

Will Rules in Other Countries Lead to New Regulations in Canada?

The U.K., Australia and the Netherlands have banned embedded fees. Australia has imposed a “best interest duty” on advisors. Are these types of rules likely to be introduced in Canada?

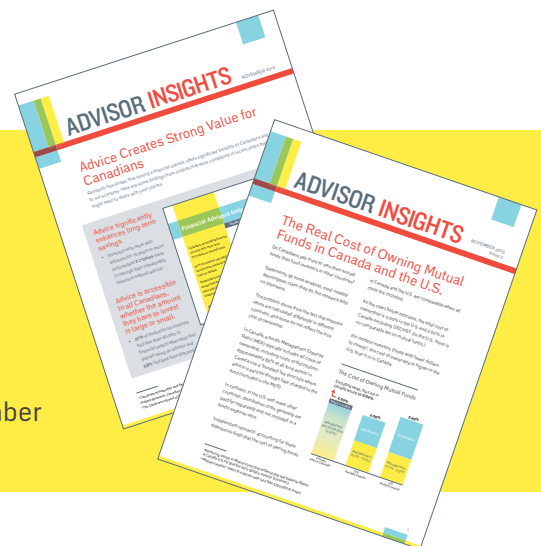
Securities regulators in Canada and internationally have increased their focus in recent years on regulatory reforms aimed at improving investor protection and enhancing the investor experience.

This issue of *Advisor Insights* looks at one area under regulatory review: advisor compensation. Specifically, it:

1. Summarizes changes to fees options recently implemented in the U.K., Australia and the Netherlands and identifies some unintended consequences that have arisen;
2. Highlights unique aspects of the Canadian marketplace that are relevant to regulatory decision-making in Canada; and
3. Suggests opportunities for advisors to help advance regulators’ goals within the current framework by supporting investor understanding of their account statements and encouraging investors to be fully engaged in their investment decisions.

Advisor Insights is published several times per year by The Investment Funds Institute of Canada (IFIC). In addition, IFIC has developed a series of plain-language tools to help dealers and advisors prepare to implement CRM2. Advisors are welcome to share these materials with their clients.

For more information, visit IFIC.CA > Member Centre > Member Resources.



How Canada Compares

Canada's regulatory environment has some unique features (described below) that bear careful consideration when considering regulatory changes. The industry in Canada is actively engaged in reminding local regulators of the importance of tailoring global standards to reflect Canada's legal, market and regulatory structures, policy priorities, industry business models and investor preferences.

| | Foreign Regulatory Approaches | The Canadian Context |
|------------------------------------|---|--|
| Impetus for Changes | The U.K., Australia and the Netherlands banned embedded fees in direct response to mis-selling and corporate corruption scandals. | Canada has not experienced any such market failures. |
| Regulatory Scope | <p>Most foreign regulators that have imposed stringent reforms on financial advice have broad mandates that include insurance, investment, mortgage and other commission-driven financial products.</p> <p>When measures are applied to all financial products, there is equitable treatment among products. This supports investor understanding and avoids regulatory arbitrage. These are important principles to achieve; however, it remains equally important to consider the potential for unintended consequences before new measures are put in place.</p> | Most Canadian securities regulators have no jurisdiction over non-securities investment products. |
| Market Conduct Oversight | Jurisdictions outside of Canada do not have dedicated market conduct oversight agencies – an important contributing factor to the mis-selling and corruption that triggered fee bans. | Canada's robust regulatory framework includes self-regulatory organizations (IIROC, MFDA and CSF) ¹ that provide dealers and advisors with ongoing guidance, clear rules, enforcement and compliance. This brings added oversight of market conduct activities not present in many foreign jurisdictions. |
| Advice Options | In at least one jurisdiction (the U.K.) that banned embedded fees, the options for receiving advice have narrowed significantly, as higher costs made advice unaffordable, especially for smaller accounts. The interim chair of the U.K.'s Financial Consumer Agency recently acknowledged that the ban has had some negative consequences, including making it difficult for smaller investors to obtain advice. | Canada has a wide range of distribution and compensation models available to investors. The most common model – embedded fees – delivers access to advice for investors of all levels, including those just beginning to save and those with limited amounts to invest. |
| Transparency and Disclosure | The U.K. and Australia are only now turning their attention to improving the quality and amount of cost disclosure. | Canada is leading the world in providing meaningful disclosure to investors through the development and delivery of Fund Facts and CRM2. |

¹ IIROC is the Investment Industry Regulatory Organization of Canada.
MFDA is the Mutual Fund Dealers Association of Canada.
CSF is the Chambre de la sécurité financière (in Quebec).

Is There a Relationship Between Fees and Product Recommendations?

The Canadian Securities Administrators (CSA) commissioned two research reports to help inform their deliberations on whether to make any changes to the fee structure.

The first report – a literature review undertaken by the Brondesbury Group – summarizes existing global research on the extent to which the use of fee-based vs. commission-based compensation changes the nature of advice and investment outcomes over the long term. The second report – undertaken by Professor Cumming – uses sales data from fund manufacturers to study the relationship between fund fees, net flows and performance.

Around the same time, IFIC retained Investor Economics to analyze all factors that influence fund flows.

The reports found some associations between compensation and fund sales. The Cumming research found patterns suggesting that trailers might be influencing sales. The Brondesbury report concluded that product recommendations sometimes favour more compensation for the advisor. The Investor Economics report identified 40 factors that influence fund sales and redemptions, with fee levels far down the list. It found that there is a “tenuous” relationship between trailer levels and fund sales, and that higher trailers may have an influence in containing redemptions.

Taken together, the three reports provide some insights into the relationships between mutual fund sales, compensation structures and other factors. However, due to the limits of their mandates, none of the reports were able to evaluate sales and redemptions in the context of the investor experience and the additional factors that come into play at the account level (e.g. portfolio diversification, risk tolerance, tax strategies, or the potential trading costs of “chasing performance”).



Indeed, the Brondesbury report points out that there is no such thing as a “behaviourally neutral” compensation scheme: there is inherent conflict even within fee-based arrangements and there is no empirical evidence that investors have greater after-fee investment returns with fee-based compensation.

Where Do Canada's Regulators Stand?

Canadian regulators are strongly committed to protecting investors. Some of the ways they aim to do so are by requiring full disclosure of information material to investment decisions, and educating investors about the risks and responsibilities of investing.

Over the past few years, the regulators have introduced a robust disclosure regime, including CRM1 and 2, Funds Facts and ETF Facts. All of these initiatives put Canada firmly at the forefront of the world when it comes to investor disclosure.

The CSA is studying whether additional actions, such as banning embedded fees and imposing a best interest standard, are warranted. IFIC supports the CSA's research-based approach to decision-making. The research reports that were done last year, combined with evidence from international jurisdictions that have changed compensation rules, are useful inputs to inform future CSA decision-making.

More research is needed. It is important for regulators to assess how well Fund Facts and CRM2 improve investor engagement and decision-making before making further regulatory changes. The CSA is proceeding with multi-year research to assist with its assessment.

In the meantime, according to CSA staff, the regulators will release two documents for discussion in 2016 that will provide guidance on future potential regulation with respect to a best interest standard and advisor compensation. We expect regulators to consult further with the industry and other stakeholders before making final decisions.

Opportunities for Advisors

The Canadian investment funds industry shares our regulators' commitment to improve the investor experience. Our goal is to ensure that investors are well-served and can make better decisions based on increased knowledge and understanding.

As the industry's main points of contact with investors, you have a key role to play and a potential opportunity to impact regulators' future decision-making. You can do this by:

- Helping your clients be clear about their tolerance for risk;
- Encouraging your clients to ask questions about their investments and the fees they pay;

- Prompting your clients to ask questions before accepting your recommendations; and
- Ensuring that your investment recommendations are suitable and that they deliver the best value to your client.

Job one for the industry is to support you in understanding the two new reports that investors will receive under CRM2 and the concepts that they address, so that you are ready to have meaningful discussions with your clients about the information. IFIC has produced clear, plain-language materials to help inform advisors and educate clients regarding CRM2, the value of advice and other relevant topics. You are welcome to share these materials with your clients.

Prepared by



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