ICI Global

Dan Waters
MANAGING DIRECTOR

110 Bishopsgate
19th Floor, Suites 19-06 and 19-07
London EC2N 4AY, UK
+44 (0) 207 961 0830
www.iciglobal.org

Suite 715–717, Level 7
Two Exchange Square
8 Connaught Place
Central, Hong Kong
+852 2168 0882

1401 H Street, NW
Suite 1200
Washington, DC 20005, USA
+001 202 326 5800
www.ici.org

+44 (0) 207 961 0831
MOBILE: +44 (0) 7584 077751
dan.waters@iciglobal.org

9 June 2017

Canadian Securities Administrators

c/o The Secretary, Ontario Securities Commission
20 Queen Street West, 19th Floor, Box 55
Toronto, Ontario M5H 3S8
comments@osc.gov.on.ca

Me Anne-Marie Beaudoin, Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
consultation-en-cours@lautorite.qc.ca

RE: CSA Consultation Paper 81-408 – Option of Discontinuing Embedded Commissions

Dear Sirs and Mesdames:

ICI Global[1] appreciates the opportunity to comment on the Canadian Securities Administrators' ("CSA") Consultation Paper 81-408 regarding the option to discontinue embedded commissions ("Consultation"). The Investment Company Institute ("ICI") and its members have closely followed global regulatory developments in this area for several years. In the United States, we have been actively engaged in the fiduciary rulemaking of the Department of Labor ("DOL"), including during the 2015 rulemaking proposal period and most recently as a result of the President's February 2017 order directing DOL to re-examine whether the rule adversely affects the ability of investors to access retirement information and advice. As the CSA evaluates comments on this Consultation, we urge the CSA to carefully consider not only the

[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US$25.2 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

benefits that the CSA seeks to bring to Canadian investors but also the potential for the proposed changes to negatively impact investors, including reducing their access to financial advice.

In the Consultation, the CSA argues that embedded commissions cause or lead to the following harms to investors:[2]

- conflicts of interest that misalign the interests of fund managers, dealers and representatives with those of investors;
- limit investor awareness, understanding and control of dealer compensation costs; and
- generally do not align with the services provided to investors.

In support, the CSA states that "The evidence we have gathered to date shows that embedded commissions encourage the suboptimal behavior of fund market participants, including that of investment fund managers, dealers, representatives and fund investors, which reduces market efficiency and impairs investor outcomes."[3] The Consultation's Appendix A, Evidence of Harm to Investor Protection and Market Efficiency from Embedded Commissions ("Appendix") sets forth the information and studies gathered to support the CSA's identified issues with embedded commissions.

Many of the academic studies cited in the Appendix include studies relied upon by DOL for its fiduciary rulemaking. We raised significant concerns with the research cited by the DOL. We described inaccurate characterizations of the academic research and described how the academic research did not capture the current state of the US market for mutual funds sold with front-end loads. We also raised specific concerns with certain of the studies and how they were used by the DOL to support its regulatory impact analysis.[4]

The following US-based academic studies are cited in the Appendix to support the CSA's arguments concerning harms from embedded commissions and also were relied upon by the DOL for its fiduciary rulemaking:

- Susan E.K. Christoffersen, Richard Evans and David K. Musto, "What Do Consumers' Fund Flows Maximize? Evidence from their Brokers' Incentives," *The Journal of Finance*, Vol. 68, Issue 1 (February 2013) ("CEM paper").

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[2] Consultation at 3.

[3] Id.

[4] *See, e.g.*, Letter to DOL on Proposed Fiduciary Rulemaking from Paul Schott Stevens, President and CEO, Investment Company Institute, dated 21 July 2015, available at https://www.ici.org/pdf/15_ici_dol_fiduciary_overview_ltr.pdf ("2015 Letter from Paul Schott Stevens"). *See also,* Letters on Proposed Fiduciary Rulemaking from Brian Reid and David W. Blass, Investment Company Institute, dated 21 July 2017, available at https://www.ici.org/pdf/15_ici_dol_fiduciary_reg_impact_ltr.pdf, https://www.ici.org/pdf/15_ici_dol_fiduciary_def_ltr.pdf and https://www.ici.org/pdf/15_ici_dol_fiduciary_best_interest_ltr.pdf; and Letter with Supplementary Information from Brian Reid and David W. Blass, Investment Company Information, dated 24 September 2015, available at https://www.ici.org/pdf/15_ici_dol_ria_comment.pdf . Additional ICI testimony and other statements on the DOL fiduciary rulemaking is available at https://www.ici.org/fiduciary_rule/statements.

- Jonathan Reuter, Boston College Department of Finance, National Bureau of Academic Research, "Revisiting the Performance of Broker-Sold Mutual Funds," November 2, 2015 ("Reuter 2015")
- Daniel Bergstresser, John Chalmers and Peter Tufano, "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry," *Review of Financial Studies*, Vol. 22, 2009 ("BCT paper")
- John Chalmers and Jonathan Reuter, "What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes?" National Bureau of Academic Research Working Series/Working Paper 18158, June 9, 2012 ("Chalmers and Reuter paper") (the foregoing papers, together, the "US-based studies")

The CSA also references in the Appendix a 2015 paper by the Executive Office of the President of the United States, "The Effects of Conflicted Advice on Retirement Savings," and a 2004 study by Lori Walsh, Office of Economic Analysis of the US Securities and Exchange Commission, *The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns*.

As more fully described in the Appendix to this letter, we identified serious flaws in the DOL's impact analysis, including the significant misapplication and mischaracterization of several studies, including the US-based studies. Consequently, the CSA should be cautious when using these US-based studies to support broad conclusions related to adverse investor outcomes as a result of commissions paid to intermediaries.

We also direct your attention to the current re-examination of the DOL's fiduciary rulemaking and experiences with the UK's Retail Distribution Review ("RDR"). While we agreed with the DOL that advice providers should act in the best interest of their clients, we raised serious concerns that their rule would negatively impact retirement savers' access to guidance, products and services that they need to meet their retirement goals.[5] As we and others predicted, there is evidence that the DOL's fiduciary rule, as it is being phased in, is harming US investor access to financial advice. For example, since adoption of the DOL's fiduciary rule, the shift from commission-based accounts to fee-based accounts has accelerated and smaller investor accounts are being "orphaned" by intermediaries. Other disruptions and dislocations in the US retirement services industry include changes to the availability of, and investments offered in, IRA brokerage accounts as well as reductions in web-based financial education tools. Robo-advice, although offering many attractive features, will not be a perfect substitute for human interaction.[6] Similarly, the UK Financial Conduct Authority has identified concerns with higher costs for advice after RDR as well as an unwillingness of some advisers to serve smaller account customers.[7]

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[5] 2015 Letter from Paul Schott Stevens, *supra* note 4.

[6] *See*, Letter to DOL on Re-examination of Fiduciary Rule from Brian Reid and David W. Blass, Investment Company Institute, dated 17 April 2017, available at https://www.ici.org/pdf/17_ici_dol_fiduciary_reexamination_ltr.pdf ("April 2017 DOL Letter"). *See* also, Robert Van Egghen, "Survey reveals consumers distrust robo-advisers," *Ignites Europe*, May 31, 2017.

[7] "FCA admits RDR contributed to advice gap," FT Adviser, July 19, 2016, available at https://www.ftadviser.com/2016/07/19/regulation/rdr/fca-admits-rdr-contributed-to-advice-gap-hujPxa8fmBkivLaaAxxfN/article.html. *See also,* April 2017 DOL Letter at 17-18, *supra* note 6.

While we appreciate that the Canadian market may be different, we still believe that the CSA can benefit from considering the US and UK experiences to gain insights into what regulatory approaches may be most helpful in achieving the CSA's desired outcomes while avoiding unintended negative consequences for investors. The risks to investors, as briefly described above, are evident from the experiences in both the United Kingdom and the United States.

Lastly, we encourage the CSA to take time to study the effects of regulatory changes in the Canadian market, such as the new annual intermediary disclosure on fees and performance. Based on experience in the US mutual fund market, changes can take several years to be both clear and visible in terms of market outcomes.[8] The new annual disclosure in Canada provides an investor with information on direct and indirect fees paid to an intermediary. We are unaware of comparable disclosure in any other fund market. We believe that it would be valuable for the CSA to have more time to understand and assess the response of investors and markets to this information.

While we respect the CSA's request to remain Canadian-focused, we do believe the experiences in the United Kingdom and the United States are relevant and should be helpful as the CSA considers not only the benefits of the options, but also the potential for those options to create risks for investors.

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If you have any questions or would like additional information, please contact me (dan.waters@iciglobal.org or +44-207-961-0831). More specifically, for questions on our Appendix, please contact Sean Collins, Senior Director, Industry and Financial Analysis at sean.collins@ici.org or +1-202-326-5882.

Sincerely,

/s/ Dan Waters

Dan Waters
Managing Director

[8] In the United States, for example, trailing commissions paid through funds (i.e., "12b-1 fees") have been diminishing in importance since the early 2000s as a way to compensate financial professionals for providing advice. This process, though evolving over a number of years, has occurred by virtue of market forces, rather than regulatory intervention. *See, e.g.*, Sean Collins and James Duvall, "Trends in the Expenses and Fees of Funds," *ICI Research Perspective*, 23, No. 3, May, 2017.

Annex

The CSA argues that embedded commissions cause or lead to the following harms to investors:[9]

- conflicts of interest that misalign the interests of fund managers, dealers and representatives with those of investors;
- limit investor awareness, understanding and control of dealer compensation costs; and
- generally do not align with the services provided to investors.

The Consultation's Appendix A ("Appendix") sets forth the CSA's support for these assertions, including citation of the following US-based studies:

- Susan E. K. Christoffersen, Richard Evans and David K. Musto, "What Do Consumers' Fund Flows Maximize? Evidence from their Brokers' Incentives," *The Journal of Finance*, Vol. 68, Issue 1 (February 2013) ("CEM paper").
- Jonathan Reuter, Boston College Department of Finance, National Bureau of Academic Research, "Revisiting the Performance of Broker-Sold Funds," November 2, 2015 ("Reuter 2015").
- Daniel Bergstresser, John Chalmers and Peter Tufano, "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry," *Review of Financial Studies*, Vol. 22, 2009 ("BCT paper").
- John Chalmers and Jonathan Reuter, "What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes?" National Bureau of Academic Research Working Series/Working Paper 18158, June 9, 2012 ("Chalmers and Reuter paper") (the forgoing studies, together, "US-based studies").

The Appendix also refers to a study by the Executive Office of the President of the United States ("White House study"),[10] and a study by Lori Walsh, Office of Economic Analysis of the US Securities and Exchange Commission ("SEC"), *The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns*, April 26, 2004 ("SEC paper").

We are cognizant of the CSA request that comments, wherever possible, be Canadian-focused. Nevertheless, given that the CSA cites US-based studies as evidence in favor of its views that embedded commissions are problematic, we believe the CSA will be aided by our perspective on the US-based studies that it used as support.

In our view, the US-based studies in fact provide very mixed evidence on the issues that seem of most concern to the CSA, such as whether the payment of embedded commissions for advice creates significant conflicts of interest, that funds paying commissions tend to

[9] Consultation at 3.

[10] Executive Office of the President of the United States, "The Effects of Conflicted Advice on Retirement Savings," 2015.

underperform, that embedded commissions encourage biased representative recommendations,[11] or that the costs of advice provided through embedded commissions may exceed its benefit to investors.[12]

US-Based Studies and Intermediary Compensation – Costs and Benefits to Investors

Perhaps the most relevant and essential consideration—as we noted in our comment letters to the US Department of Labor ("DOL") regarding its fiduciary rule[13]—is that none of these US-based studies compares the costs and benefits of advice under a commission-based system with the costs and benefits of advice under direct payment arrangements. For example, these US-based studies do not compare the investment experiences of investors who pay front-load commissions (or trailing commissions paid through a fund) with the investment experiences of those who pay asset-based fees directly out of pocket to financial advisers. This issue is as relevant to the CSA's Consultation as to the DOL's fiduciary rule.

Instead, what these studies typically assess is the performance of funds that are broker-sold (where investor pay a front- or back end load fee, as well as a higher or lower trailing commission depending on the amount of any front- or back end load fee paid) with those that are no-load. In the United States, no-load funds typically have lower expense ratios than broker-sold funds because there is no payment for advice. But many US investors purchase no-load funds with the assistance of a financial adviser and then pay the adviser directly (*i.e.*, outside of the fund) for advice and assistance. These studies do not account for the cost and payment of advice made outside of the fund. Consequently, they cannot be used to determine whether investor performance would improve or deteriorate if investors lose the ability to pay embedded commissions.

Second, as we also pointed out in our comment letters on the DOL's fiduciary rule, fee-based advice paid directly to an adviser can, under certain circumstances, be more costly than commission-based advice (notably front-end load payments with a small trailing commission) or equally as costly (*e.g.*, when an investor pays 1.00 percent through a trailing commission paid within the fund versus purchasing no-load funds with the help of an adviser who then charges the client 1.00 percent, which the client pays out of pocket). In particular, while both compensation models (fee-based paid directly and commission-based) have their advantages, the commission-based model can in certain circumstances be a more cost-effective means to receive advice, particularly for buy-and-hold investors, which is the case for many investors with modest-sized accounts.

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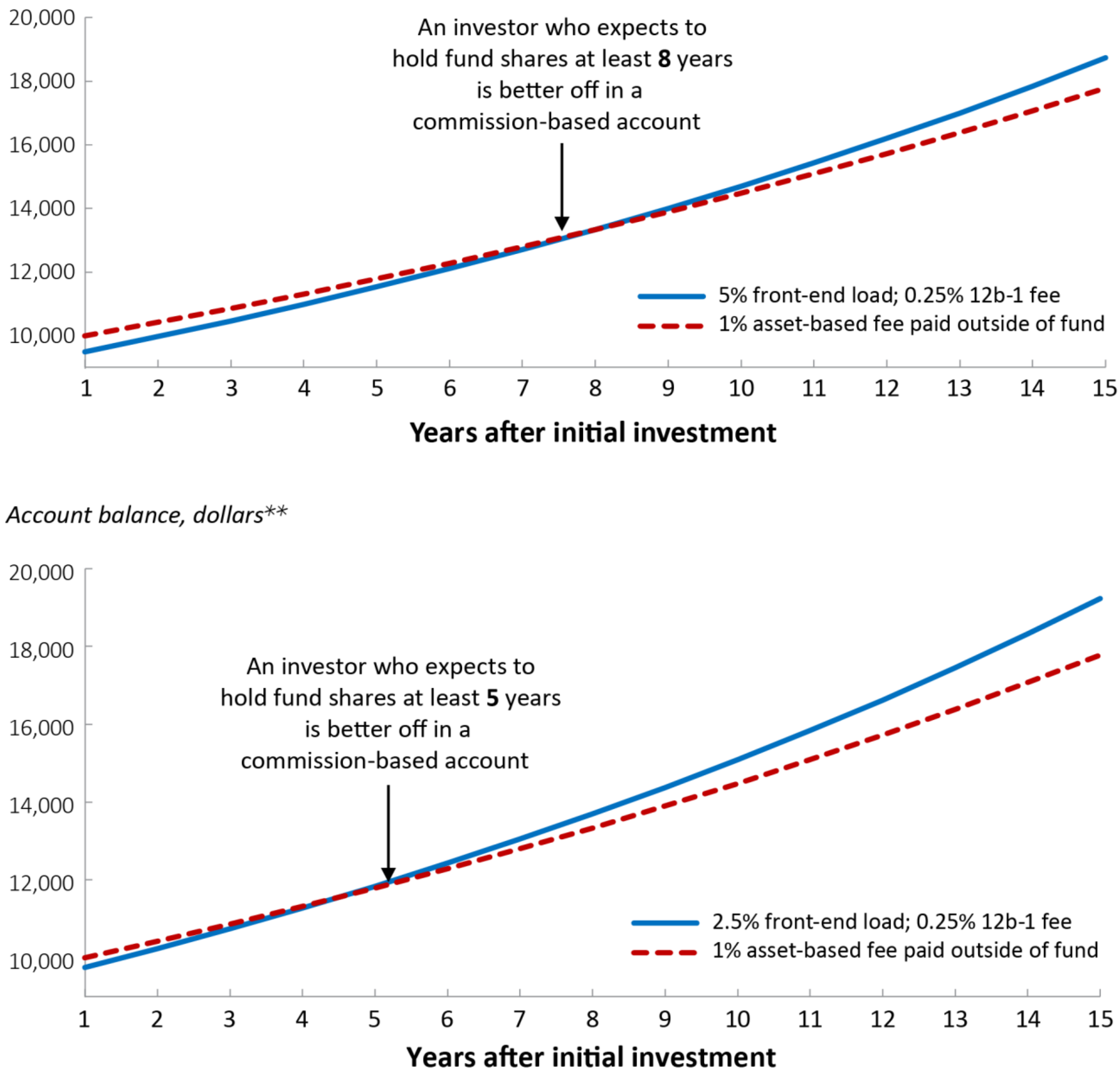
[11] Consultation at 99-106.

[12] Consultation at 125.

[13] Relevant submissions related to the DOL fiduciary rulemaking are cited in notes 4 and 6.

Figure 1
US Account Balances for $10,000 Initial Investment in Commission-Based Account versus Fee-Based Account*
*Account balance, dollars***



* Commission-based account assumes the investor pays an upfront sales load of either 5% (top panel) or 2.5% (bottom-panel) and (in both panels) an ongoing 12b-1 fee of 0.25% per year. Fee-based account assumes the investor pays an ongoing asset-based fee of 1% per year.
** Scenario assumes a $10,000 initial investment, including (non 12b-1 fee) fund expenses of 0.75% per year, ignores income and capital gains taxes, and assumes a fund return of 6% per year, of which 5% is capital gains and 1% is income.
Source: Investment Company Institute

As an illustration, Figure 1 compares investor account balances for a $10,000 initial investment placed in a commission-based account as compared with a fee-based account. In the commission-based account, as in the front-load arrangements now common in the US fund industry, the investor pays a front-load fee (of 5 percent in the top panel versus 2.5 percent in the bottom panel) and an ongoing 12b-1 fee of 0.25 percent per year. A 5 percent front load is representative of the maximum front load an investor might pay, while a 2.5 percent load is representative of what an investor who qualifies for a discounted front load might pay. The investor in the fee-based account pays only an ongoing asset-based fee of 1.00 percent per year (which we assume the investor pays directly to the adviser), which is in line with a recent study by Cerulli Associates indicating that 96 percent of US fee-based advisers charge 75 basis points or more a year, and 85 percent charge 100 basis points or more a year.

Figure 1 shows that long-term investors may do better under a commission-based arrangement as compared with an asset-based fee arrangement paid directly to the adviser. For example, the top panel shows that an investor who has the choice between paying a financial professional an asset-based fee of 1 percent per year versus a 5 percent front-load fee (plus an ongoing 12b-1 fee) ends up with a higher account balance under the commission-based approach if he or she plans to hold fund shares longer than 8 years.

The bottom panel shows that this break-even point occurs sooner if the investor qualifies for a reduced front-load of 2.5 percent. In that case, if the investor plans to hold the fund shares for at least 5 years, he or she is better off (i.e., ends up with a higher account balance) by electing to pay for financial advice using a front-end commission-based approach.

If the comparison is intended to be between paying a trailing commission through the fund or investing in a "clean" fund (zero front- or back end-load and no trailing commission paid inside the fund) but paying a financial adviser directly for services, from the investor's point of view, either arrangement offers exactly the same net outcome (in either arrangement, the dashed red line depicts the investor's net account balance).

Understanding Specific US-Based Studies Cited As Support by CSA

Another significant concern—which we also pointed out to the DOL in connection with its Regulatory Impact Analyses ("RIA")[14]—is US-based studies have frequently been mischaracterized, misapplied, selectively interpreted, or simply misunderstood. We are concerned that by utilizing these same articles, the CSA risks treading the same path, in turn risking potentially adverse outcomes for investors.

Below, we summarize the concerns we advanced to the DOL regarding its interpretations of each of the US-based studies and which we believe also are relevant to the CSA as it considers certain US-based studies in its deliberations regarding the prohibition of embedded commissions in the Canadian market.

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[14] *See*, US Department of Labor, Employee Benefits Security Administration, *Fiduciary Investment Advice Regulatory Impact Analysis*, April 14, 2015, ("2015 RIA"). *See also*, Regulating Advice Markets, Definition of the Term "Fiduciary" Conflicts of Interest—Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions (April 2016) ("2016 RIA").

1. Jonathan Reuter, Boston College, Department of Finance, National Bureau of Academic Research, "Revisiting the Performance of Broker-Sold Funds," November 2, 2015 ("Reuter 2015")

The CSA's Appendix cites the Reuter paper as evidence that funds that pay commissions tend to underperform those that do not. It interprets Reuter's paper as finding evidence that payment of dealer compensation impairs fund performs. Specifically, it states that Reuter's paper finds that actively managed non-specialized US equity mutual funds sold through brokers underperform similar actively managed funds sold directly to investors by an average of 0.65 percent on a risk-adjusted basis, or 0.42 percent after adjusting for trailing commissions (*i.e.*, 12b-1 fees).

The DOL's 2015 Regulatory Impact Analysis ("RIA") similarly claims, on the basis of academic studies, that the typical investment in a US commission-based ("broker-sold") fund underperforms direct-sold funds (i.e., no-load funds) by 100 basis points (Figure 2, Row 1). ICI, however, compared returns of front-load funds to those of retail no-load funds. We noted that to ensure commensurable return measures, it is necessary to asset-weight (to determine whether brokers' advice was causing investors to skew their purchases or holdings toward lower-return funds) and to adjust for 12b-1 fees (because investors who want advice services will have to pay for those services whether they pay an embedded commission or pay for advice directly via an asset-based fee outside the fund). On this commensurable basis, there were very modest differences (only 6 to 7 basis points) between the returns that investors earned on front-load funds and those earned on retail no-loads funds (Figure 2, Row 2).

Figure 2
Estimated Underperformance of US Broker-Sold Funds, as Reported by Selected Analyses

Row	Source	Under-performance (basis points)	Time period	Asset-weighted?	Adjusted for 12b-1 fee charges?	Risk-adjusted?	Analysis is based on assets in these types of funds:
1	2015 RIA	100	unclear	unclear	no	unclear	unclear
2	ICI 2015	6–7	2008–2014	yes	yes	yes	domestic and world equity,[1] bond, hybrid[2]
3	2016 RIA (a)	59	1980–2015	yes	unclear	yes	domestic equity
4	2016 RIA (b)	6	1980–2015	yes	unclear	yes	domestic and foreign equity
5	Reuter 2015 (a)	64	2003–2012	yes	no	yes	actively-managed domestic equity
6	Reuter 2015 (b)	18	2003–2012	yes	yes	yes	all actively-managed (excluding muni)
7	ICI 2017	11	2008–2016	yes	yes	yes	domestic and world equity, bond, hybrid

[1] World equity is an ICI category that includes funds that may invest primarily in foreign equities, or may invest primarily in a mix of both foreign and domestic equities.
[2] Hybrid is an ICI category that includes funds that invest in a (possibly changing) mix of domestic and/or foreign equities and bonds.

In part to address ICI comments in 2015, and to reflect a later, new study by Jonathan Reuter (*i.e.*, Reuter 2015), DOL's 2016 RIA, lowered its estimate of the underperformance of broker-sold funds from 100 basis points to 50-100 basis points. This is still far too high and reflects a selective reporting of DOL's own results and a selective reading of Reuter 2015.

DOL claims in its 2016 RIA that "Reuter finds that actively-managed broker-sold domestic-equity funds underperform index funds by 64 basis points per year." This result is smaller in magnitude, but consistent with previous literature showing underperformance in broker-sold domestic equity mutual funds."

In fact, when Reuter includes all types of funds (except for municipal bond funds), weights the funds by assets, and adjusts for 12b-1 fees, he finds that actively-managed broker-sold funds underperformed direct-sold funds by only 18 basis points (in Figure 2, compare Reuter 2015(a) in Row 5 and Reuter 2015(b) in Row 6). Further, when the DOL includes both domestic and foreign equity funds, it too finds very little underperformance of broker-sold funds (in Figure 2, compare 2016 RIA (a) in Row 3 with 2016 RIA (b) in Row 4) compared to direct-sold funds.

The striking difference between the performance measures in Rows 3 and 4 and Rows 5 and 6 reflects that over the periods analyzed, broker-sold domestic equity funds underperformed direct sold domestic equity funds *but* broker-sold international equity funds outperformed direct-sold international equity funds by a wide margin (about 160 basis points). Thus, commenters and policymakers that focus solely on the performance of domestic equity funds tend to adopt the view that broker-sold funds have underperformed in general, thereby evincing broker conflicts.[15]

The fact that broker-sold international equity funds outperformed direct-sold international equity funds by a wide margin suggests that the measured underperformance of domestic equity funds may arise from something altogether unrelated to broker conflicts of interest. Presumably, if conflicts of interest cause underperformance, broker-sold international equity funds should also underperform direct-sold international equity funds—not outperform by a significant margin.[16] The CSA should consider whether this same feature is present in the measured performance of Canadian mutual funds.

2. <u>Susan Kerr Christoffersen, Richard B. Evans and David K. Musto, "What do Consumers' Fund Flows Maximize? Evidence from their Brokers' Incentives," *The Journal of Finance*, Vol. 68, Issue 1 (February 2013) ("CEM paper")</u>

The CSA suggests that the CEM paper found that among "US mutual funds with loads or revenue-sharing that higher payments to fund brokers lead to higher inflows and that net returns are approximately 50 basis points lower for every 100 basis points of loads."[17]

This interpretation, however, is misleading. The CEM paper focuses on the relationship between fund net returns (relative to a benchmark) and "excess loads" paid to brokers. They define excess loads as the amounts paid to a broker over and above that that would normally be expected given the level of load a fund collects from an investor and given a range of other factors. Thus, taking their results as given, one would properly conclude that net returns are approximately 50 basis points lower for every 100 basis points of *excess loads* paid by funds to brokers.

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[15] The CSA may invite readers to draw that conclusion when it states that Reuter 2015 indicates that "the average 10-year return for direct-sold funds held a 0.42% point advantage over broker-sold funds, using a value-weighted average." In fact, in Reuter's 2015 study that is true only if the focus is on actively-managed *domestic equity* funds. When Reuter includes *all* funds (excluding only muni funds), he finds underperformance of only 0.18% for broker-sold funds, slightly above the 11 basis points that ICI found for the period 2008 to 2016.

[16] The DOL's 2016 RIA was unable to explain this inconsistency in the US data. See 2016 RIA at 337, footnote 628.

[17] Consultation at 100.

An excess load of 100 basis points is extremely high, so high in fact as to be all but unobservable in the data. In fact, for 2013, averaged across all funds that made greater-than-expected payouts to brokers (i.e., had excess loads above zero), the average excess load is just 0.15 percent. On this basis, we calculate that the Christoffersen et al. model would predict underperformance of just 8 basis points.[18] Moreover, this would be true only for those funds that made greater-than-expected payouts to brokers. Those that made lower-than-expected payout to brokers (which amounts to half of the load fee funds in the sample) would be expected to *outperform* their benchmarks by some amount.

Moreover, the DOL's application of the CEM study embodies a mathematical error. This caused the DOL to overstate by 15 to 50 times any potential dollar benefit from its fiduciary rule (the effects of the DOL's fiduciary rule are in the main expected to have the effects of banning commissions at the fund level, whether front-load, back end-load or trailing commissions). After adjusting for this mathematical error, the net benefits of the DOL's fiduciary rule are about zero.[19]

In short, we urge the CSA to be cautious about interpreting the results in the CEM paper.

3. John Chalmers and Jonathan Reuter, "What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes?" National Bureau of Academic Research Working Series/Working Paper 18158, 9 June 2012 ("Chalmers and Reuter paper")

In support of the CSA's claim that conflicted advice may negatively affect investor outcomes, and also that investors may not derive offsetting benefits from the payment of trailing commissions, the Consultation cites the Chalmers and Reuter paper. The Chalmers and Reuter paper, updated in 2015, attempts to measure the impact of broker recommendations on US client portfolios. The authors find that plan participants in an Oregon University System who used brokers that were offered by one of their defined contribution plan providers between 1996 and 2009 were likely to need help with asset allocation and fund selection. Over the period 1996 to 2007, participants had access to a broker but no access to a target date fund. The authors found that plan participants who used a broker would have had better outcomes if they had been able to be defaulted into a target date fund. What this suggests is that well-designed target-date funds can be a valuable default option for participants in US employer-sponsored plans.

But, this must be interpreted carefully. The results in Chalmers and Reuter may be entirely consistent with plan participants doing better with advice than without. For example, during the period 1996 to 2007 when plan participants had the choice of using a broker or not (but in either case did not have access to a target date fund), a rather high proportion (roughly 30 percent) of the plan participants who chose not to use a broker were defaulted into a money fund option. For many US long-term retirement savers this is likely a sub-optimal choice. In contrast, plan participants who used a broker were defaulted into a somewhat similar option (a fixed annuity) very infrequently (only 2 percent of the time), instead apparently taking broker advice to invest in US equity mutual funds. Thus, although Chalmers and Reuter do not present evidence on this issue, it is possible that plan participants

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[18] This is based on 2013 data, which is the most recent data ICI had available to it when these calculations were undertaken.

[19] *See,* April 2017 DOL Letter, *supra* note 6.

who used brokers over the period 1996 to 2007 experienced better performance than plan participants who over the same period did not use a broker.

In addition, Chalmers and Reuter show that over the period 1996 to 2007, plan participants who elected to use a broker had access to a much wider array of fund choices compared to plan participants who chose not to use a broker. For example, Chalmers and Reuter show that in 1996, plan participants who elected to use a broker could choose from among 40 different fund options, including 21 different US equity funds and 3 passively managed funds. At that time, plan participants who elected not to use a broker had a much narrower array of funds available to them, just 10 in total, of which only 2 were US equity funds, and only 1 fund was passively managed. Clearly, plan participants may have been willing to incur a distribution charge in order to have the benefit of investing in a much wider array of investment options.

In short, the CSA claims too much in suggesting that the Chalmers and Reuter paper provides evidence that "investors derive almost no offsetting benefits from the payment of distribution fees." In fact, as we discuss below with respect to the next paper—the BCT paper—there are very likely significant "intangible benefits" to using a broker.[20]

4. Daniel Bergstresser, John Chalmers and Peter Tufano, "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry," *Review of Financial Studies*, Vol. 22, 2009 ("BCT paper")

The CSA cites the BCT paper as evidence that "[c]onflicted advice may negatively affect investor outcomes."[21] In fact, the evidence in the BCT paper is highly mixed and the authors are very careful in their interpretation of their evidence. For example, they, like Reuter 2015, report that "broker-sold funds deliver lower risk-adjusted returns." But, as in Reuter 2015, BCT also report that broker-sold foreign equity funds outperform direct-sold funds by a wide margin. Again, if broker incentives were causing brokers to direct investors to underperforming funds, that should presumably be evident across the entire spectrum of funds. That that is not the case suggests something other than broker incentives may be driving the results on fund performance.

The CSA also cites the BCT paper as evidence that "[i]nvestors may not derive offsetting financial benefits from the payment of trailing commissions."[22] We also would caution against this interpretation. The authors themselves note that their results are consistent with two quite different hypotheses. One is that, as CSA seems to suggest, there are material conflicts of interest between brokers and their clients. The alternative the BCT paper offers is that "brokers deliver substantial intangible benefits that we [the authors] do not observe."[23] For example, as BCT state, "[b]rokers may help their clients save more than they would otherwise save, they may help clients more efficiently use their scarce time, they may help customize portfolios to investors' risk tolerances, and they may increase overall investor comfort with their investment decisions."[24]

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[20] The BCT paper uses the term "intangible benefits" to refer to benefits they are unable to measure using their data. This should not be construed, however, as implying that those benefits are "intangible" to the investors who receive financial advice and assistance from brokers or other financial professionals.

[21] Consultation at 106.

[22] Consultation at 125.

[23] *See* BCT paper at 4130.

[24] *See* BCT paper at 4131.

In our view, this latter interpretation is correct, but is in fact only a partial list of the benefits brokers or other financial advisers may provide to clients. Other benefits may include helping clients: plan for and manage their assets in retirement; manage tax-related issues; create estate plans; determine how best to react to market downturns; plan for, and choose investments suitable for, saving for home purchases or education.

These kinds of "intangible" benefits can be very significant. For example, a 2013 Morningstar study attempted to quantify the benefits to consumers of receiving financial advice. They focused on five financial planning decisions and techniques, finding that advice creates value in each of the five categories, for a total increased gain of 1.6 percent, compared to the baseline when no advice is received.[25] An additional Morningstar study showed that financial advice can help investors improve their optimal timing of taking Social Security benefits, adding gains of another 0.74 percent per year.[26] Combining both estimates, these studies suggest that better financial decision making achieved through professional financial advice, can add 2.34 percent annually to an investor's returns. By this standard, even if studies such as the BCT paper are correct that broker-sold funds underperform direct-sold funds by 50 to even 100 basis points,[27] investors who seek financial advice might on net still come out far ahead.

The Appendix describes Canadian studies that also discuss the value of advice for mutual fund investors. For example, the Appendix cites one study as indicating that clients who work with an adviser can theoretically add about 3 percent to their net returns.[28] Another Canadian study the CSA cites suggests that advice can help overcome biases such as "the tendency to prefer short-term gratification (consumption) over longer-term returns (saving), inertia and status quo bias and a propensity to push to a later date actions that require self-control."[29] Finally, the Consultation cites a study of Canadian investors by Foerster et al., which posits that funds investors may seek advice from fund dealers or representatives who provide benefits "in the form of financial planning, including advice on saving for college and retirement, tax planning and estate planning."[30]

5. Other US-Based Papers

The Annex also describes a White House study and a 2004 SEC paper. We briefly discuss each of these papers.

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[25] *See* David Blanchett and Paul Kaplan, "Alpha, Beta, and Now… Gamma," *The Journal of Retirement* (Fall 2013). An earlier version is available from Morningstar at https://corporate1.morningstar.com/uploadedFiles/US/AlphaBetaandNowGamma.pdf.

[26] *See* David Blanchett, "When to Claim Social Security Retirement Benefits," *Journal of Personal Finance*, 11(2), 2012. Also see Wade Pfau, "The Value of Sound Financial Decisions: From Alpha to Gamma," *Forbes*, online edition, available at https://www.forbes.com/sites/wadepfau/2016/05/05/the-value-of-sound-financial-decisions-from-alpha-to-gamma/#7127ba7255df.

[27] The BCT paper indicates that broad equity funds (i.e., excluding foreign equity funds), underperform direct sold funds by anywhere from as little as 23 basis points to as much as 88 basis points, depending on how they risk-adjust fund returns.

[28] *See*, Vanguard research, "Putting a value on your value: Quantifying Vanguard Advisor's Alpha", (September 2016), https://www.vanguard.com/pdf/ISGQVAA.pdf.

[29] *See* Consultation at 128, citing a paper by The School of Public Policy at the University of Calgary.

[30] *See* Consultation at 128, citing Stephen Foerster, Juhani Linnainmaa, Brian Melzer and Alessandro Previtero, "Retail Financial Advice: Does One Size Fit All?," NBER Working Paper 20712, (2014), available at http://www.nber.org/papers/w20712.

● *White House study.* The CSA cites the White House study in support of the view that conflicted advice may negatively affect US investor outcomes. The CSA states that the White House study found that "conflicted advice leads to lower investment returns. Savers receiving conflicted advice earn returns approximately 1 percent point lower each year." The White House study, however, undertakes no independent analysis. Instead, it simply seeks to summarize and synthesize results from a number of academic studies, including those discussed in this Appendix.

It should be apparent from the discussion around Figure 2 above, however, that the White House conclusion is not supported by recent studies comparing performance of US broker-sold to US direct-sold funds. Even a highly selective reading of those studies suggests that broker-sold funds underperform by at most 64 basis points. But the broadest, most comprehensive, and most pertinent measures of fund performance—including those provided by the DOL itself—offer little support for the contention that US broker-sold funds dramatically underperform (see Figure 2, lines 4, 6 and 7). At most, the evidence suggests broker-sold funds might underperform very modestly. Further, even if so, as the BCT paper suggests, investors might be willing to bear this modest cost in exchange for the valuable "intangible" financial advice that brokers provide.

● *SEC paper.* The CSA cites as evidence a 2004 study by the Office of Economic Analysis of the SEC as highlighting that trail commissions (*i.e.*, 12b-1 fees) might create conflicts of interest. Namely, the CSA summarizes the SEC paper as indicating that "investment fund managers use fund unitholder money to pay for asset growth from which the investment fund manager is the primary beneficiary through the collection of higher fees and the unitholders are not obtaining the benefits they should from the payments of 12b-1 fees."[31]

At root, the issue that the SEC's paper tries to tackle is whether investors who seek advice should pay for it through a disclosed front-end load rather than a trailing commission paid inside the fund. The SEC paper seems to conclude that advice-seeking investors will always be better off paying a front-load fee.[32] The SEC's paper, however, did not take into account an investor's holding period. A 2004 paper by ICI staff shows that shorter-term investors, when faced with the choice of paying for advice through a front-load fee or a trailing commission, will generally be better off paying a trailing commission.[33] Longer-term investors will generally be better off paying a front-load fee. Figure 1 illustrates the same message.

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[31] The quote is drawn from the Consultation, not the SEC paper.

[32] The SEC paper argues that "If 12b-1 plans constitute a net benefit to investors, the amount of the annual fee should be recovered through higher net returns. Higher net returns could derive from either lower expense ratios due to economies of scale or higher gross returns due to the enhanced capacity of funds to either invest in assets with higher yields or reduce transactions costs. Overall, the results are inconsistent with this hypothesis. 12b-1 plans do seem to be successful in growing fund assets, but with no apparent benefits accruing to the shareholders of the fund." There is, however, another possibility. It could be that investors pay for the assistance of a broker or other financial adviser through a 12b-1 fee. Although this reduces the net return an investor may receive on any given fund, the investor's overall portfolio return may be higher because, for example, the broker provides advice on which group of funds to select in light of the investor's characteristics and market conditions, when to rebalance, when and how to drawn down balances for retirement in order to minimize taxes and so forth. The SEC study does not measures the increased returns investors may experience from the "intangible" benefits of better overall financial decision-making.

[33] *See* Sean Collins, "The Effect of 12b-1 Plans on Mutual Fund Investors, Revisited," working paper, Investment Company Institute, 2004, available at https://ssrn.com/abstract=522442.

In sum, the SEC paper is not about whether investors are better off paying for advice versus not paying for advice. It is about whether investors are better off paying for advice through front-load commissions or through ongoing asset-based fees. As the paper by ICI staff shows, there is no single "right" answer. It depends on the individual's characteristics.

In addition, it is worth noting that the SEC paper was published in 2004 and the results are thus somewhat dated. The US advice market has changed significantly since then, with a shift away from the payment of commissions through front-load fees toward the payment for advice using asset-based fees outside of the fund. Because the paper is somewhat dated, and the issue the paper addresses is whether investors are better off paying front-load versus trailing commissions inside the fund, the CSA may wish to reconsider the relevance of this paper for the issues at hand.