 CIRANO Report at p.36.
[29] Douglas Cumming, Sofia Johan and Yelin Zhang, *A Dissection of Mutual Fund Fees and Performance*, February 8, 2016. Available at: https://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20160209_81-407_dissection-mutual-fund-fees.pdf (hereafter, the "Cumming Report").

modern advisor, but on gamma. To focus on the former is to miscast the role of the advisor as a transactional processor, rather than as a trusted guide in a longstanding relationship.

This improper focus on alpha explains why it is inappropriate to use flow of funds studies, like the Cumming Report, to judge whether an advisory relationship delivers value. Flow of funds studies focus on actions in the *aggregate*, so they will haphazardly suggest that advisors are initiating the 'wrong' flows when they are doing precisely the things they are supposed to be doing at the *individual* client level, such as rebalancing portfolios by selling assets which have gained in value and now represent an overweight position for a client.

What the Cumming Report tells us is that sales under fee-based models are more sensitive to past performance than under the embedded commission model. But we cannot discern the reasons why this is so. Only by studying actions at the account level can we know whether this is because fee-based advisors are chasing past performance or whether, perhaps, the commission-based account is pursuing an accumulation strategy, such as is often seen with pre-authorized contribution plans.

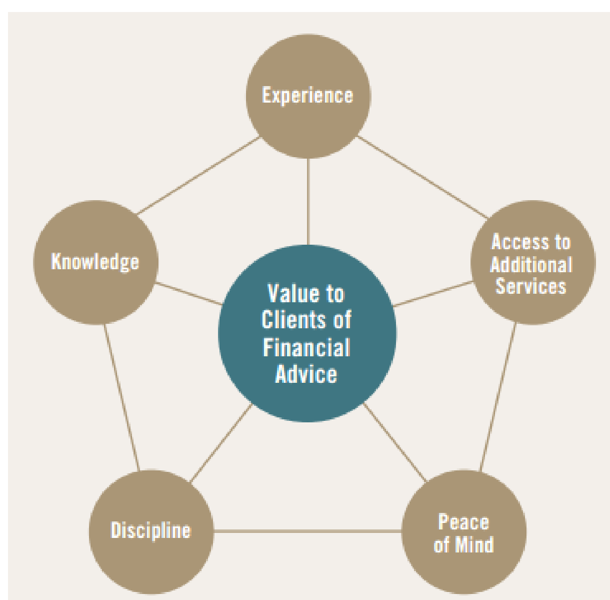
Because of the limitation of aggregate data, no study of fund flows can capture the investor experience and explain how compensation structures impact, at the client level, the ability to achieve financial objectives related to wealth accumulation, diversification, risk tolerance, tax strategies and so on. Critically, no flow of funds study can analyze long-run investor outcomes.

The qualitative components of the gamma factor

In developing the relationship of trust, advisors provide their clients with (*inter alia*):

- Knowledge – including an understanding of financial instruments, investment strategies, and insurance products;
- Experience – on market trends and behaviours, including on the nature of economic cycles;
- Discipline – through savings and investment behaviour, helping clients stay on plan during volatile markets;
- Peace of mind – evidenced by consumers' high levels of trust, satisfaction and confidence in their financial advisors; and
- Access to additional services – with tax strategies warranting particular mention given the huge importance of taxation in financial planning.[30]

[30] PricewaterhouseCoopers LLP, *Sound Advice: Insights into Canada's Financial Advice Industry*, July 2014. Available at: http://www.advocis.ca/sareport.pdf.



Source: Sound Advice

These salutary benefits manifest themselves in many ways.

Advised households are more likely to have, and stick to, a financial plan. According to IFIC's 2012 *The Value of Advice Report*,[31] investors with financial advice are more than 1.5x more likely to maintain a long-term investment strategy relative to those without financial advice. And investors with a written financial plan are almost twice as likely to rebalance appropriately during a bear market than investors without a written plan. Having a financial plan creates a critical accountability mechanism that makes achieving long-run financial goals more realistic.

Advisors help consumers invest confidently. In the 2016 IFIC/Pollara Investor Survey,[32] respondents said that they would have limited confidence choosing mutual funds without the help of an advisor. The majority (56%) say they would feel 'not very confident' or 'not confident at all', while only 3% would feel completely confident. A separate report prepared for the Financial Consumer Agency of Canada found that "financial confidence has important effects on retirement preparedness among seniors and near-seniors" but that "high knowledge alone is not enough to lead to financially desirable behaviours."[33] Given the importance of investing in risk-bearing assets

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[31] https://www.ific.ca/wp-content/uploads/2013/02/IFIC-Value-of-Advice-Report-2012.pdf/1650/.
[32] https://www.ific.ca/wp-content/uploads/2016/09/IFIC-Pollara-Investor-Survey-September-2016.pdf/15057/.
[33] The Social Research and Demonstration Corporation, *The role of financial literacy in financial decisions and retirement preparedness among seniors and near-seniors*, May 2016.

to retirement readiness, advisors are a crucial link in enabling access for mass market consumers to the growth potential of investments.

Advisors help reduce consumer anxiety about money. A 2014 survey of Canadians by Leger Marketing found that financial anxiety is the number one source of stress.[34] In the study, 42% ranked money as their greatest stress, far more than work (23%), personal health (19%) or relationships (17%). 87% of respondents wished they had made better financial decisions earlier in life, including saving and investing more. A separate study found that those who engage with a financial advisor have a significantly higher overall sense of financial well-being[35] and are more likely to experience positive emotions about their finances.

The result is retirement readiness. Research reveals that having a financial advisor makes a major impact on retirement readiness. A study by McKinsey and Company shows that households that do not have an employer pension plan, but are nevertheless on track to maintain their standard of living in retirement, are twice as likely to use financial advice (49% use rate) compared to those households that are not on track (27% use rate).[36]

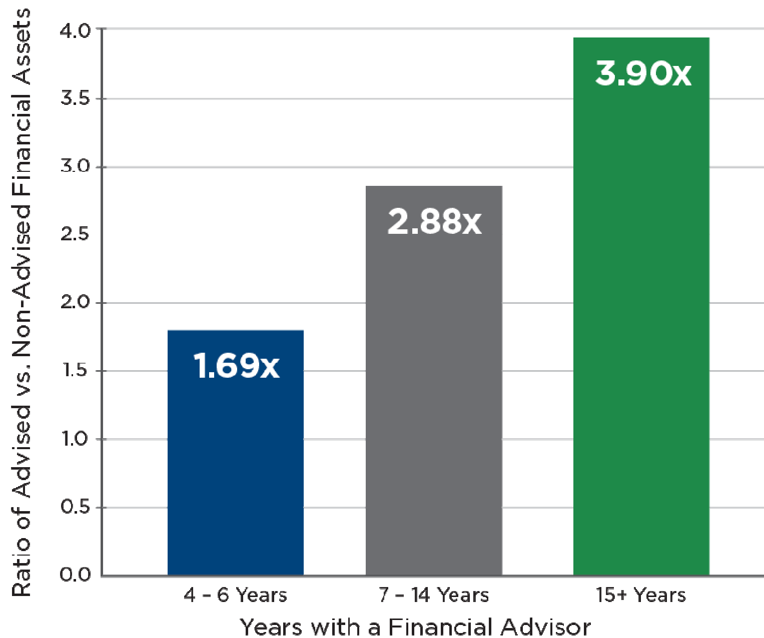
And according to the Financial Consumer Agency of Canada's *Canadian Financial Capability Survey*,[37] retirees who frequently sought financial advice reported a standard of living that met or exceeded their expectations at a higher rate than those retirees who did not seek advice; and near-retirees (defined as working Canadians aged 55 or greater) who frequently sought advice on financial matters reported higher levels of assets in their RRSPs, TFSAs, and other account balances. Consumers overwhelmingly credit their advisors for these positive outcomes, with 82% saying that advisors are responsible for helping them achieve their savings and investment habits.[38]

The value of advice, quantified

These qualitative benefits translate into quantifiable impacts on client wealth accumulation. According to the updated 2016 CIRANO Report,[39] advice has a positive and significant impact on wealth accumulation, relative to non-advised persons. Households with four-to-six year long

[34] http://www.fpsc.ca/news/publications-research/how-is-financial-stress-affecting-canadians.
[35] John Ameriks, Andrew Caplin and John Leahy*, Wealth Accumulation and the Propensity to Plan*, Quarterly Journal of Economics (2003); and Annamaria Lusardi, *Explaining why so many households do not save*, University of Chicago (2000).
[36] McKinsey & Company, *Building on Canada's strong retirement readiness*, 2015.
[37] Simhon, Y, *Financial Literacy and Retirement Well-Being in Canada: An Analysis of the 2014 Canadian Financial Capability Survey*. Paper presented at the 50th Annual Conference of the Canadian Economics Association, Ottawa, Canada (June 2016).
[38] Pollara, *Mutual Fund Investors Perceptions of Mutual Funds and the Mutual Fund Industry*, 2016.
[39] Claude Montmarquette and Nathalie Viennot-Briot, *The Gamma Factor and the Value of Financial Advice*, CIRANO, August 2016 (the "2016 CIRANO Report", and together with the 2012 CIRANO Report, the "CIRANO Studies").

advisory relationships accumulated 69% greater assets, and households with 15+ year advisory relationships accumulated 290% more assets, relative to non-advised peer households.



Source: The Gamma Factor and the Value of Financial Advice, CIRANO, August 2016

Vanguard, the major fund manufacturer that is known for championing a low-fee message, conducted its own study which found that financial advice creates real value.[40] It found that, over time, advisors add about 3 percentage points of value in net portfolio returns per year. More importantly, Vanguard sees meaningful value in the behavioural coaching (or gamma) element of an advisor's work – so even after accounting for the fees that necessarily must be paid to an advisor (as no professional works for free), there is additional value for investors when they obtain professional advice.

The 2016 CIRANO Study considered an additional intriguing variable: what happens when households with financial advice discontinue their use of that advice, and branch out on their own? Does the behavioural coaching learned from their time with an advisor persist beyond that relationship? That is, once the behaviour is learned, can it be retained by investors acting alone?

[40] Vanguard Canada, *The added value of financial advisors*, May 2015. Available at: https://www.vanguardcanada.ca/documents/added-value-of-advisors.pdf

Simply, no. Between 2010 and 2014, households that discontinued the relationship with their advisor accumulated 45% less additional assets than households who continued their relationship.[41]

From this, it is clear that the gamma factor is not a one-time event that, once experienced, forever alters the client's behaviour for the better. Instead, the advisor's work must be ongoing, continuously pushing back against human inclinations (of excessive present consumption, poor savings discipline, costly emotional investing decisions and so on) that would undo the good work achieved during the advised period – the advisor is providing value in every year of the relationship. This finding also explains why the positive impact of financial advice, as quantified in the CIRANO Studies, grows in magnitude with the duration of advice.

6. Why Embedded Compensation Must Be Preserved As An Option

If the CSA were to discontinue embedded commissions, we argue that a sub-optimal number of consumers would be willing to pay for financial advice because they are unable to properly value that advice. This will result in materially worse outcomes for consumers.

The nature of financial advice

The oft-cited and common sense argument against embedded commissions is that if it has value, consumers should be willing to pay for it. The idea is that financial advice should not have to be embedded in the 'actual' product that consumers are purportedly seeking (the underlying financial product) – it should be able to stand on its own as a valued service, garner its own consumer demand, and carry its own price. To embed it within a financial product is perceived as a deceptive sales practice, with the idea that consumers are forced to purchase it because it is intertwined with the product they are actually seeking.

This argument does not hold with financial advice. Consumers will not pay directly for financial advice because it is a *credence* good. Pierre Lortie explains the fundamental difference between credence goods and other goods as follows:

> In economic terms, "credence goods" differ from "experience goods" and "search goods." A search good is a product or service with features and characteristics that can be easily evaluated before purchase. An experience good is a product or service where the characteristics and features are assessable, but only after consumption or use. In the case of a credence

[41] *Supra*, note 39.

> good, its "utility" is difficult if not impossible to ascertain even after consumption. [42]

What makes financial advice a credence good is that the value of advice is realized over a very long timeframe – for many consumers of advice, all the way through retirement and the de-accumulation phase – and this long horizon means that its consumers receive feedback about its impact at low frequencies.

It is very difficult for consumers, making decisions today, to value something whose benefits are abstract, delayed in time, and not even necessarily understandable (at the individual level) in hindsight; after all, how do consumers assess what their comparative financial situation would have been had they *not* engaged an advisor? While large, econometric studies such as the CIRANO Studies tell us definitively that accessing advice drives wealth at the aggregate level, there is no way for any single consumer to know exactly how advice may or may not have impacted their individual situation and outcome.

Confronted with this uncertainty, studies have demonstrated that a large proportion of individuals will shun financial advice if they are required to pay directly for it.[43] Consumers are reluctant to pay up-front for advice because they do not want to lock in a guaranteed loss (*i.e.* the payment of direct fees for advice) when they cannot adequately judge the value they are receiving in exchange. This skepticism is the rational consumer response to a credence good, but it is not the optimal response for consumers as a whole, over the long run.

Embedded compensation is an effective mechanism for fostering greater access to credence goods that consumers would otherwise under-subscribe to in a direct pay model. By eliminating the large psychological barrier of a direct-pay requirement, and financing the benefit of the gamma factor (the ongoing nature of which is proven by the outcomes of households who discontinued use of their advisor in the 2016 CIRANO Study) though trailers, this model allows skeptical consumers to get at least partial feedback on their own value of advice as they pay for it on an incremental basis. In doing so, this model aligns payments with the periods where the benefit is received and promotes the accessibility of advice to the lower- and middle-income price-sensitive consumers that need it most.

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[42] Pierre Lortie, *A Major Setback for Retirement Savings: Changing How Financial Advisers are Compensated Could Hurt Less-than-Wealthy Investors Most* (April 1, 2016). SPP Research Paper Vol 9, Issue 13, 2016. Available at: https://ssrn.com/abstract=2804696.

[43] N. Chater, R. Inderst and S. Huck, *Consumer decision-making in retail investment services*, Report to the European Commission (SANCO), 2010.

Embedded commissions also encourage the development of a diverse and vibrant horizontal industry structure, where manufacturers distribute their financial products through unrelated financial intermediaries. This promotes market transparency and competition at both the product and distribution levels.

This is ultimately about freedom of choice

We do not believe that the embedded commission model is right for everyone. Depending on an individual investor's needs and size of portfolio, a direct-pay model may be more appropriate. Generally speaking, once an investor achieves a sizeable portfolio (typically $250,000 or more), an investor should consider whether moving to a different service model makes sense for them.

But we absolutely disagree with a notion that the embedded commission option should be eliminated by regulatory decree so that all investors are forced into a direct pay model. The significant and proven benefits of the gamma factor should not be restricted to the wealthy who can afford a direct-pay model. Let *all* investors benefit from advice, and when their assets have grown to a size that can support other payment models, let consumers decide what is best for them.

Eliminating embedded compensation would also run counter to public opinion. A 2015 survey by PMG Intelligence found that 88% of consumers want to preserve choice in how they pay for advice, 88% feel that losing choice would negatively affect them personally and 85% feel that governments should not implement changes in how they do business with their advisor.[44]

A separate survey found that a majority of investors with advisors (54%) prefer to pay their advisor through embedded fees, with 37% choosing to pay directly in some form.[45] The point is that regulators should preserve consumer choice: not only is it beneficial for consumers' financial outcomes, it is also what consumers themselves want.

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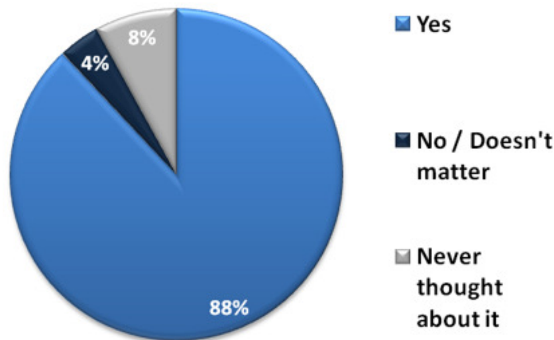
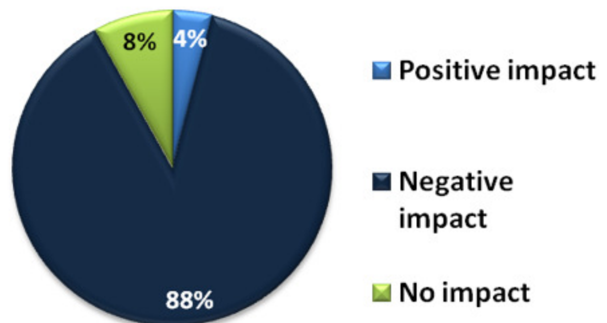
[44] PMG Intelligence surveyed 1,739 Canadian investors with a financial advisor between January and March 2015. The study has a margin of error of +/- 2.35% at a 95% confidence interval.
[45] *Supra*, note 15.





Source: PMG Intelligence

Source: PMG Intelligence

7. PROBLEMS ARISING FROM A COMMISSIONS BAN

Implementing a ban on embedded commissions would create several serious problems – impacting small investors, the competitive vitality of stakeholders, and the stability of the market as a whole.

Recently, The Honorable Joe Oliver, former federal Minister of Finance, stated that "the decision raises a broader issue: the overarching need for balance in regulating our capital markets."[46]

In his view, a commissions ban would "undermin[e] the competitive structure of the securities industry, shrinking the weakening independent brokerage sector even further." He adds that "[h]owever well intentioned, excessive regulation inflates costs, undermines efficiency, impairs competitiveness and can have uneven, unintended and perverse results."[47]

Below we detail several of these perverse results.

The loss of the cross-subsidy means a focus on high net worth clients

The CSA has repeatedly asked why the elimination of embedded compensation would restrict access to lower-income consumers. During the April 11, 2017 session on the Consultation Paper hosted by the OSC, OSC staff questioned why servicing small investors would not be economically viable in a post-commission world. The reason is that, under the embedded compensation mechanism, wealthier investors with larger portfolios subsidize access to advice for investors with smaller portfolios.

While the time and effort required to service larger, more sophisticated portfolios is greater than that required to service smaller portfolios, the increase is not necessarily linear. Instead, servicing every client requires a certain 'core' level of service (such as fulfilling know-your-client and anti-money laundering requirements) and the attention required to address specialized needs stemming from larger portfolios may not be as demanding on a proportionate basis.

By receiving a relatively large amount of compensation from clients with larger portfolios, advisors are able to provide service to clients with smaller portfolios – with the shared goal of helping that smaller investor become a larger investor as well, over time. Policy-wise, there is nothing inherently wrong with cross-subsidization. For example, Canada boasts a progressive income tax system, where large taxpayers allow small earners to pay lower amounts of, or even no, income tax; and public schools are funded by the taxes of those with or without children, not only by parents utilizing the infrastructure.

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[46] Joe Oliver, *Banning embedded mutual fund fees will only hurt the investors we should be helping*, Financial Post, April 17, 2017. Available at: http://business.financialpost.com/fp-comment/joe-oliver-banning-embedded-mutual-fund-fees-will-only-hurt-the-investors-we-should-be-helping.

[47] *Ibid*.

PriceMetrix analysis demonstrates that smaller clients (defined as those with less than $250,000 in assets) have a negative effect on advisor revenues – they cost more to serve than the revenue they bring about.[48] Without the cross-subsidy of embedded commissions, and the promise of the smaller investor's commission revenue growing over time (in absolute terms rather than percentage, by virtue of the portfolio growing larger), it will become uneconomical to provide service to smaller investors. Consequently, advice will become out of reach for many consumers, including the lower-income consumers who need it most.[49] As discussed above, there is already evidence of consumers failing to seek advice even when they feel they should do so; if the cross-subsidy is eliminated, the problem will only worsen.

As a natural consequence of all of this, those advisors remaining in the industry will naturally gravitate towards high net worth clients. We saw this occur in the U.K. after the Retail Distribution Review ("RDR"), where research found that smaller investors were "abandoned by advisers in the fall out."[50] We see this already with the fee-based business in Canada, where the average account size is approximately $300,000[51] – far larger than the average $42,000 account size served by small- and medium-business sized advisors.

Banks will not fill in the gap

The CSA should be wary about assuming that Canadian banks will step in and serve low income consumers in a post-commission world. In the U.K.'s post-RDR environment, there was an exodus of banks from the mass advice market – which included major players such as Barclays, Lloyds and Santander that had a large retail presence.[52] Consequently, millions of consumers became orphaned, without access to the advice they had once relied upon.[53] The U.K. regulator, the

[48] PriceMetrix, *Moneyball for Advisors*, Pricemetrix Insights, Volume 7, October 2012.
[49] Patrick Ring, *The Retail Distribution Review*, Journal of Financial Regulation and Compliance, Vol. 24, Issue 2.
[50] CoreData Research, *High-end clients are RDR's big winners*, available at: http://www.coredataresearch.co.uk/?inmedia=high-end-clients-are-rdrs-big-winners-coredata.
[51] *Infra*, note 65.
[52] MoneyMarketing, *The death of bank advice: more than just the RDR to blame?*, May 23, 2013. Available at: https://www.moneymarketing.co.uk/the-death-of-bank-advice-more-than-just-the-rdr-to-blame/. While certain banks that left the mass market have recently begun re-entering it, they have been doing so very cautiously, with demands for high account minimums to compensation them for the risk. For example, in restarting its 'retail' advice service, HSBC required customers to have £50,000 as a minimum balance.
[53] Fundscape, *Navigating the Post-RDR Landscape in the UK*, 2014. Available at: http://www.alfi.lu/sites/alfi.lu/files/Navigating-the-post-RDR-lanscape-final-web.pdf.

Financial Conduct Authority, now admits the major role of the RDR in creating this disastrous unintended consequence.[54]

Commentators have opined that the exit of banks and the creation of the advice gap clearly shows where regulators have "failed to meet its objectives of bringing better quality advice and better investment outcomes to retail investors."[55] Banks were simply not able to balance the cost of providing advice in a direct-pay world at a level that is palatable to mass market consumers.

Fintech does not replace the human element

The CSA should also be wary about assuming that fintech can replace the traditional advisor, particularly for lower- and middle-income investors. There is an important and growing role for fintech in the retail financial services sector – it can provide amazing tools to streamline a human advisor's practice (for example, to assist in taking care of certain regulatory requirements, tracking progress or rebalancing a client's portfolio), or for do-it-yourself investors that have the knowledge and the discipline to manage their own financial affairs (although, as stated above, this is an exceedingly small subset of investors[56]).

But the CSA should see fintech for what it is today: it is a tool that makes discrete transactions easier to execute. It is not a substitute for advice and guidance. Remember that the gamma factor is driven by client trust in their advisor, and the consequent willingness to invest in the risk-bearing assets that are necessary for retirement security. An algorithm simply cannot forge the same connection of mutual accountability that is necessary to overcome basic human fallibilities and emotions that manifest themselves during the course of long-run investing, such as the tendency to panic-sell during a downturn – which leads to disastrous outcomes for clients.[57]

The numbers bear out the fact that consumers are ready to use fintech to help their everyday lives, but are not prepared to *trust* them for true financial advice. According to a Pollara study, 37% of respondents expressed that they would be comfortable with making a discrete purchase of mutual funds on-line, but only 17% said they would be comfortable with using a robo-advisor for holistic advice. Only 3% of respondents had ever tried robo-advice, and only 12% were interested in doing

[54] FTAdviser, "FCA admits RDR contributed to advice gap", July 19, 2016. Available at: https://www.ftadviser.com/2016/07/19/regulation/rdr/fca-admits-rdr-contributed-to-advice-gap-chujPxa8fmBkivLaaAxxfN/article.html.
[55] *Supra*, note 50.
[56] *Supra*, note 11, in regards to how just 6% of the population are qualified to be true self-directed investors.
[57] See, for example, DALBAR's 2016 Quantitative Analysis of Investor Behaviour that found that over a 30-year period, the average self-directed equity mutual fund investor earned only 3.7% per year, compared with 10.4% per year for the S&P500 over the same period. Much of this shortfall is due to panic selling during market downturns, or attempts to "time the market."

so.[58] And according to an international comparative report by U.K.-based HSBC Holdings PLC, Canadians are particularly reticent to 'go it alone' using fintech, relative to residents of other nations: only 7% of Canadian respondents said they are likely to trust recommendations delivered by a robo-advisor, compared to 44% in China and 38% in India. Only 18% of Canadians surveyed feel that robo-advisors are able to offer more accurate advice than their human counterparts.[59]

So fintech facilitates transactions – it does not engender trust or create long-run changes in investor behaviour. It can be a boon for advisors, freeing up time for advisors to focus on their clients, with "more robust conversations that lead to greater understanding and, ultimately, a superior investment experience."[60] But it is certainly not a replacement for human advisors, and the CSA should not believe fintech can address the fallout from a commissions ban.

Favours vertically-integrated firms and concentration in the financial services sector

Embedded commissions are crucial to the health of a horizontal market structure. They allow independent fund manufacturers to secure distribution through independent advisors. A ban on embedded commissions would give a decided advantage to vertically-integrated firms, furthering the concentration of wealth in Canada's large financial institutions and decimating independent dealers and advisors.

As the CSA is aware, many of the large vertical firms do not charge the sales and trailing commissions that are targeted by this consultation, but as explained in Section 8 below, they use sales practices that carry their own conflicts of interest that are arguably more problematic than the commissions at issue here.

Further favouring the vertical channel would limit the breadth, variety and independence of advice because advisors in vertical channels tend to recommend proprietary products, as they are strongly incentivized to do so by their payout structure. The Cumming Report oft cited by the CSA demonstrates that funds sold by dealers affiliated with the manufacturer tend to perform worse relative to independent structures.

The vertical structure also encourages bank-based advisors to put clients' funds in low-yielding savings accounts or GICs, as banks are under pressure to satisfy the increasing capital requirements

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[58] *Supra*, note 15.
[59] Beatrice Paez, *Canadians prefer financial advisors to robo-advisors*, May 24, 2017. Available at: http://www.investmentexecutive.com/-/canadians-prefer-financial-advisors-to-robo-advisors.
[60] Peter Intraligi, *Embracing the fintech revolution*, July 7, 2016. Available at: http://blog.invesco.ca/embracing-fintech-revolution/.

of Basel III. While good for the welfare of the banks, putting money in these instruments is harmful to the needs of their clients – clients should be investing in risk-bearing assets to generate the returns needed for retirement. With 35% of Canadians' financial wealth already in deposit instruments,[61] the CSA should ensure that it does not incentivize a greater migration of funds earmarked for retirement into low-performing asset classes.

The CSA notes in Table 5 of the Consultation Paper that deposit-taker and insurer owned dealers already dominate in Canada, with about an 80% market share. It further states that "[h]ouseholds with lower levels of accumulated wealth are less likely to purchase their funds through an independent dealer." Unless the CSA wishes this situation to deteriorate further, the CSA should be wary about inadvertently giving large financial institutions such a major advantage and harming the vitality of the independent channel through a ban on commissions.

New and costly administrative burden

The Consultation Paper states that fund companies may not collect and pay commissions or fees to dealers. In other words, in a post-commission world, assets held by fund companies must be moved to dealer-held assets. As MFDA firms hold the majority of their assets in client name accounts at fund companies, there will be significant migration costs borne by dealers. This will create new and unintended costs for clients in the form of dealers' annual self-directed fees (with most dealers charging from $135 to $150 per account), as well as numerous additional service fees that fund company-held clients do not currently pay.

Advisors will be tasked with the unenviable responsibility of explaining to clients that they will be paying hundreds of dollars more in fees for the same services that they had before. For example, if a husband and wife each have $50,000 in assets, instead of paying a 1% trailer, they now accept a professional fee of 0.75% and thus save 0.25% each on their accounts – equating to a total family savings of $250. But they must now pay a new trustee fee of $300 charged by the dealer trustee, resulting from moving to dealer-held administration, when they previously did not have to pay trustee fees – resulting in a net loss for the family. The only ones making money after the business costs associated of transferring the accounts are the trustees, which are generally bank-owned.

The elimination of embedded commissions will create significant new administrative burdens by disrupting well-established business models. As all costs are ultimately borne by consumers, these new costs will end up harming consumers' outcomes.

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[61] Investor Economics, *2015 Household Balance Sheet Report*, June 18, 2015. Available at: http://investoreconomics.com/issue/2015-household-balance-sheet-report-statistical-tables-pre-release.

Reduced cost transparency and increased total cost of ownership

In the Consultation Paper, the CSA suggests that the elimination of commissions could put competitive pressure on fees, which could improve consumer outcomes by lowering their total cost of ownership. Empirical evidence tells us that eliminating commissions creates a host of new problems that put upward pressure on fees, actually increasing total costs for retail investors and reducing consumer welfare.

The U.K. experience is illustrative. Under the RDR, although the cost of products themselves fell with commissions parsed out (which is simply a matter of subtracting the advisory charge from the management expense), the total cost of ownership for consumers is similar or greater than what it was before RDR. And many consumers were pushed out of the market for financial advice entirely – it is estimated that clients now require somewhere between £61,000 (~$105,000 CAD) and £100,000 (~$170,000 CAD) in investible assets to gain the attention of an advisor – although 75% of the population does not have even £60,000 in assets.[62]

Under an unbundled service model, a major challenge arises for small investors as they are required to individually negotiate the fee structure with their advisor, whether operating under a fee-based or an assets-under-management model of direct payment. Investors have far less negotiating power on their own, and small, novice clients are particularly disadvantaged as negotiators in this scenario.

Compare this to the embedded fee model, where it is very easy for consumers to see the total cost of ownership on one single line – the mutual fund's management expense ratio. This allows investors to compare prospective funds easily. This transparency also promotes fee competition amongst fund manufacturers, with individual investors able to take advantage of market-wide competition. Mandating a direct-pay model will obscure the transparency of pricing for clients and lead to price disparity amongst retail consumers that is contingent on their individual bargaining abilities.

Below are some of the particular issues arising with both the fee-based and asset-based models of direct pay arrangements.

[62] *Supra*, note 49.

Fee-based service. According to the U.K.'s Money Advice Service, under the RDR, the average hourly rate for financial advice ranges from £75 to £350, with the average being around £150,[63] or over $250 CAD. Unsurprisingly, many retail consumers are unwilling to pay this amount, with the average *total* willing commitment per consumer being a paltry £250, or 1.67 hours worth of advice.[64] On its face, this is clearly not enough time to instill the life-long behavioural change that is critical to wealth accumulation. This is a clear example of the mismatch that occurs when forced to price credence goods in this manner.

Asset-based service. The disadvantages faced by individual small investors negotiating fees on their own becomes starkly evident when looking at asset-based direct fees. According to consultancy firm PriceMetrix, clients with lower levels of investible assets (<$250,000 in assets according to PriceMetrix's brackets, which would include more than of 80% of households) pay about 1.43% of their assets for advice alone in an asset-based direct pay model.[65] Other fund expenses are still automatically deducted through the MER, boosting the total cost of ownership much higher.

Compare this to Investor Economics' finding that under the embedded compensation model, on average, the annual trailer is only 0.78%, with advisors receiving about two-thirds of that.[66] Also note that PriceMetrix's data show that wealthier clients do much better under this compensation model, with those with $2 million or more in assets paying just 0.79% for advice – which shows how disadvantaged smaller investors are in negotiating asset-based fees.

Troubling statistics are also coming out of the U.K. According to the Financial Conduct Authority's *Post-implementation review of the retail distribution review – Phase 1,*[67] there is clear evidence that the cost of advice has increased. Thisismoney.co.uk reported that when advisers started charging fees "most started charging clients 0.5 per cent of their total investment as an annual advice fee… However, research from Schroders Adviser Survey has found [that] more than four in 10 advisers now charge clients 0.75 per cent of their assets – a hike of 50 per cent in just four years."[68] Similarly, FTAdviser reported that according to recent research, "adviser charges have steadily increased in recent years with a 1 per cent charge now being the norm."[69]

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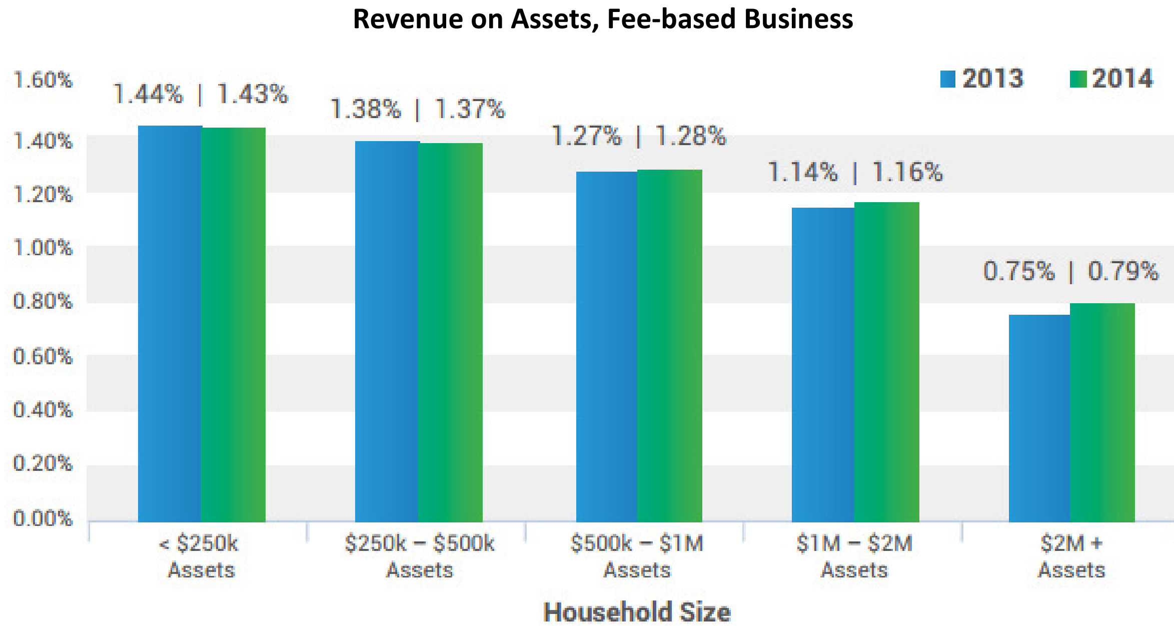
[63] https://www.moneyadviceservice.org.uk/en/articles/Guide-to-financial-adviser-fees.
[64] *Supra*, note 49.
[65] PriceMetrix, *The State of Retail Wealth Management – 5th Annual Report*. Available at: http://www.pricemetrix.com/cms/wp-content/uploads/State-of-Retail-2015-05.pdf.
[66] *Supra*, note 16.
[67] Available at: https://www.fca.org.uk/publication/research/post-implementation-review-rdr-phase-1.pdf.
[68] Lawrie, Eleanor, *Financial advisers hike investment fees 50% in four years and even admit dumping clients with less cash*. Available at: http://www.thisismoney.co.uk/money/investing/article-4024484/Financial-advisers-hike-investment-fees-50.html.
[69] Fantato, Damian. Financial advisers charge 1% in 2016. FTAdviser. December 15, 2016. Available at: https://www.ftadviser.com/your-industry/2016/12/15/financial-advisers-charge-1-in-2016/.

It is doubtful whether forcing smaller investors into direct pay arrangements is truly serving their interests.

Revenue on Assets, Fee-based Business



Source: PriceMetrix

Over-reliance on passive strategies is harmful to capital markets

In the Consultation Paper, the CSA predicts that upon the discontinuation of commissions, mass market investors would be serviced by new entrants such as online advice providers that offer passive products because of their low costs. The CSA seems to believe this would be a net positive outcome for consumers, which, in our view, demonstrates the CSA's continued but incorrect focus on alpha as the value of advice. And having a large proportion of investors shift into passive products could create distortions in the capital markets and increase systemic risk.

Passive products do not help the growth of the capital markets: they generally do not participate in IPOs and other capital-forming activities, they do not exert market pressure and discipline on any particular company to continuously improve and innovate, and they are not involved in shareholder democracy or hold boards to account. They abscond from the responsibility of being contributors to efficient markets and instead 'free ride' on the efforts of others who undertake the effort of research and analysis in the capital markets.

Compare this to active management, which distributes capital efficiently by rewarding productivity and innovation and reprimanding poor business management. Active management allows small but innovative companies to grow. It has a fundamental role in the capital markets, in that by analyzing

the state of individual companies, active managers determine prices – and without price discovery, there is a major risk of the formation of asset bubbles.

A recent Bloomberg article quotes a major fund manager as stating that passive products such as most exchange-traded funds are “weapons of mass destruction” that distort prices and create the potential for a market selloff.[70] The flood of money into passive products makes prices move in lockstep as prices of any one particular security becomes increasingly divorced from that company’s underlying fundamentals. So as more investors opt for passive investing over active management, “the more inefficient the market is likely to become.”

Also note that for individual investors, the market capitalization weighting of passive funds means that unitholders are peak weighted at exactly the worst time. So while there is a role for passive products, regulators should not be emphatically endorsing policies that favour passive investing without fully appreciating the consequences.

8. THE CONFLICTS OF INTEREST PROBLEM

The CSA states that one of its key motivations driving its proposal is its concern that embedded commissions create conflicts of interest that cannot be adequately controlled by disclosure and materially impact the quality of service that consumers receive.

We agree in principle that conflicts of interest can harm investor outcomes. All professional principal-agent relationships, where one party’s skill and knowledge is exchanged for financial consideration, will raise certain conflicts of interest related to adverse selection and moral hazard. The question for policymakers is how best to address these conflicts without reducing access to the service rendered so that clients can continue to enjoy its benefits.

[70] Charles Stein, *ETFs Are ‘Weapons of Mass Destruction,’ FPA Capital Managers Say*, Bloomberg, April 27, 2017. Available at: https://www.bloomberg.com/news/articles/2017-04-27/etfs-are-weapons-of-mass-destruction-fpa-capital-managers-say.

Bias in financial advice

The CSA's stated concern with commission compensation is that financial advisors may be biasing their product recommendations to their clients, who often accept these recommendations, based not on the quality of the product as it relates to the needs of that particular client but based on the expected value of the commission compensation that would be payable from the investment fund to the advisor. That is, investment fund companies are competing for advisors' loyalty by offering higher trailing commissions.

This is largely not the case – investment funds do not compete for flows sent their way by advisors because the trailers they pay are *de facto* uniform across the industry. Almost all large-cap equity funds pay around a 1% trailer, and almost all large-cap fixed income funds pay around a 0.5% trailer.[71] And there is no bias that emerges with scale: a fund manufacturer offers the advisor who sells $1 of its fund the same percentage commission as it does to the advisor who sells $1 million in that same fund.

This does not mean that there is no bias in the advice given by advisors – multiple studies have confirmed that there is a definite bias in the recommendations that advisors make. But the largest factor creating bias is not the level of commission compensation from investment funds. Instead, advisors tend to bias client portfolios to mimic what advisors themselves hold, putting clients in line with their own beliefs about investment strategies.[72] Another rigorous examination of Canadian investment portfolios found that the composition of the advisor's own portfolio "is far and away the strongest predictor of the risk taken in their client's portfolios even after controlling for advisor and client characteristics."[73]

This suggests that advisors' recommendations are not biased due to the presence of commissions, but because they personally and genuinely believe their own portfolio is best positioned to achieve success in the long run, and they wish to share that success with their clients.

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[71] Peter Intraligi, *A simpler approach to the future of fees*, March 8, 2017. Available at: http://blog.invesco.ca/simpler-approach-future-fees/.

[72] Juhani T. Linnainmaa, Brian T. Melzer, Alessandro Previtero, *Costly Financial Advice: Conflicts of Interest or Misguided Beliefs?*, December 2015.

[73] Stephen Foerster, Juhani Linnainmaa, Brian Melzer and Alessandro Previtero, *Retail Financial Advice: Does One Size Fit All?*, NBER Working Paper 20712, (2014). Available at: http://www.nber.org/papers/w20712.

Trailing commissions do align the interests of client and advisor

When an advisor is paid an ongoing commission based on a percentage of the assets held in a client's account, there is a long-term alignment of interests between the advisor and the client in growing the account. Advisors are interested in seeing their clients do well as it will result in a growing income stream, which encourages the advisor to provide the utmost in ongoing service – with the end result being retirement readiness for the client. In contrast, in a fee-for-service direct-pay relationship, there is less of an incentive for the advisor to achieve long-run asset growth for the client.

Commissions also help level the playing field between large and small investors, as investment fund trailers apply at the same percentage rate to large and small investors alike. This is not the case in direct-pay arrangements, with larger investors invariably paying a lower rate – as expressed as a percentage of their assets – than smaller investors. (See the chart on page 31 above.)

A commission structure also encourages investors to take a 'buy and hold' stance. A major investor behavioural problem is the tendency to chase after past winners or panic sell at the first sign of setback. Timing the market is generally not a good strategy – particularly for investors with long time horizons. For the vast majority of investors, the vast majority of the time, the best investment decision is to continue to hold their existing mutual fund positions. It is excessive trading that gets long-term investors into trouble.

Conflicts of interest still exist in direct pay arrangements

As mentioned, all compensation structures – including direct-pay arrangements – inherently create certain conflicts of interest. It is arguable that the market distortion caused by forcing all investors into direct-pay schemes would result in inferior outcomes for investors, and especially for small investors who are particularly vulnerable to the conflicts that would take prominence in a post-commission world.

Increased influence of vertically-integrated firms and push of proprietary/related party products. With the loss of independent firms and advisors, large, vertically-integrated firms (mostly being bank- and insurer-owned entities) will have an even greater influence in the market. If these firms do serve smaller investors, they will only do so by exacting pressure to extract maximum revenue from these "low margin" clients – with these institutions likely establishing structures that strongly incent their employees to push clients towards proprietary or related party products by rewarding sales thereof with commission-like internal transfer payments and requiring high minimum revenue targets in order to remain employed.

This conflict arguably does far more harm to clients than the conflict from a trailing commission. It virtually assures that clients will be shuffled directly to the in-house portfolio and other competitive investment platforms that could better serve clients will be ignored. A recent IIROC review found cases where the compensation grid payout was greater for non-arm's-length products than for comparable third-party products.[74] IIROC also found more subtle forms of bias that could indirectly motivate representatives to inappropriately favour related-party products, such as bonuses based on the overall percentage of fee-based revenue, and equity ownership programs in related-party issuers.

We have recently seen a great deal of public concern over this very situation. There has been a barrage of stories in the mainstream media about bank-based employees being unleashed on the public, with very little training and qualifications, yet pressured by 'higher ups' to hit revenue targets or fear losing their jobs.[75] Some staff report of pressures to hit targets that are monitored weekly, daily and in some cases hourly.[76]

Remember that this is all occurring in an environment that is separate from the sales and trailing commissions at issue in the Consultation Paper. In our view, the conflicts caused by poorly trained and unprofessional staff pushing non-arm's length products under the extreme pressure of hitting revenue targets – under threat of being dismissed – is a far greater public interest concern than commission compensation, and banning of commissions will only further accentuate the power of these vertical entities.

'Active' advisors. A fee-for-service structure will incentivize advisors to be more "active", initiating a larger number of trades, even if those trades are unnecessary or harmful to the client. According to the president of an independent investment management firm, trailer fees were the mutual fund industry's answer to the persistent and wealth-destructive switching that occurs when investors are left entirely to their own devices or, worse still, when the only source of compensation for advisors is commission derived from making a mutual fund switch.[77] Consider what actually happened in the U.K.: following RDR, advisors have been accused of charging higher fees that do not fairly reflect the actual work that was needed to be carried out – by a factor of two-and-a-half times more, compared to before commissions were eliminated.[78]

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[74] *Infra*, note 79.
[75] CBC News, *'I feel duped': Why bank employees with impressive but misleading titles could cost you big time*, March 29, 2017. Available at: http://www.cbc.ca/news/business/bank-s-deceptive-titles-put-investments-at-risk-1.4044702.
[76] CBC News, *'We are all doing it': Employees at Canada's 5 big banks speak out about pressure to dupe customers*, March 15, 2017. Available at: http://www.cbc.ca/news/business/banks-upselling-go-public-1.4023575.
[77] Brendan T. N. Caldwell, *In praise of mutual fund trailer fees*, Financial Post, June 17, 2013. Available at: http://business.financialpost.com/fp-comment/in-praise-of-mutual-fund-trailer-fees.
[78] Julia Faurschou, *Advisers accused of overcharging post RDR*, FT Adviser, March 16, 2017.

Regulator-mandated reverse churning. Recently, IIROC issued Notice 16-0297, *Managing Conflicts in the Best Interest of the Client – Status Update* on December 15, 2016.[79] One of the three major concerns identified was the potential that higher advisor compensation for fee-based accounts could incent representatives to move clients from commission-based accounts to fee-based even when that might not be in the clients' best interest. The effect of reverse churning is particularly harmful for smaller accounts, but amazingly, this is what would be *mandated* by regulators should they proceed with a ban on embedded commissions.

Our view of the issue

Conflicts of interest arise in all principal-agent situations. But the conflict created by embedded commissions may not be as serious as regulators purport it to be, as commissions also align the long-run interests of both clients and advisors. The largest biasing factor in an advisor's practice is the tendency to have clients' portfolios match their own, demonstrating their true belief in the quality of their recommendations. And the direct-pay structures that regulators are so eager to push all clients into create serious concerns for consumer welfare, especially for smaller investors vis-à-vis large, vertically-integrated firms.

All of this is not to say that conflicts of interest are not a problem or to dismiss the seriousness of the CSA's concerns. In relationships of trust such as that between an advisor and a client, we should do everything we reasonably can to minimize conflicts of interest, including making available, as an option, compensation structures that minimize conflicts for the most vulnerable investors and coupling accessibility with plain-language disclosure that makes clear to the client the nature of the conflict. We must also take a serious look at the proficiency and qualifications of those who provide advice, which is the subject of the remainder of this submission.

But we must take great care not to promulgate policies that effectively eliminate access to advice, particularly for those with modest means. It is not the role of regulation to restrict the tremendous benefits of a service such as financial advice to those who can afford a regulation-burdened, high-cost version of it. We believe the CSA should focus on addressing the larger underlying issues of professional qualifications and standing. In attempting to insulate smaller investors from potential harm by eliminating choice in compensation models, the CSA may end up suffocating their retirement prospects.

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[79] IIROC Notice 16-0297, *Managing Conflicts in the Best Interest of the Client – Status Update*, December 15, 2016. Available at: http://www.iiroc.ca/Documents/2016/4dd98e70-f053-4980-bc75-10ceb6f3940d_en.pdf.

To that end, we urge the CSA to carefully study the line of thinking from Sweden, which considered, but ultimately decided against banning embedded commissions. The government's position was summarized by Per Bolund, Sweden's Minister of Financial Markets and Consumer Affairs:

> The government is not going to introduce a general ban against third party remuneration nor ban commission-led sales of financial advice and products. The ambition is to reach a balanced solution, which supports good advice to customers at the same time that household needs to access financial services are met in a good way.[80]

9. A BETTER WAY FORWARD

The bottom line is that all Canadians, regardless of their income, deserve access to sound and trustworthy financial advice delivered by qualified professionals. Financial advice creates tremendous value for consumers – not from alpha or beta, but from gamma, the advisor-driven behavioural change that pivots consumers' inherently poor savings and investing habits towards a more forward-looking vision. But because gamma is built on trust, we must ensure that advisors are worthy of this trust.

The CSA has focused prescriptively on commission compensation in its Consultation Paper as a vulnerability through which consumer trust can be exploited by unscrupulous advisors. But banning embedded commissions in an attempt to address conflicts of interest would only serve to restrict (or eliminate) access to advice for lower-income consumers and give greater weight to business models that carry their own, arguably more serious, conflicts of interest. And such a ban would do nothing to enhance the quality of advice that consumers receive.

We believe the CSA's narrow focus on commissions is misdirected. There are legitimate concerns about the quality of financial advice and the proficiency and conduct of those who purport to provide this advice to consumers. It is these concerns that should be the primary focus of regulators. After all, the financial advisor is at the front line of the entire financial services industry – their standing is the culmination of the work and effort of all stakeholders, from regulators, product manufacturers, dealers, industry associations and advisors themselves. For the majority of investors, it is the financial advisor that is their only point of contact with the industry. And as such, advisors serve as the key consumer safeguard.

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[80] Investment Europe, *Swedish government proposes not to ban commission-led sales*, May 24, 2016. Available at: http://www.investmenteurope.net/regions/swedendenmarkfinlandnorway/swedish-government-proposes-not-ban-commission-led-sales/.

The existing framework puts consumers at risk

Given this critical role, consumers should be able to trust that their financial advisors are proficient, up-to-date in their knowledge, and compliant with the highest standards of conduct and ethics. While many advisors meet these expectations, there are inevitably some who do not – and due to persistent gaps in the current regulatory framework, retail investors are unnecessarily exposed to risk. There are five major sources of this risk:

(i) Anyone can call him- or herself a financial advisor and offer financial advice.

Across Canada, other than in Quebec, anyone can hold themselves out to the public as a financial advisor, financial planner, investment advisor, or countless other titles, regardless of their training, experience or education. Neither the title of 'financial advisor' nor the scope of the work under that title is protected in law, so there is nothing to prevent an unscrupulous, incompetent or merely inexperienced individual from calling themselves a financial advisor and offering what is purported to be financial advice to the public.

This is a significant risk which must be addressed; time and again, research has shown that most consumers mistakenly believe that titles such as financial advisor are regulated and someone holding themselves out as such has earned the right to do so through education and experience. But unlike doctors, lawyers or architects, anyone can claim to be a financial advisor or offer financial advice and planning — which leaves the public vulnerable to incompetence or outright fraud.

(ii) Existing regulation focuses on products, rather than the most critical aspect — the ongoing relationship between financial advisors and their clients.

Much of our existing regulatory framework does not reflect the reality of how most consumers access financial advice and planning. Existing regulation is often based on the type of product being sold to the retail consumer. And while existing regulators are adept at regulating their member dealers or brokers, including regulating the constant product innovation in the industry, they do not have a focus on the retail consumer's complete advisory experience.

Considering the issue from the consumer's perspective is illustrative: many advisors hold multiple licenses which allows them to provide consumers with complete risk management and wealth solutions from across the insurance, mutual fund and securities sectors. But as a practical matter, most consumers do not conceive of the retail financial services industry as structured in such rigid 'silos.' Nor should they be expected to understand the laws and regulatory processes which have produced this model. Consumers work with their advisors to develop holistic financial plans which reflect their personal circumstances; they do not receive piecemeal product-centred advice. Above

all, consumers want assurances that their advisors are professional, knowledgeable and accountable, so they can get the most out of the relationship.

Most consumers are not particularly interested in knowing that product *x* comes from the insurance universe and product *y* comes from the mutual fund universe. But, in the current regulatory framework which is so tied to product sales, it is often the case that the advisor-client relationship is not governed by a single regulatory entity, but by a combination of them. The result is that the protections which consumers currently receive vary widely as they are based on the sector from which the product originates. We have seen the importance of this distinction coming to light if problems arise, leaving consumers confused and disappointed.

This sectoral approach also explains why the existing regulatory framework cannot effectively regulate today's holistic advisory relationships. It is true that in recent years, regulators have given greater attention to the advisory relationship — such as the CSA's Client Relationship Model reforms. Despite this laudable effort, existing regulators are structurally limited by their jurisdictions of authority; for example, even if an insurance regulator were to completely overhaul its expectations of licensees, those changes would only impact the consumer's experience in regard to purchases of insurance products, leaving the consumer's experience with other products unaffected. This is what necessarily happens when consumer protections are ancillary to the sale of product.

In an ideal world, all regulators would set comparable standards so that clients would be equally protected, regardless of the product's origination. But a century of experience and general common sense tells us that when you have multiple regulators that were created on the basis of regulating products – rather than the advisory relationship – and which already have standards that (in some cases) vary widely from each other, coordinating policies on financial advice is nearly impossible. And even if regulators did manage to agree to a uniform set of policies, those policies would do nothing to capture those individuals who are not registered at all, such as a fee-only planner who does not sell product.

(iii) There is no firm, clear, and universal requirement for advisors to keep up-to-date their core areas of knowledge.

One of Advocis' core membership requirements is that advisors keep their knowledge up to date by completing continuing education courses each year, including courses on professionalism and ethics. But for the same reasons discussed above, the regulatory requirements for continuing education vary based on a product's sector of origination. For example, Ontario requires that life insurance licensees commit to 30 hours of continuing education every two years, without requiring a minimum learning component on professionalism or ethics. Several provinces do not have any CE requirements with respect to insurance licensees. And while IIROC has continuing education

requirements for registered representatives, the MFDA only states that continuing education "should be provided" to its approved persons.[81] And those advisors who are not registrants with any regulator have no continuing education requirements whatsoever.

Advisors who do not keep their knowledge current fail to properly serve their clients and very likely puts their clients at risk. Moreover, the breadth of knowledge that advisors should have is continually expanding, as product change and innovation is constant. Therefore, static knowledge quickly becomes obsolete and impedes the ability of advisors to act in the best interests of their clients. We believe that all individuals who offer financial advice and planning to retail consumers should be required to complete continuing education on a regular basis, with an emphasis on education related to professionalism and ethical conduct.

(iv) There is no effective, industry-wide disciplinary process.

The majority of advisory relationships are beneficial to the public, but some inevitably do not work out as anticipated. Sometimes, this is a result of negligence, incompetence or fraud on the advisor's part. Accordingly, the industry requires a strong and effective disciplinary process, one which will ensure that those advisors who have committed misconduct are appropriately disciplined, and which will also protect the public and deter other advisors from similar misbehaviour.

Insurance regulators, the MFDA or IIROC are each empowered to impose a variety of sanctions, including the stripping from an advisor of his or her license or registration. However, the limitations of the existing product-based regulatory framework become most apparent when considering the practical impact of having multiple regulatory authorities investigate and act on matters of discipline: each regulator's enforcement powers are limited to its respective sector, creating unacceptable gaps in consumer protection.

Suppose, for example, an advisor engages in misconduct so egregious in the course of selling a mutual fund that the MFDA determines he or she is unfit to work in the fund industry and, as a result, revokes the advisor's registration. In such a case, there is nothing to prevent that same advisor from continuing to provide advice, and sell segregated funds through his or her insurance license.

We believe this sector-hopping represents an unacceptable consumer risk. The type of serious misconduct which warrants an advisor's outright expulsion from one sector, such as fraud or gross

[81] On June 22, 2015, the MFDA launched a consultation to consider whether it should require mutual fund dealer representatives to fulfill continuing education requirements. Available at www.mfda.ca/regulation/bulletins15/Bulletin0644-

negligence, is clearly indicative of that advisor's inadequate commitment to ethical and professional conduct. This is not a sector-specific concern. It is, rather, an industry-wide concern that speaks to larger underlying issues.

Permitting such an advisor to continue to service any consumer is a disservice to the public. And even if that advisor is eventually identified and removed by other regulators in their respective sectors (quite possibly, with a lag measured in years, not weeks), that person can simply continue offering advice on an unlicensed basis since the scope of work is not protected: for example, he or she could "advise" clients to invest in an affiliate's Ponzi scheme.

(v) There is no centralized, pan-sectoral way to review an advisor's credentials.

Also currently lacking is an effective, accessible and industry-wide mechanism through which the public can easily verify their advisor's credentials and disciplinary history. While several regulators, SROs and industry bodies maintain websites where the public can search for information on their advisor, the information returned is confined to the particular entity's sector. As discussed above, the general public does not understand the difference between the various regulatory bodies governing their one holistic relationship with their advisor and is not likely to canvass the registries or databases of each individual regulator to investigate a potential advisor.

In the example from the previous subsection, if a client were to review their prospective advisor's credentials and disciplinary history solely through the insurance regulator's website, they would not become aware of the advisor's expulsion from the mutual funds sector. The client might then mistakenly believe that the advisor's overall disciplinary history was clean.

Advocis strongly believes that consumers should have a one-stop access point for reviewing a prospective advisor's complete disciplinary history that is not limited to the domain of one product sector and respective regulator. It must also capture those individuals who offer advice and planning without the sale of product who are therefore not registered with any existing regulator. That is, rather than being based on today's archaic product-focused regulatory structure, this critical consumer tool must be reconceived at the level of the advisor-client relationship, in order to properly ensure regulation is informed by the consumer's perspective – as all good regulation should be.

These five major shortcomings of the existing regulatory framework expose consumers to unnecessary and unacceptable risk. They arise from the fact that current product-based regulation

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does not reflect the modern, holistic and cross-sectoral approach to financial advice and planning that most consumers receive. But these risks are addressable with the will and courage to re-align the regulation of financial advice with the consumer's perspective. It is to such a solution that this submission now turns.

The solution: Raise standards and make financial advice a profession

The solution to these problems is simple, straightforward, and does not require significant government resources to implement. What it does require is a willingness to re-think the regulation of financial advice, taking it away from its product-based roots to a client relationship-centric model.

The solution envisions recognizing the provision of financial advice as a true profession, through the creation or accreditation of a professional body that regulates financial advisors and the practice of financial advice in the public interest. The professional body would be responsible for the licensing, registration, standard-setting, investigation and disciplining of financial advisors. This would be akin to how other professional bodies operate, such as the College of Physicians and Surgeons of Ontario and the various provincial law societies.

The following is a high-level overview of the defining characteristics of the professional body.

(i) Mandatory membership.

Analogous to the professional bodies for engineers or accountants, the solution requires that anyone who holds themselves out as a financial advisor, or who is in the business of offering financial advice or planning services to the retail public, be a member in good standing of the professional body for financial advisors.[82] The membership requirement would cross traditional product sector boundaries, capturing everyone who offers retail-level financial services – thus introducing a unified oversight of all retail client-facing advisors, including financial planners and those that do not transact in product.

[82] Certain exemptions could apply to the mandatory membership requirement, such as professionals licensed by another recognized body that offer financial advice as ancillary to their main service offering, such as lawyers or real estate agents. It may also be desirable to distinguish between the holistic full-service financial advisor and those who purely offer one-time transactional services, such as discount brokers. The number of service providers falling into this latter group would likely be relatively small.

(ii) Enhanced proficiency and continuing education requirements.

The professional body would establish a mandatory minimum baseline of skills, education and other competencies which all financial advisors, including financial planners, would be obligated to meet in order to achieve membership. These requirements would apply across product sectors, thereby harmonizing advisor skill and competency and ensuring that clients interact with proficient advisors in all cases.

Continuing education would be a mandatory requirement, including content dedicated to topics on professionalism and ethics. The professional body would monitor and enforce continuing education requirements designed to ensure that all financial advisors maintain a high standard of proficiency. It would also require member advisors to maintain errors and omissions insurance to protect the clients they serve.[83]

(iii) Meaningful titles and designations.

Select titles such as "financial advisor" and "financial planner" would be defined as a professional title and protected from misuse by the unqualified, just like the titles of lawyer, doctor or landscape architect are protected by those respective self-governing professions. Additionally, it is of critical importance that title protection not only be about the use and misuse of specific titles. Rather, protections must encompass both the title and the scope and function of the work, as they do for other professions.

A number of leading designations would also be granted proficiency recognition by the professional body, as conceptualized in the figure below, and these areas would denote areas of specialization – for example, through designations such as the CFP®, CLU® and CH.F.C®. Specialization is common in established professions: consider the medical profession, where all doctors must meet a minimum standard to be called a medical doctor and be a member of their professional body. But within that larger group, there are smaller groups who have specialized further: while every member of the profession is a doctor, only those who have completed additional training are allowed to use designations which identify their specialization, such as cardiologist and oncologist.

The basic principle should be that an advisor cannot hold him- or herself out to the public in a manner that deceives or misleads – or could reasonably be expected to deceive or mislead – a client or prospective client with regard to the advisor's proficiency, qualifications and service offerings (including specializations).

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[83] Current requirements to maintain errors and omissions insurance vary by province, industry sector and product type.

(iv) An enforceable code of conduct.

The professional body would have, at the cornerstone of its commitment to professionalism, a code of conduct that inculcates ethical norms in individual advisors. The code would address, *inter alia*, the duties surrounding conflicts of interest; the duty to provide competent service; the duty to act with honesty and integrity; the duty to preserve and protect client confidentiality; and the duty to cooperate with the professional body and regulators. At the core of the code of conduct, as its first tenet, would be the priority of the client's best interest; this is discussed in greater detail in the following subsections.

The code of conduct would be backed by a complaints, investigation and disciplinary process that empowers the professional body to suspend or cancel the advisor's membership. What is unique about this is that because membership in the professional body is mandatory across product sectors, discipline conditions or suspensions are not limited to one product sector. Instead, they are able to address the serious issues of negligence, incompetence or fraud directly in a complete manner, bolstering consumer protection.

(v) An accessible, consumer-facing central registry.

The professional body would maintain a public-facing database whereby consumers can conduct a "one-stop" check of a prospective advisor's credentials and disciplinary history. Unlike the registries maintained by existing regulators and SROs, which only contain information pertaining to the advisor's activities in the regulator's or SRO's respective sector, the professional body's registry would be based on the conduct of offering advisory services to the retail public. It would therefore transcend product sectors, addressing the "sector hopping" problem of miscreants. This focus on scope of work and conduct would also capture those advisors and planners who are currently not registrants of any regulator.

(vi) Advisor representation in their own regulation.

One of the hallmarks of a true profession is involvement of its members in their own regulation – this is true of lawyers, doctors, dentists, architects and so on. Involving members allows the professional body, including the government to which the body ultimately reports, to leverage the vast accumulated knowledge and real-world experience of the membership to set policy in a way that is more likely to achieve its objectives.

Financial advisors are currently regulated without representation. Advisor oversight is presently in the hands of regulators such as the MFDA, IIROC, and so on – these are product-based regulators who do not consider advisors to be true members of their organizations and refer to advisors as mere 'approved persons'. Indeed, because of how detached they are from the ground level of working with clients, these organizations often do not fully understand what advisors do in their day-to-day work.[84] And advisors lack true standing and a 'voice' within these organizations. For example, neither the MFDA nor IIROC mandate the presence of advisors on their boards of directors.

The professional body would have a board of directors comprised of financial advisors, members of the public, and government appointees, among other persons. The mandate of the body would be, first and foremost, the regulation of financial advisors and the provision of financial advice in the public interest. The professional body, through its board, would report directly to the provincial finance minister, rather than indirectly through a product regulatory body. As financial advice has

[84] While branch managers and other dealer staff receive and review paperwork documenting the advisor-client interaction, it is usually only the advisor that has a direct relationship with the client. As with any in-person, face-to-face interaction, there are many nuances that are difficult or impossible to distill into writing. The advisor's ability to understand the "human" elements in a client interaction is critical to the quality of that relationship.

evolved into a true profession, it is time to give professional financial advisors a dedicated voice in their own regulation.

Putting clients' interests first

We understand and appreciate that motivating the proposals in the Consultation Paper is the CSA's efforts to improve investor protection. We support that underlying objective. But rather than abolishing compensation structures in a top-down move that would create disastrous unintended consequences, the best way to achieve our shared investor protection goals is through the establishment of a profession for advisors which would have at its core a duty to act in a client's best interest. A best interest duty would better address the CSA's concerns about conflicts of interest relating to all compensation structures, including direct-pay structures, without disrupting access to the advice that consumers so critically need.

A significant feature – indeed, perhaps the defining feature – of the "best interest" concept is its moral ambition, which lies in the expectation by the client of absolute good faith on the part of the advisor. In this light, the ultimate focus of the duty is trained on the advisor's motives and actions in advancing the client's overall interests, and not merely on the state of the client's accounts at any given point in time.

The duty must be interpreted by the professional body. We believe that advisors must be granted professional standing before a best interest duty can be enacted. We are opposed to a best interest duty that is interpreted and applied by existing regulators that are not connected with the client-facing work of advisors and are therefore not positioned to understand the nuances of an advisor's real-world practice.

A best interest duty is a professional standard of care meant to ensure that a client receives the utmost in their advisor's care and judgment. It necessarily involves subjective assessments that take into account the client's objectives, risk tolerance and financial position, as well as the market conditions known at the time and projected out into the (sometimes distant) future. The breaching of a best interest obligation creates significant ramifications for the client, advisor, and the reputation of the industry as a whole, so a fair hindsight determination of whether a decision was in the client's best interest requires an understanding of the real-world practice dynamic in play when the advisor made that decision.

A best interest duty interpreted and enforced by a professional body would be enriched by the first-hand knowledge of its practicing member advisors, some of whom would serve as members of the profession's hearing tribunals. As in the case of any profession, it is the professionals within it who are best suited to understand how the concept should be applied to their peers. This flexible and

evolving approach would be the ideal way to address novel situations or evolving market conditions.

It would be manifestly unfair to apply a best interest duty to a profession while failing to involve members in their own regulation. Critically, we draw attention to the fact that there is no other profession, whether it be law, medicine, or so on, whose members are subject to a best interest duty but who are not accorded professional standing and given a voice in their own regulation. Senior regulators or ministries in those industries recognize they have an important role to play in setting the basic framework, but they cannot, should not and do not attempt to regulate the nuances of the professional-client relationship or judge whether a professional's actions were in the best interests of the client. Instead, they respectfully defer to accredited self-regulatory bodies, such as the College of Physicians and Surgeons or the association of Chartered Professional Accountants.

We urge the CSA to take note that professionalizing advisors and involving them in their own regulation – including in regards to administering a best interest duty – is exactly what is proposed in Australia.[85] We urge the CSA to study Australia's efforts and take a similar enlightened path.

<u>All stakeholders would benefit from advisor professionalization</u>

In summary, the establishment of financial advice as a profession would create benefits for all market participants: first and foremost, consumers would benefit from working with true professionals that are driven by an underlying duty to place clients' interests first. They could rely on the fact that all advisors would meet proficiency and ongoing education requirements, just as they do with their architects or engineers. They would also benefit from a simple way to verify their advisor's credentials and disciplinary history without having to navigate the maze that is the current regulatory landscape. Finally, they would enjoy the support of a disciplinary system with teeth: it would be a system that actually protects the public, rather than potentially off-loading one sector's problem onto another product sector and a new set of unsuspecting consumers.

Professionalizing the industry would align regulation with what is most important from the consumer's perspective: the relationship of trust with their advisor, which is the key to establishing the gamma factor and unlocking retirement readiness. Advisor regulation could finally be moved away from being a corollary of the byzantine world of product regulation. And professionalization would permeate through all facets of the advisor-client relationship and would be far more

[85] Financial Standard, *Advisers to be judged by peers*, Available at: http://www.financialstandard.com.au/news/advisers-to-be-judged-by-peers-94256311.

effective than prescriptive rules ever could be in addressing consumer protection issues that arise in a rapidly-changing environment.

Financial advisors would benefit from enhanced public trust, status and confidence as true professionals, and we know that our members would be very supportive of seeing unethical advisors who tarnish their collective reputation being removed once and for all.

Governments and regulators would benefit from enhanced consumer outcomes, including reduced public financial reliance, and the expertise and support of the professional body in crafting and implementing their policy agenda. And product manufacturers and distributors would benefit from the professionalism of the advisors who represent their companies to the public on a day-to-day basis.

10. CONCLUSIONS AND NEXT STEPS

The CSA says its proposed ban on embedded mutual fund commissions will “put the investor’s interest first.” But, in reality, forcing all investors to pay directly for financial advice puts millions of Canadians at serious risk. This ill-conceived move would diminish choice and erode access to financial advice for those who need it most, like seniors on a fixed income and young people just beginning to save for retirement, for whom direct-pay arrangements are simply unaffordable.

The CSA acknowledges that those with less than $100,000 to invest are already underserved in the market, noting they are the “least likely to be receiving advice today and when they do receive advice, the range of services provided tends to be less than for those with higher levels of wealth.” Considering approximately 80% of the population falls into this category, one would expect our regulators to look for solutions that expand access and improve the quality of financial advice available to all Canadians. Regrettably, this isn’t the case.

Instead, the CSA is focused on doing away with commissions based on an incorrect belief that the value of financial advice lies in alpha, or the pursuit of excess returns. The CSA seems unwilling to accept the gamma factor: the power of changing ingrained human behaviour that favours present consumption, underestimates future needs and results in poor retirement outcomes. This behaviour is extraordinarily hard to change: frankly, if consumers could do it themselves, Canada would not be facing the retirement crisis that now looms large. But based on its flawed analysis, the CSA is now asking middle-income Canadians to take a leap of faith that they will continue to have options for financial advice.

Despite conceding that “independent fund dealers may choose not to continue to service these households” after commissions are eliminated, the regulators say we need not worry because the masses largely receive their advice from the big banks and insurance companies anyway, and they

assume that will continue. In saying this, the CSA is setting the stage for further concentration of Canada's retail financial services sector in the hands of large, vertically-integrated firms – and the high-pressure sales tactics of commission grids and proprietary products that put small investors at particular risk.

While it's troubling that the CSA appears unfazed by Canadians having less choice over who helps them manage their financial futures, what's even more worrisome is that our regulators are turning a blind eye to overwhelming evidence that many households could lose access to advice altogether. In light of the U.K.'s failed experiment, it is staggering that the CSA continues to pursue a commission ban here in Canada, particularly at a time when financial advice is needed more than ever.

Canadian household debt has reached record heights and there is a growing need to be more financially self-reliant in retirement as less than a third of workers today are covered by an employer pension plan. While working families struggle with these challenges, independent academic research has confirmed that those who work with a financial advisor are better protected, accumulating nearly four times more wealth than those who don't.

And while market risks and the moral hazard inherent to the principal-agent relationship are real, non-participation in financial markets and poor investor savings practices and investment decision-making have much larger negative impact on individual household wealth accumulation – and society, in general, as those who fail to save adequately for retirement will necessarily demand more on the state. But governments are facing their own financial crises, with the 2016 census showing that, for the first time in history, there are now more seniors than children. Something has to give.

Make no mistake, no one is suggesting that investors be forced to pay commissions — but simply that they continue to have a choice in the matter. The second phase of the client relationship model (CRM-2) regulations, which only recently came into effect, are now working to increase transparency around fees on account statements and help investors better understand their investment performance and the associated costs. Why not assess the impact of these changes before moving hastily ahead with a regulatory overhaul that will put financial advice out of reach for so many?

Banning commissions is not the answer to protecting Canadians. A more pressing problem we should be addressing is that the current regulatory system is failing to ensure the proficiency and professionalism of financial advisors across the country.

Rather than debating about how advisors are paid, we should be working to create an environment where all Canadians—irrespective of their net worth—have access to sound financial advice

delivered by competent and qualified professionals. The best way to do that is to oversee financial advisors as we do all other professionals that provide essential advice, from lawyers to accountants and engineers. Every financial advisor should belong to a professional body and be required to adhere to a common code of professional and ethical conduct, mandatory professional liability insurance, ongoing continuing education, and a disciplinary process with the authority to suspend an advisor who has wronged an investor.

Only then can we truly say that we are putting the interests of all investors first.

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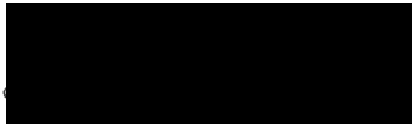
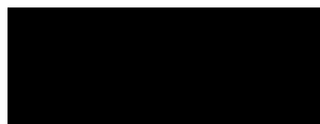
We look forward to working with the CSA as it proceeds with this challenging issue that is so critical to the financial well-being of millions of Canadians. Should you have any questions, please do not hesitate to contact the undersigned, or Ed Skwarek, Vice President, Regulatory Affairs and Public Affairs at 416-342-9837 or [redacted].

Sincerely,





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