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Manitoba Securities Commission
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Re: CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Conflicted Compensation

Harold Geller and MBC Law Professional Corporation are pleased to comment on the Canadian Securities Administrators ("CSA") consultation paper 81-408 – Consultation on the Option of Discontinuing Conflicted Compensation ("Reform Proposal"). Consultation paper 81-408 is an important part of the overall CSA review of the conflicts of interests which harm Canadian investors and impair market efficiency.

The Reform Proposal, on its own, is an essential effort to resolve the overall problem whereby investors' interests are in conflict with the self-interest of advisers and their dealers (hereinafter collectively referred to as "Salespeople"). This conflict of interest is not one that is resolvable through disclosure, or in the case of CRM2, partial disclosure of the conflicts. The CSA Reform Proposal is a welcome and overdue step towards providing protection to investors from unfair, improper and abusive practices which harm investors and undermine the integrity of Canadian capital markets.

The following comments are limited to those issues of interest to the individual retail investor only. In summary, it is our opinion that:

1. The overriding issue is the conflicts of interest inherent in the current conflicted compensation model used for the sale of investment products. These inherent conflicts of interest routinely result in the interests of the investor being subordinated to the interests of those selling the investment products. Salespeople have far greater knowledge of capital markets than do their retail clients. This creates significant reliance by the investor on Salespeople, which reliance leads to vulnerability in many cases. Salespeople have the opportunity to exploit this vulnerability when acting in a conflict of interest.

2. This conflict is long-standing.

3. The industry has failed to resolve this issue on its own.

4. Regulatory steps are required to align the interests of Salespeople with that of investors.

We agree with the presentation of the issues as described in Part 1 – these conflicts are well known and the issues are appropriately summarized.

The industry has failed to remedy the conflicts arising from conflicted compensation either by requiring greater proficiency or managing the conflicts by avoiding biased compensation models. Examples include the spreads on fees paid for sales which incent salesperson to sell of particular products or, in particular, proprietary, inferior performing, and higher risk products. Given this failure, action is needed.

Will investors pay for advice?

Salespeople and manufacturers allege that investors will not pay for advice. There is no empirical evidence presented to support this contention. This paternalistic argument (that Salespeople know what is best for the investor) comes from the industry, a conflicted interest group. Further, this argument undermines the counterproposal, rejected in the Reform Proposal, that disclosure by itself will remedy the conflict.

Salespeople claim on one hand that the investor is capable of appreciating the nuance of the complex disclosure post-CRM2, yet deny that the investor will continue to invest if clearer disclosure of true costs and market-distorting incentives is required. "Mass-market" and "mid-market" clients (i.e. smaller accounts) are less likely to have the sophistication necessary to appreciate the significance of the disclosures. As the Reform Proposal makes clear,[1] 88% of all households that owned investment funds in 2012 were in these two categories.

At the same time, there is no empirical evidence of which we are aware that investors will not pay for advice. Indeed, this argument is self-defeating. Investors have always paid for advice one way or another. Salespeople argue that clients should pay without knowing, because if they knew they would act differently (see the Direct Pay discussion below). The Reform Proposal merely requires that investors know what they pay for advice.

There is no social scientific study to show what clients will do if conflicted compensation is banned. As the Reform Proposal states,[2] the Canadian experience is unique. Salespeople, their lobby groups and manufacturers, often refer to sales surveys as evidence that no change is necessary or, alternatively, change is harmful. Survey results conducted by industry players require careful examination of their construction and implementation. Consider the analogy of the rigorous oversight by regulators of drug trials conducted by pharmaceutical companies.

Studies referenced by the CSA reveal that investors who receive conflicted advice have worse outcomes than those with non-conflicted advice. This is true regardless of how the regulators move towards transparent disclosure of the costs of advice. This motivated Salespeople to resist the introduction of CRM2's mandatory disclosure of costs. Essentially, the industry does not want to be accountable for the services it renders to its clients.

There appears to be no relationship between advice and fees charged. As noted in the Reform Proposal, DIY investors get no advice from discount brokers, yet often pay the same fees as other investors.[3]

Impact of the Reform Proposal

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[1] At pages 26 et seq. Table 2.

[2] At page 6.

[3] At page 51, at page 51.

Once informed of the true cost of their investments, investors may choose to cease relationships with product-driven Salespeople. This is predicted by the Reform Proposal.[4] Indeed, one impact may be that investors switch to holistic planners in place of product Salespeople. To distinguish themselves from others with a similar shelf of products, Salespeople often promote their holistic planning services ("We provide peace of mind." "We act in your best interest.") In other words, they sell planning advice. None advertise that they sell better products. ("Our stocks are better than theirs.") Even proprietary products often closely resemble products sold by competitors (at a lower price). In any event, there is no downside risk to investors being better informed of the true cost of advice or in the elimination of the temptations posed by a conflicting compensation model.

What compensation should be covered

The Reform Proposal suggests elimination of all payments to Salespeople to incent sales of specific products. As the proposal suggests, the issue is the distortion of advice as a result of conflicted incentives. All compensation should be captured. For example, underwriting compensation, referral fees and other sales incentive sweeteners have long been known to result directly in increased sales and more favourable recommendations by Salespeople. The retail investing public is entitled to bias-free advice. Most retail investors cannot appreciate the bias created by the conflicts and what that means for the advice. Disclosure cannot overcome this deficit. Consider the "best interests" debate, where a product is "suitable" for a client, but rewards the Salesperson more than a better (for the client) product available. Salespeople will usually sell the inferior product if incentives reward this.

Exempt products

There is no policy-based fairness principle to exclude exempt products from the Reform Proposal, whether they be structured notes or insurance products (segregated funds). Regulatory arbitrage is a bane of the present system. Our office has seen many cases in which insurances licensees sell exempt products with high compensation to them that are easily replicated at far lower cost by non-exempt investment funds. This arbitrage opportunity rewards conflicted sales recommendations.

Integrated Salespeople

The Reform Proposal observes that integrated dealers make up more than 80% of the investment fund market for retail investors.[5] This is more significant for more vulnerable investors (mass-market and mid-market), who rely on their bank branches to recommend proprietary products from a very restricted shelf. The Reform Proposal must capture internal transfer payments or the integrated dealers will circumvent the Reform Proposal, at risk to the most vulnerable clients. The recent furore raised by the CBC's investigation into bank practices,

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[4] In the "Impact" analysis at pages 62 *et seq.*

[5] At page 30 *et seq.*, Tables 5-8

highlights the urgency felt by the public.[6] This must be a broadly based ban to avoid workarounds in Salesperson distribution and compensation models.

Payment options – automatic pay

Any limited permission for payment by the investor from assets held with the Salespeople, requires considerable study. Notionally, this facilitates the investor paying for advice. In reality, there is great risk of this being a backdoor equivalent of conflicted compensation. Many investors, especially in mass-market and mid-market households, lack the financial experience to read and appreciate their periodic statements. They routinely sign forms presented by trusted advisers without reading them – as do we all.

While this mechanism may have merit, the CSA should consider carefully how to permit this option without risking the very harm that the Reform Proposal targets. The Reform Proposal discusses "reverse churning", where a "buy and hold" investor is charged a percentage fee.[7] With automatic pay, there is no bill to pay, no "aha" moment in which the client asks whether the advice is worth the cost and then comparison shops.

Payment options - direct pay

The Reform Proposal also refers to the "direct pay model" where the client writes a cheque for the advice. The industry argues that this raises a major risk. They contend that retail clients who do not pay for advice will not get advice, to their detriment. Direct pay raises the risk that clients will not value the advice as much as its cost. Automatic pay raises the risk that clients will not appreciate that they are paying for the advice, as is often the case with investment fund trailer fees. Which is better? Full, mandatory disclosure or the risk of no disclosure? CRM2 answered this question. Direct pay merely reinforces the CRM2 policy.

There is some evidence that the only benefit to investors of working with a Salesperson is the encouragement to save for retirement. This evidence focuses on the value of planning advice as opposed to product sales. In fact, few investors who invest with self-described financial planners receive financial planning. Most of those who do receive any financial planning, receive template plans which are better described as sales pitches.

Financial planning vs. Product sales

In the conflicted compensation model, the value of advice is disconnected from the sale of a product. The two most important components of financial planning are: pay down debt, and save money. Neither is part of a product sales strategy. Indeed, conflicted compensation encourages asset-gathering strategies through deferral of debt repayment, leverage loans/margin investing and commutation of pensions. These are the antithesis of financial planning, yet are strategies commonly promoted by self-described financial planners. Financial planning and the sale of products can be irreconcilable objectives.

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[6] http://www.cbc.ca/news/business/bank-s-deceptive-titles-put-investments-at-risk-1.4044702

[7] At page 65, and footnote 127.

The Reform Proposal should encourage Salespeople to offer and provide conflict-free, financial planning in the best interest of their clients. Direct pay supports this.

The advice gap

The Reform Proposal defines the "advice gap" as being "investors who cannot obtain the amount of advice they desire at the price they are willing to pay", an access to service issue.[8] We agree that this is an issue, but we submit that there is a far greater issue facing retail investors in all the markets identified by the CSA, from mass-market to affluent. This is the mismatch between what clients think they are buying (financial planning) and what they receive (sales promotion).

The Reform Proposal should alleviate the real advice gap.

1. The advice gap is not, as salespeople claim, related to the lack of advisors, but the lack of proficiency among advisors. Investors suffer when conflicted advisors provide conflicted planning advice which is, at its heart, sales recommendations.

2. As the UK experience has shown, many non-proficient and conflicted advisors will not continue to offer services when a fair playing field is offered to the investor. This is a positive outcome that narrows the advice gap. The advice gap is inherent in a product sales compensation model. Planning advice is the key to successful investor outcomes, not product sales.

3. Incenting the advisory relationship and de-incenting the sales relationship will directly lessen the advice gap. Consider that advisors usually promote return on investment as the key metric. Clients want to accumulate savings. Returns are only one component of a successful client experience. Returns should not be earned at risk to the client's outcome, unless there is full disclosure in plain language without bias.

4. The value of advice will become clearer when the full cost of advice is transparent. This is a major problem with CRM2 which requires opaque disclosure of the payments to the advisor without clear disclosure of the other conflicted compensation. Thus, this failure of CRM2 will be addressed with the removal of conflicted compensation.

As noted in the conflicted compensation, Salespeople and manufacturers of lesser quality products have little incentive to act in the best interest of investors. Disclosure of compensation removes this anti-market efficiency behaviour.

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[8] Page 62 *et seq.*

Predicting the impact of the Reform Proposal

The Reform Proposal makes predictions.[9] These appear to be reasonable. A freer market should respond with new and improved models. Disruption will occur and creative models will emerge. A great hope in this regard is Canadian versions of Fintech. Regardless of fear mongering, the industry will prosper.

The removal of conflicted compensation is good for compensation of professional financial planners. Instead of a front-end payment for sale, clients should pay for planning and advice as services are rendered. Thus, good client behaviour (spend less, save more, pay debt) will replace poor client behaviour (maintain and even increase debt and purchasing high fee products) driven by variable, disproportionately upfront sales compensation. This different model aligns the work of good advisors with their compensation.

Further, the best outcome for clients is the professionalization of Salespeople. Proficiency and professionalism should replace sales. This is good for those advisors who provide advice of good and excellent quality. It will push out those that are merely interested in sales (churning), and support those who put the best interests of clients first.

Conclusion

The Reform Proposals are a necessary and important step towards aligning the interest of Salespeople with that of their investor clients. This alignment will address the present advice gap. This alignment will remove incentives that harm both investors and market efficiency. The CSA proposal is timely and necessary.

Yours very truly,

Harold Geller

[9] At page 62 *et seq.*