De : Brian Gertenstein, Doheny Securities Limited/Doheny Insurance Services Ltd.
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À : comments@osc.gov.on.ca; Consultation-en-cours
Cc : Brian Gertenstein
Objet : Banning of Embedded Trailer Fees

Removal of Embedded Fees

Introduction

The following is an argument against the removal of embedded trailer fees. While a common discussion point has been access to advice, this paper also addresses the consequences to investors who will continue to access advice if embedded trailers are removed. The overall theme is that, were embedded trailer fees banned, more harm than good would come to investors. Consequences of the ban to be considered in this paper include:

1. Access to Advice—The Smaller Investor and DSC
2. The Loss of the Young and Best Advisors—Reduced Competition
3. Controlled vs Uncontrolled Fee Environment--Potential for Investor to Pay Higher Fees
4. Movement to Segregated Funds—DSC and Embedded Trailers
5. Movement to the Wrong Product Apart from Segregated Funds
6. Potential for More Emphasis on Proprietary Products
7. The Elimination of Choice
8. Loss of the Smaller and Independent Firm
9. The Practical

1. Access to Advice—The Smaller Investor and DSC

Understanding and navigating the many different investment options that exist in the market today is complicated. This is particularly true for investors who have little or no investment knowledge. It applies however, also to those investors that have some knowledge. Even investors who regard themselves as sophisticated benefit from financial advice. Over the past 25 or 30 years, this has become more pronounced as the option of simply going to the bank to buy a GIC no longer provides the return that investors are seeking from a growth perspective. Neither does it provide them with the revenue they need to live in a manner with which they are comfortable. Although not cited here, the fact that investors who receive advice fare better than those who don't, is borne out by many studies.

Common place in the market is for the sale of mutual funds to take place on a deferred sales charge basis (DSC) including both full commission and low load options. This form of compensation is particularly valuable for relationships between smaller investors and their advisor and will be lost if embedded trailers are removed. Financial advisors, like all professional service providers, need to be compensated for the services they render. The DSC model provides advisors with the revenue they need to make the relationship make sense financially. It will not be economically viable for many advisors to serve smaller accounts if the option to earn income on a DSC basis is removed.

It should also be noted that, in determining if it makes financial sense for an advisor to serve an investor without DSC as an option, it is likely that an advisor would not be able to set a precise threshold of assets that an investor would need, to the exclusion of any other factor, in order to determine if the relationship would be economically viable. For example, some investors live in areas where access to advice is more limited. This is particularly true in rural areas. It may be that for those investors, with the DSC option no longer available, advisors will decide that investors who live in more remote locations must have more assets than those in urban centres as the costs to service them is higher. Accordingly, to the extent that certain investors are already less serviced than others, the removal of DSC would further restrict these investors to access financial advice.

To the extent an argument will be made that smaller investors will seek their advice from a channel which can afford taking them on as clients, this hardly seems fair or more importantly in the best interest of the investor. Smaller investors want access to the same distribution channel as wealthy investors and taking actions which discriminate against them, does not seem to be acting in their best interest. This is particularity true given the structure that will be mandated to negotiate advisor fees can already be accessed by those who wish to.

2. The Loss of the Young and Best Advisors—Reduced Competition

The DSC option is an important revenue stream particularly to younger advisors getting into the financial service business. While the focus of the removal of the embedded trailer fees should be considered from the perspective of the investor, it would be short-sighted not to take into account its impact on younger advisors as this impact ultimately effects the delivery of advice and hence investors.

It is the contention of this paper that investors benefit from financial advice. Having young advisors enter the business is critical to the continued offering of quality financial advice to all investors. What's more, the industry should have as its goal the desire to attract the best and brightest people to deliver that advice. Creating an environment where it is difficult to make a living will not support that objective as less people will strive to enter the business. Although not immediately, in the end, the people who will suffer from less financial advisors coming into the financial services business is the investor.

Another consequence of less people coming into the business is that those that remain will have less competition. Competition is critical to creating the best advisor. Although advisors will continue to strive to provide the best financial advice, competition is always a useful tool to create an incentive to be the best one can be. Competition among advisors will also help ensure fees remain competitive and reasonable. With less competition, the potential for high fees exists. Ultimately, investors will be the group that is negatively impacted by less competition.

3. Controlled vs Uncontrolled Fee Environment--Potential for Investor to Pay Higher Fees

Presently, embedded trailer fees fix the amount of income an advisor can earn on a particular mutual fund. Although there exists today an option to negotiate advisor fees through, as an example, F class mutual funds, by removing the embedded fee option for the delivery of mutual funds, advisors will be forced to negotiate and help to determine the amount of income they earn in all instances.

While this may result is some investors paying less, it is not necessarily the case that all investors will pay less. The most vulnerable investors are likely to be smaller investors and those that are less educated. Investors who now pay a common 1% trail (FE) or .5% (DSC) may very well find themselves paying a 1.5% trail or possibly higher. While compliance will have some obligation to monitor this issue, there will be a range of fees that are reasonable and compliant with proper disclosure and that range may provide for many investors paying more than they already do.

In addition, to the extent investors have both fixed income mutual funds and equity mutual funds in their portfolio, the embedded trailer (on FE) is often a blend of 1% and .5%. A shift to a model where fees are no longer embedded may very well result in a flat fee of 1% or higher thereby increasing the fee paid by investors on balanced portfolios.

4. Movement to Segregated Funds—DSC and Embedded Trailers

As reported by the Mutual Fund Dealers Association (MFDA), a significant number of representatives in the MFDA are licensed to sell segregated funds. Given that segregated funds are very similar to mutual funds, in many instances their essential difference is in their costs and certain guarantees (although there are some other difference), many advisors may move to recommend segregated funds where DSC commissions can be earned and trailer fees are embedded. Advisors have already likely recommended segregated funds over mutual funds on the basis that they feel there is less compliance surrounding the sale of segregated funds. Compound the advisor's view of less compliance obligations with the ability to earn a DSC commission and not having to worry about negotiating their trailer fee will certainly mean a more pronounced movement to segregated funds. This will be true whether the investor really needs the benefits of segregated funds. If those benefits are not needed by the investor, the investor will end up paying substantially more in fees for features he or she does not need so that the advisor can earn the compensation that he or she feels is necessary and reasonable in order to deliver the service the investor wants and needs.

While it may not be the responsibility or concern of the CSA to deal with matters that fall under the jurisdiction of insurance regulators, it is impossible to ignore the reality that many investors may find themselves unnecessarily investing in segregated funds and therefore paying more in fees if there is a ban on embedded fees. If the goal is to pursue what is best for investors, creating an environment that pushes investors into similar but more expensive and unnecessary alternatives is not the solution.

5. Movement to the Wrong Product Apart from Segregated Funds:

By the Investor

If the total fees paid by investors become more pronounced as an issue, investors may very well find themselves pursuing options that are cheaper but not better. There is no debating that the fee an investor pays for advice is important. However, fees are only one factor to consider. The more investors focus on this factor to the exclusion of others, the more they are inclined to harm themselves.

By the Advisor

Similarly, advisors who find themselves under pressure to lower fees may recommend investments where the underlying products have lower fees (the fee independent of the advisor fee) so that the total fee to the investor is lower. This shift to an over-emphasis on fees as opposed to the right investment will harm investors.

As an example, advisors may offer index funds so that they are able to maintain their same fee while the total fee to the client is lower. Index funds may however, not be best the solution for a client in a fee based environment.

6. Potential for More Emphasis on Proprietary Products

In the event that removing embedded fees creates greater focus on the part of investors to acquire services with less fees, there may be a push to proprietary products. This may occur if firms with proprietary products offer their product at a fee lower than that of third party product. This would enable the advisor to charge the same or higher fee that he or she is presently earning on third party product although the all in fee (advisor fee and fee to the firm/manager) may be lower. This may be appealing to the investor. The potential harm is that the advisor may be motivated to recommend the proprietary product even though it may not be the best solution for the investor. This would be a detrimental outcome to the investor.

Investors benefit when they are given multiple investments to choose from. When advisors are given incentives to promote proprietary product over third party product, especially when the advisors are able to offer third party products, investors lose.

Although it has been argued that different embedded fees have also influenced advisor behavior in the context of different mutual funds, it is noted that the industry has taken increased measures to make embedded fees on similar products more consistent.

7. The Elimination of Choice

The mutual industry already provides many ways for investors to own mutual funds. This includes investing in mutual funds on a DSC basis (back end load), front end load, volume pricing, embedded trailer fees, and separately negotiated trailer fees. These different choices have different appeal to different investors and advisors and certain options are more suitable for some investors while other options are more suitable for others.

Removing choice is seldom, including in this instance, a good option. Investors benefit when they and their advisor are able to choose the particular fee structure that is best for the investor. Creating a “one size fits all” approach has consequences. The consequences described in this document, while arguably may be unintended, are nevertheless real and negatively affect the investor. Given these negative impacts and the fact that investors can, as it stands today, separately negotiate their trailer fee, there seems to be little benefit to remove a fee arrangement the result of which may deprive many investors of access to independent advice and the other harms noted herein.

8. Loss of the Smaller and Independent Firm

The removal of embedded fees will result in lower incomes to firms. This may or may not be true due to a change in trailer fees. However, it will certainly be true because of the loss of DSC commissions. The effect of lower income will in all likelihood hurt smaller firms and independent firms who will have less resources to meet their increasing compliance obligations and remain profitable. The end result may be that there are less independent firms and fewer and fewer small firms.

On its face, less income to firms and less firms does not seem as it should be of particular concern to those charged with regulating the securities industry and protecting the investor. However, with fewer firms, particularity independent firms, more and more investors will be forced to seek their advice from firms with proprietary products.

With less firms and less advisors there will be less choice. While not immediate, it seems almost inevitable that, as the distribution world shrinks, investors will end up getting less independent advice and fees will ultimately rise.

9. The Practical

In recent years the mutual fund industry has made the change from providing investors with a simplified prospectus to Fund Facts in an effort to provide investors with information that is more meaningful and easier to understand. Included in this information is the management expense ratio which advisors are to discuss with investors. In addition, there is now the requirement that investors be provided reports annually so that they see the actual fees they are paying their advisors/firms in dollars as opposed to simply a percentage as expressed in the Fund Facts. It is felt however, that this additional disclosure may not be enough for investors to fully understand and appreciate the fees they are paying for the services they are receiving. Instead, in order to ensure investors understand and agree to the fees they are paying to their advisor, the embedded fee must be removed and the investor must negotiate the trailer fee earned by the advisor.

Negotiating advisor fees separately is, however, just another layer of disclosure. While it will force conversations about fees, it is difficult to reconcile how, on the one hand providing Fund Facts and disclosing the actual fees paid are not sufficient disclosure, and, on the other hand adding another layer of disclosure, the negotiation of embedded fees, will rectify the issue of investors knowing the fees they pay.

If investors are not sophisticated or knowledgeable enough to manage the information that is disclosed to them through Fund Facts or reports disclosing the dollar amount they are paying in fees, will they be sophisticated enough to negotiate the fees they pay to their advisor? Will they know that they were paying 1% or .5% and are now possibly paying 1.25% or 1.5% or higher? If the existing disclosure hasn't done what it was intended to do, it seems adding another layer of disclosure where investors are forced to negotiate their fees will not be the solution.

Conclusion

Investors need to know what they are paying for the services they receive. Initiatives to pursue this objective as well as the objective of ensuring investors know the different options they have for paying for financial advice is important. The delivery of Fund Facts as opposed to a simplified prospectus and reports that disclose in dollar terms the fees investors pay is a good start. Time will tell how to improve on methods for delivering information to investors on fees they are paying and choices of fee arrangements that they have.

Investors benefit from advice they receive from advisors. All investors should have access to independent advice. The independent channel should not be limited to investors of a certain wealth. By removing embedded trailer fees and forcing all investors to negotiate their own fee arrangement there will be significant and substantial unintended consequences which will negatively impact investors. Some of the negative consequences include but are not limited to:

1. Denying small investors access to advice through the independent channel by making the delivery of service to them economically not feasible;
2. Making entry into the market for young advisors more difficult creating a vacuum for advice and making it unattractive for the best and brightest to pursue financial services as a profession;
3. Creating a more complex fee structure and increasing the likelihood that smaller and mid-sized investors may pay more fees in separately negotiated arrangements than in embedded fees;

4. Creating the likelihood that investors will end up owning more segregated funds which are more expensive than mutual funds and which may not be suitable for the client because they can be offered on a DSC basis and with embedded trailer fees;
5. Creating the possibility that investors may end up in the wrong product in order to keep the all in fee down while at the same time allowing advisors to maintain the same fees they earned when fees were embedded;
6. Creating the possibility that investors will end up investing in proprietary products in order to keep fees down while at the same time allowing advisors to maintain the same fees they earned when fees were embedded;
7. Reducing the number of small firms and independent firms due to the potential loss of DSC revenue resulting in less competition which will ultimately end up with investors paying higher fees and having less investment options;
8. Eliminating an option for those investors who want to use the embedded fee structure;
9. Investors will not benefit from the additional disclosure effectively created by negotiating their fees and may in fact be worse off due to their lack of sophistication.

All of the above negative consequences would occur in order to accommodate a desire for fees to be separately negotiated which, ironically, is a choice that already exists for investors and advisors.

If the only goal is to ensure investors are responsible for agreeing to the specific fee they are paying their advisor, then banning embedded fees is a solution. It seems, however, that the additional consequences, which are real and will almost certainly flow from the ban, far outweigh any benefit that may be gained. Instead the focus should be on assessing how changes in recent years are helping the investors understand the fees they are paying. Once the impact of these changes is understood, additional steps should be devised, if any are needed, to inform investors both as to the fees they are paying and choices they have with regard to fee arrangements so that the right arrangement is reached for each investor.