The Pros and Cons of Discontinuing Embedded Commissions by Regulatory Fiat

Comments submitted to the
Canadian Securities Administrators

by

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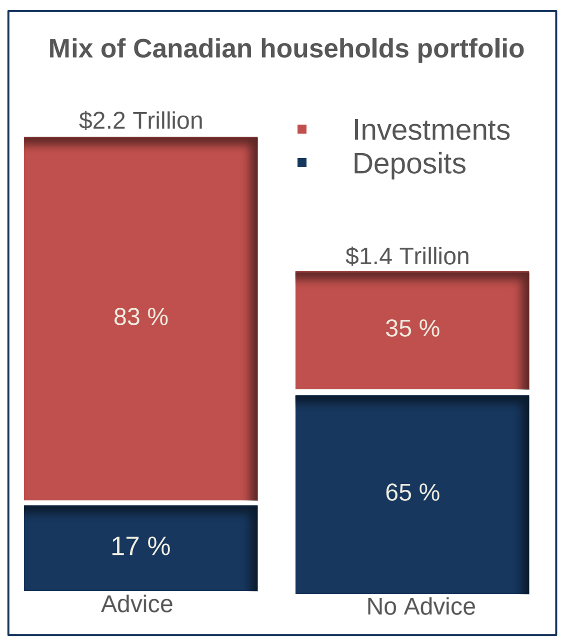
The CSA published Consultation Paper 81-408 - *Consultation on the option of Discontinuing Embedded Commissions* in January 2017 (the "Paper"). One of the main virtues of the Paper is the detailed information it contains on the structure of the Canadian fund market and the characteristics of its participants. Our concern is that the policy prescription advocated in the Paper is framed by how the CSA defined the issue of moral hazards inherent in the financial advisor-retail client relationship it seeks to address without much consideration for the critical issue of wealth accumulation, the dominant motivation for households to invest in financial products.

The fundamental role of the financial intermediation function is to facilitate savings and promote sound financial asset management. It follows that the litmus test for retail finance regulations is whether a policy favors and facilitates wealth accumulation by Canadian households. We believe that had this basic tenet been placed at the center of the analysis, the conclusions and the policy prescription would have been quite different from those advocated.

The Paper reports that 63 percent of households do not own investment funds. That some of "these households will typically hold more conservative financial products instead, such as cash, GICs, etc." (p. 28) is a fact. Given the structural modifications in the design of public and private pension programs that have shifted investment performance, inflation, longevity and markets risks onto the cohorts of future retirees, this "reckless" investment conservatism should not be characterized as cautious behavior, but considered the result of a huge "advice gap" that entails considerable socio-economic consequences.



The traditional view is that the dispersion in wealth accumulated at retirement is driven mainly by savings decisions when young.[1] Recent studies emphasize the fact that the allocation of savings between riskless and risky assets, and the choice of risky assets drives returns on individual portfolios. Sound investment practices are thus a powerful force increasing wealth inequality.[2] We also know that households with lower financial capability need to trust their financial adviser in order to invest in risky assets. This reflects in part the fact that a large proportion of households define risk in terms of a loss of capital, not with the range of metrics for measuring investment risk used by academics and the financial industry.

[1] Steven F. Venti and David A. Wise, 2001, *Choice, Chance, and Wealth Dispersion at Retirement*, Chapter 1 in Seritsu Ogara, Toshiaki Tachibanaki and David A. Wise eds., *Aging Issues in the United States and Japan*, NBER, University of Chicago Press.

[2] Thomas Piketty, 2014, *Capital in the Twenty-First Century*, Harvard University Press.

The Paper does not explain how banning embedded commissions will assist in shrinking this "advice gap" and encourage Canadian households to operationalize the "prudent investor rule" which posits that an investor should undertake to maximize return and minimize risk, matching the risk and expected return of their overall investment portfolio to their particular circumstances.

Observing that "only 22 percent of mass-market households held investment funds" (p.28), the potentially negative impact on this market segment of a regulation disallowing embedded commission is dismissed on the grounds that mass-market households will gravitate towards vertically integrated deposit-taking institutions and insurance firms. The Paper expresses no misgivings with such a regulatory-induced restructuring despite the conclusion of the CSA's own commissioned research to the effect that "affiliated dealer flows showed no flow-performance sensitivity at all which was found to be relatively more detrimental to investors relative to all trailing commission paying purchase options for non-affiliated dealer flows."[3] We will return to this issue.

We agree with the Paper that, in line with the changes observed in other markets, Canadian financial intermediaries are gradually shifting their business model towards a fee based on the value of assets under management ("AUM"). This trend is driven by the strategic intent of broker-dealer firms and other fund distributors to dampen the volatility of revenues arising from a business model based on transaction-related commissions. As the value of assets under management is much more stable, broker-dealers and financial advisors compensation tied to the value of AUMs well serves corporate purposes: stability of revenues, an incentive to grow the AUM and, incidentally, to encourage retail clients to keep up their savings habit. The practical consequence of this change of the business model is that, as the Paper reports for Canada, investors who desire advisory services but who wish to pay for them directly rather than through embedded commissions have limited options because direct pay arrangements for access to professional financial advice are typically available only through dealers servicing higher net worth investors (p. 13), notably IIROC dealers that "typically aim to service households with investable assets of $500,000 or more" (p. 37). The disallowing of embedded commissions will invariably accelerate and accentuate the adoption of the AUM fee-base model with the ensuing consequences concerning access to professional financial advice.

As long as the transition in the financial advice business model is the result of market forces, one would expect the structure of the industry to evolve towards another competitive equilibrium. Regulation should encourage choice. Canadian investors should have access to a wide range of competing products and financial intermediaries, regardless of whether advice is delivered using commission or fee-based advice models.

■ A PRELIMINARY QUESTION

The Paper identifies many areas where the Canadian retail market for funds should and can be improved. It does not, for reasons set out below, make a solid case for disallowing embedded commissions by regulatory fiat. Nor does it address a preliminary question: does the Autorité

[3] Douglas Cummin, Sofia Johan and Yelin Zhang, *Frequently Asked Questions about the Dissection of Mutual Fund Fees, Flows and Performance Report*, CSA, 2016.

des marchés financiers ("AMF") have the right to prohibit an industry practice common around the world in the face of strong evidence that households investing with the guidance of a financial advisor, the majority under the prevailing pricing regime, accumulate substantially larger financial wealth than those who do not?

The AMF's mission includes the supervision of the activities related to the distribution of financial products and services.[4] The meaning of "supervision" is to oversee, superintend, keep under surveillance, monitor. It is a dubious proposition to suggest that the phrase covers the imposition of a business model for the distribution of financial products and the outright ban of a practice that has long been accepted and has been proven to be effective in facilitating access to financial advice.

The standard of judicial review that concerns parliamentary delegations of legislative authority to administrative agencies addresses whether an agency action is "in excess of statutory jurisdiction, authority, or limitations, or short of statutory rights". Courts have held that an administrative agency's power to regulate in the public interest must always be grounded in a valid grant of authority from the legislator and that the ambit of the rule must not be in excess of statutory jurisdiction, authority, or limitation, or short of statutory right.[5]

In this regard, it is worth noting that with respect to the churning of accounts, Article 193 of the Québec Securities Act specifically provides that "no dealer or adviser may multiply transactions for the account of a client solely to increase his remuneration". As far as embedded commissions are concerned, Québec securities legislation is silent.[6] In contrast, in Europe, the MiFID II Directive which imposes limits to the use of commissions and stricter requirements for product distribution and design and mandates improved disclosure of costs and charges in the financial retail markets was adopted by the European Parliament on 15 April 2015[7].

Hence, the preliminary question: can the AMF impose a ban on embedded commissions in the absence of an explicit mandate from the Québec National Assembly?[8]

■ THE PRINCIPAL-AGENT CONUNDRUM

The central thesis of the Paper is that financial advisers are in a situation of conflict of interest vis-à-vis their clients, a position exacerbated by embedded commissions. Therefore, by prohibiting embedded commissions to broker-dealers, the problem is solved.

There is no denying that because financial advisers generally perform the dual function of advising clients and selling financial products, it exposes financial consumers to both adverse selection and moral hazards. Although the commingling of the advice and sale roles is typical of technically complex product markets, academics and policy-makers in Canada and abroad have, as the Paper does, questioned the appropriateness of arrangements where the remuneration of financial intermediaries distributing financial products and providing advice is

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4 Act respecting the Autorité des marchés financiers, art. 4.

5 "It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress." Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988).

6 Act respecting the Autorité des marchés financiers and the Québec Securities Act.

7 The Directive is set to come into effect for all investment firms on 3 January 2018, four years after its adoption.

8 This preliminary question applies to all other securities commissions in Canada.

embedded in the price of the financial products and dependent on commissions and other contingent fees from the manufacturers of financial products rather than being paid directly by their customers. It remains that the wisdom of an unbundling policy is not a forgone conclusion. There exists little empirical evidence to support the assertion that fee-based pricing favor behavior more responsive to client interest. Weinstein, in a study commissioned by the CSA, concludes from his review of the literature that "it is not yet clear whether moving from commission-based to asset-based compensation will result in a net improvement in the overall return to the investor."[9] Very little is known "about individual responsiveness of financial advice outside an environment with moral hazard"[10] and what is known about advice taking and receiving does not favour the superiority of the neutral advice hypothesis.[11]

The findings of several academic studies suggest that when evidence does exist that the financial advice given as a matter of course was not optimal, concerns about the role of commission-based arrangements were not as problematic as those set out in the Paper. An analysis of a sample of 12,000 individual investment accounts for a 34-month period at a large retail German bank leads to the conclusion that the "empirical evidence is broadly in line with honest financial advice."[12]

One important factor overlooked in the Paper is that financial advisers want to sustain their business over time; the repeated-game nature of the relationship provides an incentive to offer accurate advice to their clients or, at the very least, not to knowingly provide biased information.[13] Within financial institutions and professional organizations, conflicts of interest infrequently materialize in corrupt actions – the domain of enforcement; rather, biased advice is generally the result of unintentional and unconscious motivations.[14] The results of three comprehensive studies support these critical points and suggest a fundamentally different diagnosis of the underlying dynamics between financial advisers and their clients than the one centered on conflicted behavior advanced in the Paper.

- Using a unique set of data on Canadian financial advisers and their clients, a study shows that most advisers invest their personal portfolios just like they advise their clients, in line with their beliefs about their investment choices and own practices. Only a small fraction of advisers exhibited a conflicted behavior. The authors conclude that their "estimates suggest that correcting advisers' misguided beliefs, through screening or education, may reduce the cost of advice more than policies aimed at eliminating conflicts of interest."[15]

- A rigorous examination of the investment portfolios of Canadian households at three large Canadian financial institutions found that the composition of the advisers' portfolio

[9] Edwin Weinstein, *Mutual Fund Fee Research*, The Brondesbury Group, 2015.
[10] Angela A. Hung and Joanne K. Yoong, *Asking for Help, Survey and Experimental Evidence on Financial Advice and Behaviour Change*, WR-714-1 (RAND Corporation, 2010), 5.
[11] Upta Bhattacharya et al., *Is Unbiased Financial Advice To Retail Investors Sufficient? Answers from a Large Fiels Study*, Review of Financial Studies (2012).
[12] Ralph Bluethgen et al., *Financial Advice and Individual Investors' Portfolios*, Abstract, March 2008.
[13] Luis Garicano and Tano Santos, *Referrals*, American Economic Review 94, 3 (2004); 499-525; Patrick Bolton, Xavier Freixas and Joel Shapiro, *Conflicts of Interest, Information, Provision, and Competition in the Financial Services Industry*, Journal of Financial Economics (February 2006).
[14] Don A. Moore and George Loewenstein, *Self-Interest, Automaticity, and the Psychology of Conflict of Interest*, Social Justice Research 17 (2004): 189-202.
[15] Juhani T. Linnainmaa, Brian T. Melzer, Alessandro Previtero, *Costly Financial Advice: Conflicts of Interest or Misguided Beliefs?*, December 2015.

“is far and away the strongest predictor of the risk taken in their client’s portfolios even after controlling for adviser and client characteristics."[16]

– A study of 401k plans in the United States reaches a similar conclusion: the composition of client 401k plans was similar to their financial adviser’s plan.[17]

These findings indicate that most advisers give the advice they give not because they are influenced by conflicts of interest, but rather because they personally believe that their recommendations will outperform alternatives. Regulations attempting to "sterilize" the relationship by imposing a ban on embedded commission are more likely to prove ineffective because such a policy does not address the primary factor which is the financial advisers’ beliefs about the value of the financial products they recommend … and acquire for their own portfolio. Thus, not only would such a policy miss the mark, its implementation would create a lot of collateral damage by hampering easy access to professional financial advice by a broad segment of financial consumers, a matter we address below.

The results of the studies mentioned above are consistent with those examining the influence of financial advice on wealth accumulation, which is not the case for those based on transactions and benchmark comparisons that form much of the substrate underlying the Paper’s conclusions.[18] The Paper gives short shrift to the results of empirical studies that examine the impact of professional financial advice on the accumulation of financial wealth by households. This omission is regrettable because the findings are critical, particularly those that describe and measure the impact of financial advice over time on a wide range of financial households. This empirical evidence deserves to be emphasized since it makes no sense that it not inform public policies:

– In the United States, using the 2004 and the 2008 waves of the U.S. National Longitudinal Survey of Youth shows that financial advice has a strong positive impact on net worth and retirement savings (controlling for income earned in prior 14 years).[19]

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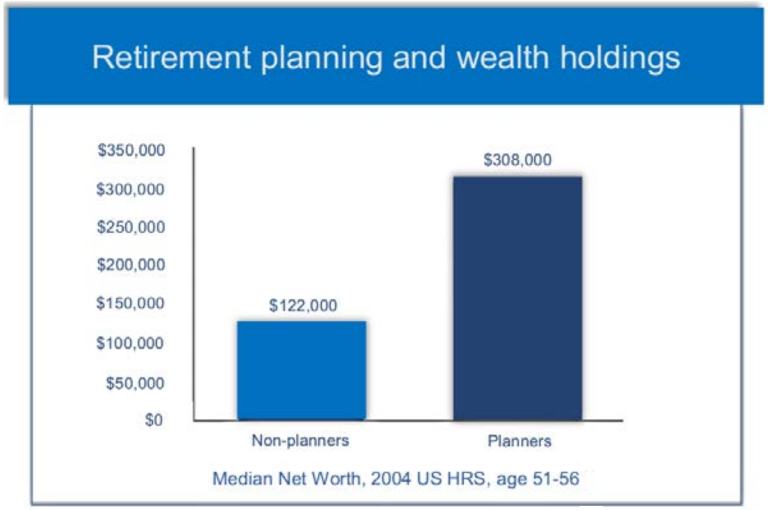
16 S. Foerster, J.T. Linnainmaa, B.T. Melzer, A. Previtero, *Retail financial advice: Does one size fit all?*, Journal of Finance. Forthcoming. 2015.

17 T. Dvorak, *Do 401k plan advisors take their own advice?*, Journal of Pension Economics and Finance 14 (1), 55-75, 2015.

18 Care must be taken when comparing actual mutual fund performance to an index. Even if mutual funds did not charge expenses, their performance would still likely be different from the return on an index for a number of reasons. First, by purchasing and selling securities, they incur a transaction cost that reduces their return below that of an index. Second, funds need cash management policies to handle inflows and outflows from investors and policies regarding the timing of the reinvestment of dividends. Funds can choose their policies, while index returns are calculated based on a mechanical rule for reinvesting dividends and assuming no inflows or outflows. Third, funds can choose how they handle sales and purchases caused by changes in the companies contained in the benchmark index. Again, these changes are handled mechanically when calculating a return on an index. Fourth, funds need to have policies on how to handle tender offers and mergers while these are handled mechanically in index construction. Finally, funds can lend securities and earn a return on the securities that are lent; the index return cannot do so.

19 Terrance Martin and Michael Finke, *A Comparison of Retirement Strategies and Financial Planner Value*, Journal of Financial Planning 27, 11 (2014): 46-53.

- In another U.S.A. study, it was shown that households that used a financial adviser where five times more likely to have calculated their retirement needs, a key factor associated with much improved wealth holdings; and that those who knew their retirement needs saved significantly more than households without a plan and "generated more than 50 percent greater savings than those who estimated retirement needs on their own without the help of a planner."[20]



- In Canada, the results of a rigorous econometric study show that, on average, individual investors assisted by a financial adviser accumulated significantly more financial assets than did non-advised respondents with comparable age, income levels and other socio-economic characteristics. This benefit of financial advice grows with the length of time households have received advice: after four to six years, the advised households have accumulated 1.58 times the amount accumulated by non-advised households; after 15 years, the difference has increased to 3.9 times.[21]

- The converse also yields a major lesson. Looking at households that discontinued the use of a financial advice between 2010 and 2014, another study finds that they accumulated 45 percent less asset value than was the case for those who retained a financial adviser. Obviously, their decision to "go alone" proved costly.[22]

- The findings concerning the contribution of financial advisers to wealth accumulation by Canadian investors are congruent with those obtained in The Netherlands. Using the longitudinal data of about 16,000 Dutch individual investors over a 52-month period, the author found that the characteristics and portfolios of advised and self-directed investors differ remarkably: advisers add value through better diversification, lower idiosyncratic risk and reduced trading activity. The findings that financial advisers add positive value to portfolios are confirmed by the results of investors that switched from execution-only to advice.[23]

By providing insight into the underlying dynamics of the adviser-financial consumer relationship, the results of these studies suggest that strong countervailing factors, including the repeated-game nature of financial advisory services, are present to maintain the relationship fair and honest. These results also raise questions about the validity of the assertion often make in the

20 John Ameriks, Andrew Caplin and John Leahy, *Wealth Accumulation and the Propensity to Plan,* Quarterly Journal of Economics (2003): 1008-1009; and Annamaria Lusardi, *Explaining Why so Many Households Do not Save,* mimeo (University of Chicago, 2000).

21 Claude Montmarquette and Nathalie Viennot-Briot, *The Gamma Factor and the Value of Financial Advice,* CIRANO, August 2016.

22 Claude Montmarquette and Nathalie Viennot-Briot, op.cit., 2016.

23 Marc M. Kramer, *Financial Advice and Individual Investor Portfolio Performance*, Financial Management, 2020, 41-2: 395-428.

Paper that the Canadian market for financial advice is not efficient or that it would be made more efficient by a ban on embedded commissions by regulatory fiat.

■ TRUST: A KEY DETERMINANT OF THE DEMAND OF FINANCIAL ADVICE

The value of financial advice and its considerable effect on wealth accumulation by households who avail themselves of the service cannot be explained by asset performance alone. It stems from its ability to counterbalance human idiosyncrasie by instilling and encouraging more disciplined savings and investment behavior and better balanced and diversified portfolios. Examination of investment behavior in eight industrial countries reveals that wealthier households who generally work with a financial adviser "take more risks and earn higher average returns both through risk taking and through the form in which risk is taken."[24] Moreover, a large body of evidence shows that the capacity to plan for retirement is closely tied to working with an adviser.[25]

To be successful in influencing savings and investment practices, financial advisory services must take the form of a relational exchange imbued with a high degree of contextual understanding, not the transaction form implicit in the Paper. Compared to transactional exchanges, relational exchanges have a longer duration, a higher degree of contextual understanding and a stronger complement of trust, loyalty and cooperation. Results from the 2016 Natixis Global Survey of Individual Investors bear this out: investors want a strong and personalized relationship with their financial adviser – one that helps them "see beyond daily market noise, helps them refine personal goals, and helps them become stronger, more confident investors. What they want most is help with making more informed investment decisions."[26]

Several studies conclude that trust is a key determinant of the propensity to seek professional advice and plays an essential role in client-adviser relationships and financial decision-making. Surveys consistently find that retail investors cite "trust" as the most important determinant in seeking a financial adviser. Comparisons of the attitudes of individual investors who have or do not have a financial adviser show that:

i. the trust towards financial advisers is about 30 percent more likely for advised investors than a similar non-advised respondents;
ii. about 70.8 percent of advised investors have high confidence towards their financial adviser versus 31.2 percent for non-advised respondents with regard to financial advisers;
iii. the confidence of an advised investor that he or she will have enough money to retire comfortably is significantly higher than for non-advised investors, which is consistent with consumer survey findings that a large majority of investors (82 percent) credit their financial adviser with helping them achieve savings and sound investment habits.

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24 John Y. Campbell, *Restoring Rational Choice: The Challenge of Consumer Finance*, Fourth Conference on Household Finance and Consumption, European Central Bank, December 2015. The study examined the situation in Canada, France, Germany, Italy, Netherlands, Spain, the USA and the UK.

25 Mitchell Marsden, Cathleen D. Zick, Robert N. Mayer, *The Value of Seeking Financial Advice*, Journal of Family and Economic Issues 32, 4 (2001): 625-643.

26 Natixis, *2016 Global Survey of Individual Investors*.

The Paper is dismissive of the proposition that trust acts as a behavioral constraining mechanism in a principal-agent relationship and of the role of disclosure, the most commonly prescribed remedy to mitigate the risks stemming from "conflicted" situations arguing that in certain circumstances, this "solution" may have perverse effects (p. 80). It cites research that suggest that people generally do not discount advice from biased advisers as much as they should, even when advisers' conflicts of interest are disclosed, and that disclosure may increase the bias in advice because – caveat emptor – it provides the advisers with the moral licence to engage in self-interested behaviour, thereby exacerbating biases.[27] However, the Paper fails to mention subsequent studies published in the same academic journal showing that other institutional factors, including sanctions, can effectively mitigate these effects of disclosure![28] In this regard, the Paper also fails to consider the role and influence of Canadian securities legislation and case law that impose a statutory duty on retail client advisers to deal fairly, honestly and in good faith with their clients. These statutory obligations impose on financial advisers and registered firms a duty of care, which is comprised of "know your product" and "know your client" obligations, along with fair and reasonable compensation. The duty of loyalty encompasses the disclosure of the terms and conditions of the relationship and material conflicts of interest and their resolution in a manner consistent with the interest of the customer. These obligations are detailed in securities regulations and the self-regulatory organizations' requirements, including the extension of the duty of loyalty to the client beyond the initial purchase, sale or recommendation of any security that is unique to Canada.[29]

The implicit message one draws from the Paper is that the trust individual investors place in their financial adviser needs to be considered with caution because it is likely that individual investors "do not know better", a classic case of cognitive dissonance. A recent survey of U.S. financial consumers designed to identify the factors that lead to paying for professional financial advice and the type of services purchased showed that financial consumers who pay for comprehensive financial advice are predominantly middle-aged, college educated, financially knowledgeable and wealthy.[30] The Paper reports similar results for Canada: the great majority of investment fund owning mid-market (66 percent) and affluent households (72 percent) used an adviser (p. 29). These facts are inconsistent with the argument that the level of trust observed through the surveys arises because financial consumers are naturally trusting and credulous toward their financial adviser. Moreover, there are indications that advised investors do terminate a financial advisory relationship when they feel a disconnect with their adviser and the advice they receive. Surveys of financial consumers who have terminated an advisory relationship cite investment performance as the primary factor (41 percent), followed closely by two more telling factors: (i) failing to understand their savings and investment goals (32 percent) and (ii) investment views that differ from their adviser's (30 percent).[31]

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[27] Daylian M. Cain, George Loewenstein and Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interests*, The Journal of Legal Studies 34, 1 (January 2005): 1-25.

[28] Bryan K. Church and Xi (Jason) Kuang, *Conflicts of Interest, Disclosure, and (Costly) Sanctions: Experimental Evidence,* The Journal of Legal Studies 38, 2 (June 2009).

[29] The Investment Industry Regulatory Organization of Canada (IIROC) Rule 42.2 provides explicitly that: "The Approved Person must address all existing or potential material conflicts of interest between the Approved Person and the client in a fair, equitable and transparent manner, and consistent with the best interests of the client or clients." The Mutual Fund Dealers Association of Canada (MFDA) Rule 2.1.4 is to the same effect.

[30] Finke, Huston, and Winchester, *Financial Advice*; Jason West, *Financial adviser participation rate and low net worth investors*, Journal of Financial Services Marketing (2012).

[31] Natixis, 2016 Global Survey of Individual Investors.

The high levels of confidence, satisfaction and trust expressed by "advised" investors are the relevant indicators of the value they ascribe to their relationship with a financial adviser. The role of trust in reducing the incidence of self-serving behaviours and, as demonstrated by recent research, that it acts as mediating factor in the relation, need to be explicitly recognized.[32] This also makes it imperative that constant care be taken to ensure that investors' trust in a competent and professional financial advice industry is not misplaced. It remains that the effectiveness of policies designed to "maintain standards of professionalism that inspire consumer confidence and build trust" does not depend on the disallowance of embedded commissions.

■ THE MOST LIKELY IMPACT OF A REGULATORY BAN ON EMBEDDED COMMISSIONS

The success of Canadian households in accumulating substantially more wealth despite the costs associated with the management of individual accounts with the assistance of a financial adviser is critical to the effectiveness of voluntary retirement savings programs and the long-term performance and resilience of the Canadian retirement income system. Given the empirical evidence that individual investors relying on the support of financial advisers are, on average, more successful than non-advised investors in accumulating and managing their financial assets, and that the socio-economic benefits stemming from broad access to formal advice sources are considerable, a key question arises: Under what conditions are the supply of and demand for regulated financial advice most likely to be socially optimal?

■ THE PECULIAR ECONOMIC NATURE OF FINANCIAL ADVICE

Investment advisory services differ from consumer goods and services because they are abstract and there exists an asymmetric information discrepancy between the buyer and the seller, who is deemed to be a subject matter expert, whereas consumers are unable to evaluate confidently, even after repeated purchases, the quality and the reasonableness of the cost of the professional services they obtain. Are good financial returns the result of luck or of investment savvy? How confident can an investor be in the explanation that inactivity was the best strategy since he cannot distinguish "actively doing nothing" from "failing to do something"? The uncertainty is about the value and the quality of the services. In economic terms, financial advice falls within the category of "credence goods." This characteristic is precisely the crux of the matter: the information costs to evaluate "credence goods" are always significantly higher than for search ("normal") goods, often unbearably high.

The "credence good" nature of financial advice has significant consequences for consumer behaviour and, consequently, on the suppliers, the financial intermediary firms and the financial advisers in their employ. Individuals with higher education and income, financially sophisticated and with larger amounts of financial assets, exhibit a much greater demand for advice from financial intermediaries — a rational outcome given that, as a rule, they tend to be more financially literate and sophisticated and for them, the opportunity cost of abstinence is much higher — whereas individuals who are non-financially literate and non-affluent are reluctant to

[32] This attribute is observed in Canada, the United States and in recent European studies. See for instance, *Understanding the relationship between bank-customer relations, financial advisory services and saving behavior*, Cecilia Hermansson, Centre for Banking and Finance, KTH Royal Institute of Technology, Stockholm, 2015; Carlander, A. and Johansson, L.O., *Trust as a strategy to cope with uncertainty in delegated portfolio management*, MINEO; Jim Engle-Warwick, Diego Pulido, Marine de Montaignac, *Trust Ambiguity and Financial Decision-Making*, CIRANO, August 2016.

seek financial advice.[33] Their attitude reflects the fact that non-affluent households tend to equate financial advice with financial risk, which they avoid because they fear it. They will resist paying upfront fees for financial advice because they do not understand what working with a financial adviser entails and they are unable to discern the benefits, which are abstract, delayed in time and with an uncertain outcome. Viewed from their perspective, paying upfront for financial advice is equivalent to "locking in" a sure loss since they just can't fathom the benefits. This loss aversion is compounded by the fact that financial planning involves a long-term time frame. Even though it is generally accurate, the warning "past performance does not guarantee future results" that accompanies mutual funds and similar financial products can hardly be considered an unabashed encouragement to incur the upfront cost. Consumer surveys confirm these observations.

A survey of Australian retail investors found that a substantial proportion were not prepared to pay for advice more than 10 per cent of the annual cost of providing the service and, if this was not possible, they would forgo the advice. The Australian Securities and Investments Commission (ASIC) reports that "a common attitude was that financial advice was too expensive when there were no guaranteed returns."[34] In the United Kingdom, studies seeking to understand financial consumers' decision-making behaviour conclude that they are most reluctant to pay upfront for advice.[35] Delmas-Marsalet had obtained similar results in France.[36] A study involving retail investors from eight European countries found that between 26 to 30 per cent of respondents were unwilling to pay upfront for advice.[37] In Canada, even though 94 per cent of Canadian mutual fund investors agreed that they trust their advisers to give them sound advice and 90 per cent agreed that they obtain better returns than they would if investing on their own,[38] only 16 per cent indicated that they would continue their relationship with their financial adviser if a shift to a fee-for-advice regime resulted in an upfront cost to them. The observed idiosyncrasies of individual investors are remarkably similar between countries, which suggest that they reflect innate human proclivities.

The fundamental issue is not that individual investors do not value financial advice; rather, it is the reluctance of a large segment of the retail market to pay for it upfront that needs to be addressed. In so doing, financial consumers may be much more rational than what they are given credit for: the quality of the information provided is shown to be enhanced when the compensation is contingent over time rather than paid concurrently with the transaction.[39] The bundling of mutual funds with financial advice through embedded and trailing fees addresses this consumer reaction by establishing proportionality between the price of advice and the duration of the service.

■ INVESTORS REVEALED PREFERENCES AND NEEDS

In his 1996 American Finance Association Presidential address, Martin Gruber sought to resolve the puzzle as to why "actively managed mutual funds have grown so fast, when their

33 Finke, Huston, and Winchester, "Financial Advice."
34 ASIC, "Access to financial advice in Australia" (2010), 49.
35 James F. Devlin and Sally McKechnie, "Consumers and Financial Advice in the UK: A Research Agenda," Financial Services Research Forum, June 2006; Andrew Clare, "The Guidance Gap" (Cass Business School, January 2013).
36 J. Delmas-Marsalet, "Report on the Marketing of Financial Products for the French Government" (2005).
37 Chater, Huck and Inderst, "Consumer Decision-Making."
38 Pollara, "Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry," The Investment Funds Institute of Canada (2013), 5.
39 Joel S. Demski and David E.M. Sappington, "Delegated Expertise," *Journal of Accounting Research* 25, 1 (1987): 68-89.

performance on average has been inferior to that of index funds."[40] His conclusions based on the empirical evidence he assembled were that "investors in actively managed mutual funds may have been more rational than we have assumed." This "puzzle" has since been examined through many lenses with head-scratching conclusions.

The puzzle remains mysterious until it is accepted that although all investors value higher net portfolio returns, a large proportion seek both financial advice and portfolio returns and that they are willing, within reasonable limits, to trade-off after-fee returns and financial advice and services to achieve their overall objectives. The heterogeneity of investors' behaviour is manifest.[41] In 2012 in Canada, 66 percent of investment fund owning mid-market households and 72 percent of affluent households used an adviser (p. 29). In the United States, 82 percent of U.S. households owning mutual funds have a financial adviser; in Germany, roughly 80 percent of individual investors rely on financial advice for investment decisions. In addition to the revealed preference of investors in Canada and abroad to invest in mutual funds through advice channels, there exists ample anecdotal evidence to support the point. This is a global phenomenon which warrants respect.

In retail markets, search costs can be onerous, if not in monetary terms at least in time spent for the task. In investment matters, the magnitude of search costs is blown-up since investors are confronted with a huge universe of investment options that extends beyond the capabilities of any one financial analyst, let alone an individual investor. The large proportion of mid-market and affluent financial consumers that retain a financial adviser makes it clear that they attach value to the information search and consolidation provided by financial advisers and to the emotional benefits stemming from the satisfaction and security of having and following a savings and wealth accumulation plan and the mitigation of psychic costs, such as anxiety over investment performance or retirement preparedness. Although it is difficult to quantify the monetary value of the intangible benefits of financial advice, they are nevertheless of paramount personal and societal importance. Surveys in Canada and the United States consistently show that more than 70 percent of adults "stressed about money at least some of the time" and half of them acknowledge that their concerns for their financial situation distracts them at work, resulting in disengagement, a higher rate of absenteeism and a lack of productivity.[42]

Other studies indicate that having a financial adviser increases the probability of a respondent declaring confidence in achieving a comfortable retirement by more than 13 percent relative to non-advised respondents.[43] Employee surveys report similar results: those who engage with a financial adviser have a significantly higher overall sense of financial well-being and are more likely to experience positive emotions about their finances.[44] These results strongly suggest that financial advice yields significant benefits not only for the advised households but for society as a whole.

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[40] Martin Gruber, *Another Puzzle : The Growth in Actively Managed Mutual Funds*, Journal of Finance, Vol. 51 (3), pp. 783-810.
[41] This is well demonstrated by the data presented in Part 4 of the Paper.
[42] *Stress in America*, American Psychological Association Survey, 2015.
[43] *Employee Financial Wellness and its Impact on Canadian Business*, Manulife, March 2016.
[44] *Financial Security : Mind the Gap*, Mercer, 2017.

Individual emotional state vis-à-vis one's financial situation		
	Advice	No Advice
Informed	64%	39%
Relieved	52%	30%
Calm	60%	35%
Confident	61%	37%
Optimistic	63%	41%

Source: *TIAA 2016 Advice Matters Survey*, September 2016

THE IMPACT ON THE SUPPLY SIDE

The Paper suggest that competition in the "manufacturing" and "distribution" sectors of the Canadian fund industry is tame, unable to force the exit of sub-performance funds and exert effective pressure on price levels and practices.

The facts are that concentration and barriers to entry in the mutual fund industry have, to this date, being lower than in other sectors of the Canadian financial industry: investors can acquire mutual funds through several channels which are in robust competition, pricing within the industry is dispersed, market shares evolve over time, a strong indication that enough investors are sensitive to comparative returns net of fees to impact market positions. At the end of 2015, the financial planner/adviser channel "which had possessed the largest share of investment fund assets ten years ago, was still the second most important distribution channel at the end of 2015" (p. 33). This channel is comprised of the majority of independent mutual fund dealers and the one with the lowest participation of deposit-taker/insurer firms.

The Paper reports that in 2015, 78 percent of investment fund and fund wrap assets were held in deposit taker/insurance owned channels, a market share increase of 9 percent since 2005. Interestingly, the Paper does not appear to assign any influence to this high level of concentration, notably in the banking sector, on the pricing and remuneration practices in the fund industry it laments, choosing rather to blame embedded commissions as the main culprit. The Paper errs in its analysis; a ban on embedded commissions is most likely to compound the inefficiencies in the fund market and increase the cost of professional financial advice to retail consumers.

Another major development in the competitive landscape has been the introduction of exchange-traded funds (ETF) that are positioned as a direct substitute to mutual funds. Despite being touted in many fora as a superior savings vehicle with much lower financial intermediation costs, ETF's assets under management (AUM) represent less than 7.5 percent of the AUM managed by the Canadian mutual fund industry. This timid market penetration of ETFs in Canada corresponds to the shares of market observed at the global level and, therefore, cannot be attributed to the structure of the Canadian financial sector.

■ THE POLICY LEADS TO A SOCIETALLY INFERIOR INDUSTRY STRUCTURE

The typical industry response to the elimination of embedded commissions is a migration from a horizontal to a vertical industry structure dominated by a small number of firms that act as the distribution arm of the institution proprietary products. This is clearly what occurred in the United Kingdom where, following adoption of RDR, large asset managers and financial companies have expanded their direct sales forces and direct-to-financial-consumer offerings and actively promote their self-directed execution-only platforms. It is also important to note that the internalization of the sales force allows the "manufacturer" to continue the embedded commissions regime since the MiFID II Directive does not prevent financial advisers providing "tied" advice from receiving embedded commissions from the manufacturer.

The same development towards a vertical industry structure occurred through market forces in the United States. It is no coincidence that the large fund manufacturers in North America are at the forefront of the deployment of automated advisory services that provide retail investors (and financial advisers) with online access to investment advice at low cost.

The transformation of the financial advice industry from a horizontal to a vertical structure — from an environment where dealer firms and financial advisers have access to the financial products of several manufacturers to one where the industry is dominated by a small number of firms that act as the distribution arm of the institution's proprietary products — should be of particular concern to Canadian policy-makers for two major reasons.

Horizontal Structure	Vertical Structure
Promotes competition where strong financial product manufacturers compete to serve independent retail distributors.	In Canada, six banks control 90 percent of bank assets.
Diversity in the industry and access to several independent manufacturers exert pressure to: • enhance the range of choices available to financial advisers and their clients • improve the quality of the financial products/advice	A vertical setting: • limits the breadth of advice since financial advisers tend to recommend in-house products as a matter of course Empirical evidence suggests that funds sold through affiliated dealers perform worse.*
Better diversified portfolio.	Tendency to privilege bank deposits rather than higher yielding financial assets and encourage "reckless conservatism".

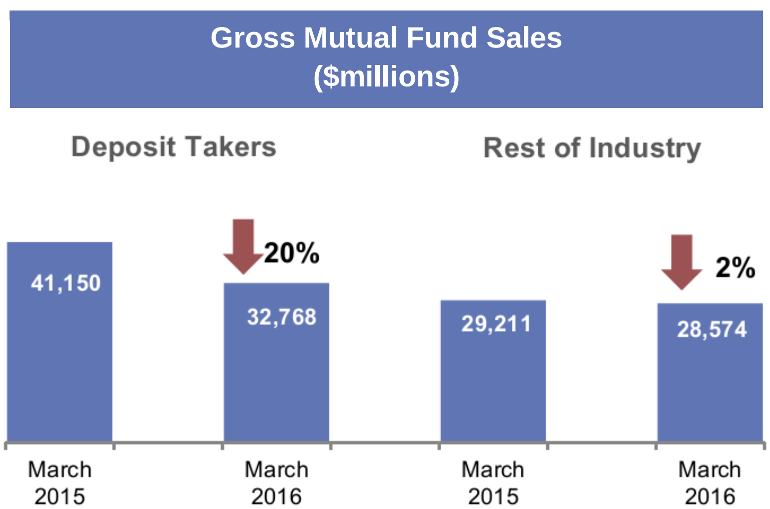
The first pertains to the breadth of advice provided in a captive setting. The Paper notes that "the majority of assets in the MFDA channel today are administered by dealers that focus on proprietary funds" (p. 35). In the branch network of deposit-taking institutions, fund distribution is solely that of proprietary funds. The evidence suggests that financial advisers at captive distribution firms are incentivized through several mechanisms to promote in-house products "regardless of the form of compensation."[45] Synovate finds that EU banks tend to recommend

[45] Edwin Weinstein, "Mutual Fund Fee Research" (The Brondesbury Group, 2015).

their proprietary products more than 80 per cent of the time.[46] A similar bias was documented in U.S. firms with proprietary funds.[47]

The second reason stems from the dysfunctional effects arising from a high level of concentration in an industry structured around a small number of vertically integrated financial organizations that manifest themselves through fund-flow patterns and fund-return performance.[48] In Canada, the process would accentuate the dominance of Canadian deposit-taking institutions. For the AMF in particular, one can only note the profound disconnect between its advocacy for a regulatory ban on embedded commissions and the consequences it would entail on the structure of the industry and its strategic orientation to "prioritize high impact initiatives for the growth and development of Québec's financial sector."[49]

A concentration of the funds industry around deposit-taking institutions would have far reaching consequences. Currently, one-third of financial wealth of Canadian households is held in deposits. Basel III incentivizes sales of daily interest accounts and GICs by deposit takers to manage capital requirements. This led to a disproportionate drop in bank mutual fund sales in the first quarter of 2016.



These results show that the assurances often repeated in the Paper that the CSA should be successful in reaching agreements with other Canadian regulators to avoid regulatory arbitrage between financial products and place IIROC and MFDA registered firms and representatives at a competitive disadvantage are of little comfort. The fact of the matter is that bank deposits and GICs issued by a chartered bank or by registered financial services cooperative are exempt from the application of most parts of securities law.[50] They also point to an important fact: the regulatory framework and financial performance pressures that apply on large financial corporations may lead to the implementation of internal policies that are not innocuous for

[46] Synovate, *Consumer Market Study on Advice Within the Area of Retail Investment Services* (European Commission, Director General Health and Consumer Protection, 2011).
[47] Michael A. Jones, Vance P. Lesseig and Thomas I. Smythe, "Financial advisers and multiple share class mutual funds," *Financial Services Review* 14, 1 (2015).
[48] Douglas Cummin, Sofia Johan, Yelin Zhang, op.cit., 2015.
[49] Autorité des marchés financiers, *2017-2020 Strategic Plan.*
[50] V-11, *Québec Securities Act*, art. 3.

financial consumers nor in their long-term best interest as evidenced by the table above. The Paper is silent on this important matter.

■ THE SOCIO-ECONOMIC CONSEQUENCES ON THE DEMAND SIDE

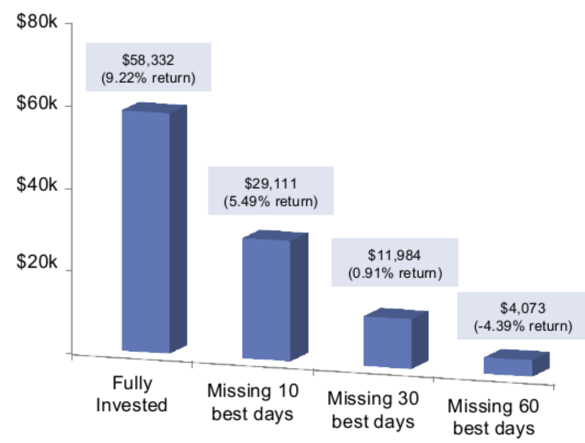
The "credence good" nature of financial advice incites a large proportion of financial consumers to shun the service. Deprived of the ability to use embedded commissions in their dealings with non-affluent households leads fund distribution firms to implement pricing policies calibrated to weed-out accounts that do not yield sufficient levels of continuous streams of revenues. The norm in the industry where embedded commissions have been discarded, either by regulatory fiat or market forces, is an AUM-based pricing model with a minimum asset threshold. It is estimated that in Canada this minimum asset threshold is about $150,000. In Canada, 80 percent of Canadian households own less than $100,000 in investable financial assets. It is noteworthy that 47 percent of them have an account with a financial advisor and that 69 percent of retail investors opened an account with a financial adviser when they had less than $50,000 in investible assets.

Canadian retail investor accounts per channel (2014)	
	Average Asset Value ($)
Canadian Banks	430,000
Small and mid-size mutual funds dealer	49,000
Branch-based mutual funds dealer	109,000
Independent full-service securities brokerages	169,000

Considering the average account value in the different channels shown above, it is difficult to believe that a ban on embedded commissions and the adoption of the AUM pricing regime that ensues will not "disfranchise" a large number of households. The most likely outcome is that, with a regulatory ban on embedded commissions, effective and practical options to access professional financial advice will be closed for a large number of middle-income households. Needing financial advice but lacking enough financial assets to make the provision of regulated financial advice an economic business proposition under a fee-for-advice or asset-under-management pricing model, they are most likely to be denied access to affordable financial advice and led to engage in financial transactions without the protections granted to investors dealing through a regulated financial adviser.

Left without professional financial advice, individual investors are prone to anchor decisions on known facts and make poor timing decisions. Empirical data suggest that poor timing decisions reduce annual returns by about 1.56 percent. [51] The response of U.S. individual investors to the 2007 recession differed significantly depending on whether or not they received professional financial advice and were impervious to their self-proclaimed financial knowledge. A study based on individual account data at a large independent financial services company found that: (i) an individual who paid for financial advice was 65 percent more likely to maintain long-term investment objectives, as measured by the decision to rebalance the portfolio but not moving into more of a cash position during the market downturn; and (ii) self-reported financial knowledge had little impact since only 5 percent of investors who were financially knowledgeable were more likely than those with low levels of financial knowledge to be prudent investor.[52] These findings are consistent with the results of a Canadian study that concludes that "sticking with an adviser induces more disciplined behavior during periods of market volatility."[53]

The performance of $10,000 fully invested in the S&P 500 compared with missing some of the market's best days



The bottom line is that "because investors are willing to tradeoff broker services and after-fee returns, it is welfare reducing to move investors with a revealed preference for interacting with brokers to lower-fee funds in the *direct* channel that lack these services and that it is not appropriate for a regulator to impose such an upheaval without an explicit legislative mandate."[54]

The assumptions contained in the Paper that the total cost of financial advice and financial products paid by retail investors will be reduced through the implementation of a ban on embedded commissions stretch credibility.

First, the suggestion that retail investors will be able to negotiate favorable pricing arrangements with their financial adviser because they now have detailed costing of the services rendered is unrealistic, except for very affluent individuals. Who believes that a retail investor with $150,000 in investable assets can bend the pricing grid established by a bank or an insurer or their affiliated broker/dealers? Supermarkets display the price of each product on their shelves; a very transparent market. This does not give consumers the power to negotiate prices at the check-out counter!

Second, industry-wide cost transparency is required to exert effective price competition and reduce price distortion. In retail markets, competitive pressure is exerted by the combined effect of consumers and competitors seemingly acting in concert in reaction to public information concerning the price and quality of services (or products) of a given firm. The supermarket

[51] G. Friesen, T. Saap (2007), *Mutual fund flows and investor returns: An empirical examination of fund investor timing ability,* Journal of Banking & Finance, 31(9), 2796-2816.

[52] Danielle D. Winchester, *Investor Prudence and the Role of Financial Advice in Three Essay on the Impact of Financial Advice*, Texas Tech University, May 2011.

[53] Claude Montmarquette, Nathalie Viennot-Briot, The Gamma Factor and the Value of Financial Advice, CIRANO, 2016s-35.

[54] Diane Del Guercio, Jonathan Reuter, Paula A. Tkac, *Broker Incentives and Mutual Fund Market Segmentation*, National Bureau of Economic Research, Working Paper 16312, August 2010.

industry is a case in point, as was recently demonstrated with the entry of Walmart. Similarly, in the financial advice market, "supply-side competition through commissions adds efficiency" that benefits financial consumers.[55] Comparability is a necessary condition for market efficiency.

In the United States, the unbundled fee-based model is the rule for about 80 per cent of the gross sales of mutual funds to retail accounts. Since U.S. dealer firms distributing mutual funds pursue different pricing strategies and tend not to disclose publicly the actual charges they demand from their customers, detailed fund distribution costs (and fees) are not widely available, except for the portion paid through a 12b-1 fee. As a result, accurate comparisons of total cost of ownership between financial intermediaries inaccessible to individual investors and competing firms. We find a similar situation in the U.K. The RDR post-implementation review indicates that the price for retail investment products has been falling whereas the cost of financial advice increased. However, the evolution of the total cost could not be determined: "The ranges in pre — and post — RDR estimates of platform, product and adviser payments, and the various ways in which these feature in different investments, means it is not yet clear whether declines in product and platform prices are more of less offset by increases in advice costs."[56]

The market dynamics unleashed by a structural shift that separates the provision of financial advice from the sale of financial products tend to benefit financial intermediaries at the expense of individual investors.[57] The lack of industry-wide transparency on the total cost of ownership lessens scrutiny on fees and the market pressure to keep costs within the bounds robust competition would allow. U.S. broker-dealers acknowledge that their revenues generated in commission-based platforms are lower than in a fee-for-advice platform that incites them to promote AUM-based-fee relationships. Strategic Insight concludes that "in total, the unbundling of fees has resulted in an increase in the total shareholder costs for many mutual fund investors — with such increases amplified due to tax considerations at times."[58] The finding of Investor Economics concerning the evolution of the cost of ownership of mutual funds in the United States confirms Strategic Insight's conclusion "that a move to unbundled fee-for-advice models has not resulted in a reduction of investor costs of mutual fund ownership."[59]

The same occurred in the United Kingdom following the adoption of regulations imposing the fee-for-advice regime on the financial industry. In 2014, the average revenue generated per financial adviser amounted to £107,166 compared to £90,197 in 2012 with a corresponding increase in pre-tax gross margin at financial adviser firms. This increase occurred even though the average number of clients per adviser has not changed. Average pre-tax profits of financial adviser firms are higher than what they had been in the years prior to 2013.[60] Market pricing is now blurred, rendering it very cumbersome — if not impossible — to make comparisons between firms.

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55 Roman Inderst and Marco Ottaviani, "Competition through Commissions and Kickbacks," *American Economic Review* 102, 2 (April 2012): 780-809.

56 Financial Conduct Authority (FCA), *Post-implementation review of the Retail Distribution Review — Phase 1* (December 2014).

57 Bolton, Freixas and Shapiro, "Conflicts of Interest."

58 Strategic Insight, "A Perspective," 5.

59 Investor Economics, "Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios: A Canadian-U.S. Perspective, 2015 Update" (The Investment Funds Institute of Canada, 2015), 11.

60 APFA, *The Advice Market*.

The Paper acknowledges "that a transition to direct pay arrangements would reduce the transparency of dealer compensation costs as investors would have no benchmark to help them assess the reasonableness of the fees they are paying for advice" (p. 79). However, the suggestion that this issue will be dealt with after the ban on embedded commission is implemented will only ensure that, if ever an effective industry-wide cost disclosure mechanism is put in place, the higher cost to retail investors that is sure to follow the ban will become the new floor. The apparent disregard for the critical importance of industry-wide cost transparency as an essential condition to ensure the efficient working of markets is a matter of concern.

CONCLUSION AND POLICY IMPLICATIONS

The fundamental role of the financial-intermediation function is to facilitate savings and promote sound financial asset management. The evidence strongly suggests that the functioning of the Canadian retail financial fund and advice industry has so far yielded beneficial results for households obtaining the service, and for society as a whole.

Under the current remuneration arrangements, access to and affordability of financial advice is increased, the advised population is much larger than would otherwise be the case under other remuneration models, the propensity to save is increased and the accumulation of wealth is enhanced through better saving habits and investment practices. 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 household wealth accumulation and society, in general.

Accordingly, the regulation of retail financial advice should aim at:

- Promoting easy and affordable access to professional financial advice by individual investors on terms that meet their expressed preferences;
- Strengthening consumer protection through full cost disclosure and timely performance reports to individual clients;
- Encouraging competition within the industry and market efficiency through the promotion of industry-wide price transparency;
- Emphasizing the need to achieve and maintain high levels of trust with regards to the financial advice industry, a key determinant of the demand for professional financial advice.

In the Canadian environment there is no evidence that a regulatory ban on embedded commissions will:

- Bring about the desired change in behavior;
- Broaden access to financial advice;
- Reduce or contain the cost of financial advice and, more generally,
- Help Canadians accumulate more wealth than would be the case otherwise; and,
- Assist retirees make an efficient draw-down of their wealth.

If the policy is adopted, the reverse is almost sure to be the case.