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À : CSA ACVM Secretariat
Objet : One Advisor's Perspective about Embedded Fees

To the CSA Secretariat,

Advisors and financial institutions keep saying that the small investor will be hurt if embedded trailer commissions are banned. Why? Wouldn't advisors be able to charge the same 1%/ yr. out-of-pocket?

Before answering these questions let me first preface this with my particular circumstances. I've been a financial advisor for more than 22 years. I deal almost exclusively in mutual funds for my income. I provide my clients with as much service as they need and only ask for up to the 1% trailer commission as compensation (FE 0%). That means no front-end fees, no DSC fees, no switch fees, no transfer fees, no nominee account fees, no annual maintenance fee, and no account close-out fees. In other words, it is about the lowest full service cost that any investor could ask for. Since my only compensation is a percentage of AUM, my incentives are to keep client costs to a minimum and to keep their portfolio performance up to the best possible for their risk tolerance, objectives and time horizon. Our rigorous compliance system ensures that I cannot exceed this risk tolerance. These incentives are what I need for my best interest. These same incentives are also what my clients need for their best interest. So although I am already a fiduciary, my method has a best interest standard built-in. So when it is claimed that I have a conflict of interest, I would ask, what method would be better? Other methods that I have investigated either encourage bad behavior, and/ or involve more fees and /or involve conflicts of interest. Also, when it comes to the perceived conflict of interest issue presented by the regulators because I am paid by the fund companies, I would argue that it does not exist. According to Morningstar Canada, there are 10,774 commission based advice mutual funds vs. 628 no load do-it-yourself funds. The majority of the commission based funds pay a 1% trailer commission. Therefore, I am not tied to any one mutual fund company that could raise a conflict of interest issue and there is no shortage of being able to find some of the best, high quality mutual funds and managers in the industry. As a matter of fact, if I were compensated in any other form other than trailer commissions, I would still recommend the same mutual funds that I am currently recommending. That alone should be proof that I have no conflict of interest.

Now to the question at hand. Advisors like myself, treat embedded commissions as a pool of income from which they are paid to service their clients. Most of my clients generate a 1% trailer commission regardless of their account size. This allows me to provide the service my clients require regardless of how much they have. My experience has been that the younger, less experienced investors, with the smallest accounts require the most education and time to service. The clients with larger accounts don't complain because the 1% is standard across the industry and they know what my incentives are. However, if the trailer commission is no longer embedded, clients would be required to pay this 1% out-of-pocket. Larger investors would then expect more, and better service to match what they pay. Since there are only so many hours in a day, advisors would then need to shift their time toward the larger accounts to compensate.

At the other end of the spectrum, the 1% of a smaller, say $10,000 account, would only generate $100 of commission per year. At an hourly rate of $150, this translates to less than 1 hour per year for service. The annual KYC paperwork alone "without an appointment" would cost the advisor more than that. Add to that the required change from client-name account to nominee account will cost the client an extra $100/yr. Therefore, the small investor would pay $200/ yr. or 2.0% to get less service than the embedded 1% provides now. If you include a "reduced" MER of say, 1.5%, the small investor would pay a total of 3.5% of AUM. That's a prohibitive fee for getting less service than the current average MER of about 2.5%, which includes the 1% trailer. The smaller investors will either leave voluntarily or be asked to leave by advisors who can't afford to service them. The end result is unhappy small investors and potentially unhappy large investors, if the advisors don't shift. That's a whole lot of unhappy investors.

A good analogy to all this is our healthcare system. It's universal so everyone pays a percentage of their income in taxes to fund the system. This means that the wealthy end up contributing the most to the system but still get the same care as the poor. If the cost of our system wasn't embedded, and everyone had to pay out-of-pocket, the rich would demand more, and better care, while the poorest would go without care at all. This, unfortunately, is what will happen in our financial world.

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