

## **A MAJOR SETBACK FOR RETIREMENT SAVINGS: CHANGING HOW FINANCIAL ADVISERS ARE COMPENSATED COULD HURT LESS-THAN- WEALTHY INVESTORS MOST<sup>†</sup>**

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### **SUMMARY**

If regulators were to simply outright prohibit Canadians with low and middle incomes from seeking financial advice, it would obviously constitute a massive setback for individual wealth accumulation and, ultimately, for the economy. In Canada, after all, the well-being of a large proportion of retirees relies heavily on their voluntary personal and private wealth accumulation, in part due to the shrinking proportion of Canadian employees covered by a defined-benefit pension plan. As it is, between a quarter and a third of households of all income levels not covered by a defined-benefit plan are not set up to retire comfortably. And yet, currently, regulators are entertaining a change to the financial services industry that will almost certainly have the net effect of keeping the vast majority of Canadians from accessing financial advice. It is not quite a ban, but given the effect it will have, it almost could be.

The role of financial advice is pivotal in helping people prepare for retirement. Evidence shows that the average individual's knowledge of basic financial products and concepts is quite limited. Research indicates that Canadian households using a financial adviser to assist in saving and investment matters and plan their retirement accumulated 1.58 times as much wealth as did non-advised households after four to six years; after 15 years, that had increased to 2.73 times. That has an effect on the rest of society, too, since wealthier retirees enjoy a better quality of life, are less burdensome on government income supplements and contribute more to the economy.

One thing that could prove immensely counterproductive to helping Canadians access financial advice to better prepare for retirement is the proposal, being considered by regulators, to unbundle adviser fees from financial products. The rationale for the move is compelling: If advisers receive different commissions depending on the financial products they convince their clients to purchase, the advisers are *prima facie* in a conflict of interest situation. There is an incentive for them to recommend products

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<sup>†</sup> The opinions expressed in this paper are those of the author and do not necessarily reflect the views of Dentons Canada.

that offer them higher commissions — and to turn over their sales (or churn) more frequently — even if the recommendations are not in the best interests of their clients.

That may seem entirely logical, although studies that investigate adviser behaviour have found surprisingly little evidence that advisers provide unsuitable advice as a matter of course and that other structures of remuneration lead advisers to adopt practices that are better aligned with their clients' interests. Indeed, research has found that turnover is even higher in unbundled fee-for-advice portfolios and that advisers tend to recommend to their clients investments that they, themselves, place in their own portfolio. Nevertheless, one thing arguably more problematic than clients receiving potentially conflicted advice is clients not having access to any advice at all. And based on the experience of other jurisdictions that have ordered fees to be unbundled and instead be structured as upfront fees, that is the result that ends up occurring for investors below a certain income level. In the U.K., after the decision was made to unbundle fees, the number of financial advisers fell from more than 40,000 in 2011 to just over 31,000, and has not recovered. Major banks, meanwhile, cancelled their financial advice services for clients that had only modest assets. The opening of investment accounts worth less than 100,000 pounds fell by half. After Australia required fees to be unbundled, there was a similar effect.

There is little to suggest that Canadians would not be left with the same income-related “advice gap” were regulators to require fees unbundled here. Simply put, many clients are unwilling to pay upfront for unknown results. And any reform that causes investors to separate from their advisers, or to never hire one, would be counterproductive to the public policy goals of helping Canadians better prepare for retirement. If it is adviser conflicts that regulators are worried about, there are better ways to address them — for example, the regulatory regime governing fiduciary duty and the potential to enhance the competencies, proficiency and professionalism of financial advisers — than creating a system that results in fewer people providing financial advice, and fewer people willing to seek it.

*“A man should always place his money, a third into land,  
a third into merchandise, and keep a third at hand”*

*Babylonian Talmud: Tractate Baba  
Mezi'a, folio 42a*

## 1. INTRODUCTION

Financial advice to the citizenry has a long pedigree, with good cause. Sound financial advice contributes to the generation of positive externalities in much the same way as education and other public goods do. The economic superiority of a more educated and financially astute population invariably leads to greater prosperity. When they are well advised, people exhibit greater levels of confidence and empowerment in their personal financial affairs. They adopt and stick to sound saving habits, which lead to better economic status, particularly in their post-retirement period. These powerful effects of sound financial advice are shared by their recipients and the rest of society.

Seeking to improve the quality of financial advice in retail markets, regulators in Canada and abroad have been focusing on how financial intermediaries deliver advice to their clients, the standards that apply to financial advice and how it is paid for. A key objective of their initiatives is to ensure that the advisers' recommendations are not tainted by personal considerations that might work to the detriment of their clients. A common measure is to significantly augment disclosure requirements.<sup>1</sup> While the scope of other initiatives varies, across jurisdictions regulators seek to impose higher standards for advisers and revamp compensation structures, some having gone as far as imposing a ban or cap on embedded or tied commissions on certain retail financial products. These regulatory trends have begun to echo in Canada. The Canadian Securities Administrators (CSA) has published a discussion paper on the appropriateness of adopting a statutory fiduciary duty for financial advisers when they provide advice to retail clients and another paper on mutual fund fees, the latter followed by two commissioned research reports. Both discussion papers take aim at practices such as embedded fees, trailing commissions, and other forms of tied compensation, implicitly suggesting that a prohibition to bundled financial advice with financial products may be the best course to follow.<sup>2</sup>

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<sup>1</sup> The Canadian Securities Administrators (CSA) initiatives are centered around: (i) the Fund Facts document; (ii) the Client Relationship Model-2 rule (CRM2) rule, which applies to mutual funds, ETFs, equities, and debt products; (iii) the requirement that investors be advised of the cost of an investment purchase in advance of trade and, (iv) changes to retail client statements that now must show book cost or original cost for each security to be completed by the end of 2016 with the addition of performance and costs in dollar terms. The European Council adopted similar disclosure rules in May 2014. Effective January 2017, the MiFID II will require firms to provide consumers with information about all costs and charges related to both investment and ancillary services, including the cost of advice, the cost of the financial instrument, and any third-party charges. Costs must be provided in aggregate and show the cumulative effect on investment return, with an itemized breakdown provided upon client request.

<sup>2</sup> CSA, “The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness in Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients,” Consultation Paper 33-403 (October 25, 2012); and CSA, “Mutual Fund Fees,” Discussion Paper and Request for Comment 81-407 (December 13, 2012). The latter was followed by two studies commissioned by the Ontario Securities Commission (OSC) on behalf of the CSA: Edwin Weinstein, *Mutual Fund Fee Research* (The Brondesbury Group, 2015); and D. Cumming, Sofia Johan and Yelin Zhang, *A Dissection of Mutual Fund Fees, Flows and Performance* (OSC, October 2015).

The main impetus for these initiatives by regulators is typically the potential impact of the measures on the behaviour of financial advisers and the investment performance of individual portfolios. Relatively less consideration is given to the demand and supply sides of the equation: how will the new regulations affect individual investors' demand for and access to financial advice and products? How will the availability and delivery of financial advice be impacted as financial intermediaries strive to adapt to the new environment? And, what will be the likely consequences on wealth accumulation by households imparted by the combined changes induced by the new regulatory regime?

This paper seeks to provide answers to these questions. We find that critics of current embedded compensation practices tend to base their policy prescriptions on a truncated analysis of the likely consequences that would unfold if implemented.<sup>3</sup> These consequences are much broader and pervasive than investment outcomes. From a public-policy point of view, the "outcome" that truly matters is the impact of financial advice on households' accumulation of financial wealth and, therefore, how it is affected under different remuneration models. We make the case that voluntary personal savings are unlikely to deliver adequate retirement income unless individual investors have access to expert advice from competent and well-regulated professional advisers and asset managers on terms that are reasonable and conform to their expressed preferences, regardless of whether advice is delivered using commission- or fee-based advice models.

We begin by taking stock of the challenges confronting the vast majority of Canadians not covered by a defined benefit pension plan to self-accumulate enough wealth to ensure their well-being in retirement. We show why individuals seek (or should seek) expert advice in personal investment matters and describe the regulators' concerns stemming from the asymmetric knowledge relationship between financial advisers and their retail clients and the manner through which these services are generally paid for. We consider the benefits stemming from sound financial advice. We argue that the social welfare implications of affordable and readily accessible financial advice confirm its value and superiority over other means to assist Canadians in adopting sound personal saving habits, make ongoing investment decisions which are in their long-term interests and, as a result, accumulate larger amounts of wealth.

We address the issue of trust in the retail financial services sector. The propensity of financial consumers to seek financial advice is predicated on their level of trust in the system and their belief that their financial adviser is dependable and can be relied upon to serve their interests. There is no denying that the principal-agent relationship between a financial adviser and his clients expose them to both adverse selection and moral hazards. We consider the criticism that has been levied in this regard against the current regulatory regime and examine how well founded it proves to be.

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<sup>3</sup> For instance, the mandates given to the third parties commissioned by Canada Securities Administrators to perform research on mutual fund fees were defined as follows: (1) "Researchers, using data sourced directly from Canadian investment fund managers, would evaluate the extent, if any, to which sales and trailing commissions influence mutual fund sales"; and (2) "Researchers would conduct a literature review to evaluate the extent, if any, to which the use of fee-based vs. commission-based compensation changes the nature of advice and investment outcomes over the long term." Nowhere is there mention of the impact of different remuneration structures on the organizational structure and dynamics of the financial advice industry, on financial consumers' behaviour and the consequences of the adaptation of the industry and consumers to a new regulatory regime on savings practices and wealth accumulation.

In the core of the article we address the following question: why does the financial advice industry take the form and behave in the manner observed? We suggest that the answer resides in the economic nature of financial advice as a “credence good”<sup>4</sup> and the interaction of the intrinsic characteristics of the service provided with the idiosyncrasies of individual investors. The interplay between these factors has significant bearing on the preferences of consumers and the conduct of financial intermediaries, which explains to a large extent the bundling of financial products with financial advice that has traditionally prevailed in financial retail markets worldwide, notably in the distribution of mutual funds. The analysis offers insights into the market dynamics for financial advice and makes clear that in an environment where saving and investment decisions are left to individuals, the *seeking of advice* by financial consumers and the *delivery of advice* by the financial industry, and the interactions between these two dimensions, must be considered.

We continue with an examination of the changes set in motion when financial advice is unbundled from financial products in a country, either by regulatory fiat or market forces. The survey of the transformations that have occurred and continue to unfold in those jurisdictions accord with the conclusions derived from the economic analysis of retail markets for expert advice. The survey provides strong indications that the dynamic consequences unleashed by the prohibition of embedded commissions paid for financial advice would not conform to the advocates’ expectations but rather produce significant effects running counter to the retirement-policy objectives sought by Canadian governments. We note that, as in the United States, Canadian full-service brokerage firms have begun to shift their business model towards an asset-based-fee business, a transition, however, that is occurring in a marketplace that allows all options. While we recognize that digital technologies for delivering advice will provide opportunities to better engage and service clients, they also have the potential to disrupt the financial advice industry.

We conclude that competent and affordable financial advice, the need to expand the advised population and means to increase proficiency standards, promote industry best practices and enhance suitability requirements must figure prominently in the design of policies seeking to promote the financial autonomy of Canadians of all ages.

## **2. BACKGROUND: INDIVIDUAL SAVING AND INVESTMENT PRACTICES, THE ALLEGED SINS OF COMMISSIONS AND REGULATORY RESPONSES**

Financial advice is a huge matter. Canada’s retirement income system differs from that of most OECD countries in that, in Canada, the financial well-being of retirees relies much more on their individual and voluntary private and personal initiatives. This feature is

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<sup>4</sup> In economic terms, “credence goods” differ from “experience goods” and “search goods.” A search good is a product or service with features and characteristics that can be easily evaluated before purchase. An experience good is a product or service where the characteristics and features are assessable, but only after consumption or use. In the case of a credence good, its “utility” is difficult if not impossible to ascertain even after consumption. Arrow’s seminal exposition on “credence goods” pertained to under- and over-provision of health care. Kenneth Arrow, “Uncertainty and the Welfare Economics of Medical Care,” *American Economic Review* 53, 5 (December 1963): 941-973.

accentuated by the structural changes brought to the Canadian retirement income system<sup>5</sup> and the shift in the proportion of the labour force covered by defined benefit pension plans (DB plans) — which offer a guaranteed income stream in retirement — to defined contribution plans (DC plans) — which do not. In 2014, about 60 per cent of retirees received retirement income from a registered pension plan (RPP); significantly, only 38 per cent of employees were then enrolled in such a plan<sup>6</sup> and less than 25 per cent of the labour force was member of a DB plan (Figure 1). Of great significance is the fact that between 2000 and 2015, the proportion of private sector employees covered by a DB plan dropped from 22.4 per cent to 12.2 per cent.

**FIGURE 1 EVOLUTION OF MEMBERSHIP OF REGISTERED PENSION PLANS (000)**

	2000	2014	△
<b>Total Labour Force</b>	14,760	17,802	3,042
<b>Members of RPP</b>			
• Total	5,268	6,185	917
• Private sector plans	2,838	3,001	163
• Ratio (%)	53.9	48.5	-
<b>Members of DB plans</b>			
• Total	4,456	4,402	(54)
• Private sector plans	2,162	1,400	(762)
• Ratio (%)	48.5	31.8	-

Source: Statistics Canada, CANSIM tables 282-0038; 280-0016.

The direct effect of these changes in the Canadian retirement income system is a wholesale transfer of investment performance, inflation, longevity and market risks to individuals. They are real. In 2012, the difference in average wealth — defined as the total value of assets minus the total value of debt — among Canadian families with the same socioeconomic characteristics between those with and without RPP assets amounted to \$177,000 (\$536,000 versus \$359,000).<sup>7</sup> For the more than 75 per cent of Canadians in the labour force who are not members of a DB plan, accumulating enough wealth for a secure retirement is a tall order. According to a recent extensive survey, 25 per cent of Canadian households covered by a DC plan or group RRSP and 37 per cent of mid- to high-income households with no RPP will most likely have insufficient income to live comfortably in retirement.<sup>8</sup>

<sup>5</sup> The changes include: the decision made in the mid-1980s to index the old age security (OAS) benefits to the consumer price index (CPI) rather than to the index of average earnings; the postponement of the age of eligibility for the OAS and guaranteed income supplement (GIS) benefits from 65 to 67 years old for Canadians born after March 1958; and the changes made to the Canada and Quebec pension plans. Since the CPI will lag the productivity-driven growth in employment earnings, the living standards of a substantial number of older Canadians that rely on OAS for retirement income will erode compared to other Canadians. Under current conditions, the after-tax ratio of elderly income to non-elderly incomes is projected to fall between 2007 and 2040. Richard Jackson, Neil Howe and Keisuke Nakashima, *The Global Aging Preparedness Index* (Centre for Strategic and International Studies, October 2010).

<sup>6</sup> Office of the Superintendent of Financial Institutions (OSFI), “Registered Pension Plans (RPP) and Other Types of Savings Plans — Coverage in Canada” (2015).

<sup>7</sup> Statistics Canada, “Study: Employer pensions and the wealth of Canadian families, 2012” (January 2015).

<sup>8</sup> McKinsey & Company, “Building on Canada’s Strong Retirement Readiness” (2015), 9.

There's no escaping it: For the vast majority of Canadians presently in the workforce, the level of retirement income they can anticipate is increasingly determined by the amount of wealth they accumulate through participation in retail financial markets by the time they retire. Canadians generally take this individual responsibility seriously. Forty per cent of Canadians 25 years and over in the labour force — including about half of those that participate in an RPP — own an RRSP account, the highest rate of participation in an individual retirement-savings scheme amongst OECD countries, after Germany.<sup>9</sup> Implemented in 2009, the tax-free savings account (TFSA) program has attained a comparable level of market penetration, particularly in the low- and middle-income segments.<sup>10</sup> The 2012 survey of financial security reports that, excluding RPPs, the value of private pension assets and tax-free savings accounts amounted to \$1.024 billion, and that of non-pension assets amounted to \$1.047 billion, although the latter is skewed towards the most affluent households.<sup>11</sup> Overall, the data show that the number of Canadians making private savings is large, varies according to age and employment income, and that “those who should be privately saving for their retirement actually do.”<sup>12</sup>

It remains, however, that 80 per cent of Canadian households own less than \$100,000 in investible financial assets, which explains to a large extent the importance of mutual fund assets in households' balance sheets. Held by about 4.3 million households, mutual funds are the most common and important holding in RRSPs and in registered retirement income plans (RRIFs).<sup>13</sup> In total, the value of mutual fund assets owned by Canadians in January 2014 exceeded a trillion dollars (\$1,011.2 billion), an amount close to the market value of Canadian employer-sponsored pension funds, which stood at about \$1.2 trillion.<sup>14</sup> Thus, the significance of mutual funds extends well beyond their investment attributes: their distribution underpins large segments of the retail financial advisory industry, a dimension that must be given full weight in the design of retail distribution policies.

In the aggregate, the amount of financial assets accumulated by individual households is huge. The acid test is whether or not the savings accumulated by individual households are sufficient and invested with a long-term perspective in a manner such as to provide the levels of retirement income expected by future retirees. The numerical skills required to understand increasingly complex financial products, compare investment alternatives and decide which ones to select call for extensive knowledge. International research on financial literacy suggests that consumers' knowledge of basic financial concepts and products is quite limited. This stems from the low level of literacy and numeracy prevailing in general

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<sup>9</sup> OECD, “Pensions at a Glance” (2013).

<sup>10</sup> In 2013, 23 per cent of tax filers contributed to an RRSP whereas 27 per cent of tax filers contributed to a TFSA. OSFI, “Registered Pension.”

<sup>11</sup> The median amount for family units holding non-pension financial assets was only \$9,900. Statistics Canada, Cansim Table 205-0002, “Survey of Financial Security (SFS), composition of assets (including Employer Pension Plans valued on a termination basis) and debts held by all family units, by age group, Canada and provinces”; and Statistics Canada, *Survey of Financial Security* (2012).

<sup>12</sup> Alexandre Laurin, “The Overlooked Option for Boosting Retirement Savings: Higher Limits for RRSPs” (C.D. Howe Institute, September 2014), 1.

<sup>13</sup> Canadian Security Administrators, *CSA Investor Index* (October 2012).

<sup>14</sup> The market value of Canadian employer-sponsored pension funds totalled \$1,228.7 billion at the end of the second quarter of 2013. Statistics Canada, Cansim Tables 280-0002 to 280-0004 (December 2013).

populations. Canada is no exception.<sup>15</sup> The lack of financial sophistication and pervasive human biases in decision-making limit households' ability to make sound financial decisions.<sup>16</sup>

Surveys of individual investors paint a consistent picture: individual investors that make investment decisions on their own tend to overestimate their financial knowledge and investment savvy.<sup>17</sup> This bias is confirmed by the results of a survey of Quebec and Ontario self-directed individual investors. Although only five per cent of the respondents had a financial knowledge score higher than 66 per cent, 22 per cent of the respondents believed they would realize returns equal or superior to that of the market.<sup>18</sup> Another survey revealed that only 17 per cent of investors had realistic expectations about the annual rate of return of their personal investment portfolio.<sup>19</sup> The U.S. Federal Reserve Board reports that 29.2 per cent of American investors who hold stocks in their portfolio owned the shares of only one company and 53.0 per cent own between two and nine companies.<sup>20</sup> These results are consistent with the investment pattern of Canadian investors: 59 per cent of Canadian investors who actively invest in stocks think there is no systematic relationship between risk and return and fail to diversify their portfolio.<sup>21</sup>

A second hurdle investors face in making sound financial decisions arises from the pervasive behavioural biases in personal finance decision-making. Psychological and behavioural economic studies have documented that people do not always act in their own best interest, their financial decisions being influenced by heuristics, biases and emotion-coping mechanisms that often override welfare-enhancing decisions.<sup>22</sup> Their decisions are influenced by such psychological proclivities as hyperbolic discounting (the tendency to prefer short-term gratification — consumption — over longer-term returns — saving); inertia and status quo bias (there are no specific functional deadlines for action) and a propensity to push to a later date actions that require self-control (St. Augustine's prayer: "give me chastity and continence, but not yet"). When investors shake out of their status

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<sup>15</sup> The results of the 2012 International Assessment of Adult Competencies (PIAAC) shows that 55 per cent of Canadians aged 16 to 65 had a numeracy score below Level 3, which is defined as the "minimum for persons to understand and use information contained in the increasingly difficult texts and tasks that characterize the emerging knowledge society and information economy." The results concerning proficiency in literacy convey the same message, with 49 per cent scoring below Level 3. With respect to problem-solving in technology-rich environments (PS-TRE), 37 per cent of Canadians surveyed scored at Level 2 or 3 on the PS-TRE scale, slightly above the OECD average of 34 per cent. Statistics Canada, pub/89-555-X, 2013.

<sup>16</sup> This is documented in an extensive academic literature, including: James Banks, Cormac O'Dea and Zoë Oldfield, "Cognitive function, numeracy and retirement saving trajectories," *The Economic Journal* 120, 548 (2010): F381-F410; Luigi Guiso and Tullio Jappelli, "Financial Literacy and Portfolio Diversification," EUI Working Paper (European University Institute, 2008); Annamaria Lusardi and Olivia S. Mitchell, "Baby Boomers Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth," NBER Working Paper 12585 (National Bureau of Economic Research, October 2006); Annamaria Lusardi and Olivia S. Mitchell, "The Economic Importance of Financial Literacy: Theory and Evidence," *Netspar Discussion Papers* (April 2013).

<sup>17</sup> Lusardi and Mitchell, "The Economic Importance."

<sup>18</sup> Cécile Carpentier and Jean-Marc Suret, "Connaissances financière et rationalité des investisseurs: une étude canadienne," (CIRANO, 2011), 31.

<sup>19</sup> Canadian Security Administrators, *CSA Investor Index*, 4.

<sup>20</sup> Federal Reserve Board, *Survey of Consumer Finances* (2012), 34.

<sup>21</sup> Cécile Carpentier and Jean-Marc Suret, "Financial Knowledge and Rationality of Canadian Investors" (Quebec: Autorité des marchés financiers, 2012), 11.

<sup>22</sup> Daniel Kahneman and Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk, Choice, Values and Frames* (2000); and Daniel Kahneman, *Thinking Fast and Slow* (Toronto: Doubleday, 2011).

quo bias, their choices of financial products are characterized by an excessive focus on past performance, insufficient attention to asset allocation and a tendency to use inappropriate timescales over which to assess performance.<sup>23</sup> An extensive body of research demonstrates that these human traits make individuals prone to investment “mistakes” with the significant welfare implications and real consequences that accrue.<sup>24</sup>

To help solve these problems, many households turn for advice to financial intermediaries and the financial advisers in their employ. Their ambit ranges from technical experts who assist clients with complex financial transaction; generalists who, through “holistic” advice aimed at wealth accumulation, help households manage their financial affairs with a long-term perspective and attain greater financial security; and others that limit their engagement with retail clients to “transaction” events where the object of the advice pertains to a small investment at a point in time. The nature of financial services a financial adviser can provide is licensure dependent. In Canada, full-service brokers offer access to the widest range of investment products — individual securities as well as mutual funds, exchange-traded funds (ETFs) and deposit products — whereas advisers holding a mutual-fund-dealer’s licence are permitted to sell mutual funds and deposit products but not individual securities and derivatives. Investment advisers are regulated by one of three self-regulatory organizations. The Investment Industry Regulatory Organization of Canada (IIROC) regulates investment dealers, which include about 28,000 brokers. The Mutual Fund Dealers Association (MFDA) regulates the mutual fund dealers outside Quebec whereas, in Quebec, the *Chambre de la sécurité financière* performs this role. There are about 100,000 mutual fund “approved persons” across the country. Investor Economics reports that about 65 per cent of retail investment assets are held in accounts supervised by a financial adviser.

As a rule, financial advisers perform the dual functions of advising clients and selling financial products. Although the commingling of the advice and sale roles is typical of markets for technically complex products, it does provide ground for self-serving practices, which must be counterbalanced by an appropriate legal and regulatory regime.<sup>25</sup> Academics and policy-makers in Canada and abroad have questioned the appropriateness of arrangements where the compensation of the financial intermediaries providing advice is 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. The knowledge asymmetry inherent to the relationship between a financial adviser and his or her clients and the indirect compensation practices have led many influencers and regulatory agencies to assert that such arrangements are laden with irreducible conflicts of interest, that they incentivize advisers to provide unsuitable advice as a matter of course and, therefore, are unacceptable from an investor-protection

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<sup>23</sup> United Kingdom, *Medium and Long-Term Retail Savings in the UK: A Review* (2002).

<sup>24</sup> S. Benartzi and R. Thaler, “Naïve Diversification Strategies in Defined Contribution Saving Plans,” *American Economic Review* 91 (2001): 79-98; J. Dominitz, and A. A. Hung, “Retirement savings portfolio management, simulation evidence on alternative behavioural strategies,” *Journal of Financial Transformation* 24 (2007).

<sup>25</sup> Roman Inderst and Marco Ottaviani, *Markets with Advice: A Framework for Consumer Protection* (presented at Toulouse Conference on The Political Economy of the Financial Crisis, 2010).

point of view.<sup>26</sup> They are comforted in their position by academic studies comparing the performance of the portfolio of “advised” retail investors to benchmarks or index funds finding that, in several cases, the fees and commissions earned by financial advisers exceeded the investment return they added to an investor’s portfolio.<sup>27</sup>

Spurred by these concerns, the U.K. Financial Services Authority (FSA), the Australian Securities and Investments Commission and the Netherlands Authority for the Financial Market have adopted sweeping reforms whereby retail investors must pay financial advisers directly when purchasing investment funds and a range of other financial products and adviser firms are prohibited from taking commissions from product providers. In so doing, it is expected that the ban on bundling financial advice with financial products will lead to improvements in the quality of financial advice and make it easier for retail investors to exercise choices between investment options and financial services providers. This in turn, coupled with the greater transparency on fees and costs that is asserted to be a key benefit arising from the unbundling policy, is posited to lead to a net improvement in overall returns to individual investors.

The implicit assumptions that underlie the portfolio-performance studies make them poor guides for sound public policy making. The assumption that individuals that manage their financial affairs without the help of a professional adviser will accumulate the same, or more, amount of wealth than those who do is contradicted by empirical evidence. Investors who receive professional financial advice save more, accumulate more wealth and feel better prepared for retirement than non-advised individuals with similar socio-economic characteristics.<sup>28</sup> These findings provide a strong indication that the value of professional advice cannot be confined to “stock-picking” and “market-timing” savvy. The academic literature on the use of external sources of advice suggests that individuals with higher education and financial sophistication are more likely to use “formal” sources of information and advice as opposed to “informal” ones, such as friends, relatives and colleagues.<sup>29</sup> This constitutes a strong indication that working with a financial adviser facilitates the search for information about various savings and investment options, thus leading to more-informed decisions, and it suggests that recognition of the benefits of financial advice and, therefore, of the willingness to pay upfront for the advice, depends on the level of wealth, formal education and financial knowledge of the investor.<sup>30</sup>

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<sup>26</sup> Keith Ambachtsheer, “Comment Letter,” CSA Discussion Paper and Request for Comment 81-407: Mutual Fund Fees (2013); Edward Waitzer, “Misdirected criticisms prove need for more reform in financial services,” *Financial Post*, November 2013.

<sup>27</sup> Diane Del Guercio and Jonathan Reuter, “Mutual Fund Performance and the Incentive to Generate Alpha,” *The Journal of Finance* 69, 4, (2014): 1673-1704; Andreas Hackethal, Michael Haliassos and Tullio Jappelli, “Financial advisers: A Case of Babysitters?” *Journal of Banking and Finance* 36, 2 (2012): 509-524; Stephen Foerster et al., “Retail Financial Advice: Does One Size Fit All?” NBER Working Paper No. 20712 (2014).

<sup>28</sup> Claude Montmarquette and Nathalie Viennot-Briot, “Econometric Models on the Value of Advice of a Financial Advisor” (2012); Terrance Martin and Michael Finke, “A Comparison of Retirement Strategies and Financial Planner Value,” *Journal of Financial Planning* 27, 11 (2014): 46-53.

<sup>29</sup> Annamaria Lusardi and Olivia S. Mitchell, “Baby Boomers Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth,” Working Paper 12585 (National Bureau of Economic Research, October 2006); Maarten Van Rooij, Annamaria Lusardi and Rob Alessie, “Financial Literacy, Retirement Planning, and Household Wealth” (2008); Danielle D. Winchester, S.J. Huston and M.S. Finke, “Investor Prudence and the Role of Financial Advice,” *Journal of Financial Service Professionals* (2011).

<sup>30</sup> Michael S. Finke, Sandra J. Huston and Danielle D. Winchester, “Financial Advice: Who Pays” (Association for Financial Counselling and Planning Education, 2011).

For sure, portfolio performance is an important consideration. Although all investors value higher net portfolio returns, a large proportion of investors seek both financial advice and portfolio returns and are willing, within reasonable limits, to trade-off after-fee returns with financial advice and services to achieve their overall objectives. Weighing in on the embedded remuneration issue, the Securities and Exchange Commission (SEC) is emphatic that, contrary to the direction followed in some jurisdictions, it harbours no intention to prohibit the use of fund assets to pay sales costs, stating “that a portion of asset-based distribution fees (i.e., asset-based sales charges) functions like a sales load that is paid over time.”<sup>31</sup> Within the bounds generally accepted for sales commissions and adequate disclosure, it has stated that the practice does not constitute an unwarranted use of fund assets and it would not benefit individual investors to deny them the ability “to pay for distribution services over time.” Their position is supported by the findings of studies that have focused on this aspect, which conclude that, contrary to received wisdom, it would be welfare-reducing to force investors with a revealed preference for personalized advice that self-select into the advice channels to forego these services, despite the lower after-fee returns.<sup>32</sup> Nor have French securities regulators been swayed by the arguments in favour of unbundling (except for discretionary portfolio management and managers of funds of funds), indicating that a move away from commission- to fee-based advice is likely to lead to account churning with its concomitant negative impact on portfolio returns. The evidence indicates that their concerns are well founded.<sup>33</sup> At the European Union level, effective January 2017, financial firms that advertise themselves as providing advice or portfolio management on an “independent basis” will be precluded from receiving commissions or other monetary benefits from any third party in relation to these services. Notably, this prohibition will not apply to firms that do not portray themselves to retail clients as “independent,” including vertically integrated financial firms.

In considering the best way forward from a social point of view, a good starting point is to consider the following question: since the welfare cost of saving too little for retirement is much greater than the cost of saving too much, why are modern societies confronted with the former when self-interest should lead to the latter situation? Examination of the price elasticity of savings indicates that the behavioural responses to price incentives to saving are not particularly large.<sup>34</sup> This relatively small impact on incremental savings suggests that, in the Canadian context, insufficient wealth to ensure well-being in retirement will not primarily result from a lack of financial incentives but from the consequence of inadequate competencies in the management of household finances accentuated by psychological and other factors not accounted for by standard theories about savings for retirement and policy solutions.<sup>35</sup> Moreover, irrespective of the amount of savings Canadians accumulate during their active life, a large majority of households remain exposed to the vagaries of

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<sup>31</sup> Securities and Exchange Commission, “Mutual Fund Distribution Fees: Confirmations,” File No. SD7-15-10 (July 2010), 37.

<sup>32</sup> Diane Del Guercio, Jonathan Reuter and Paula A. Tkac, “Broker Incentives and Mutual Fund Market Segmentation” (National Bureau of Economic Research, 2010).

<sup>33</sup> Strategic Insight, “A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders’ Total Costs in the U.S. Mutual Fund Industry” (2012), 23.

<sup>34</sup> B.C. Madrian, “Matching Contribution and Savings Outcomes: A Behavioural Economics Perspective,” in *Matching Contributions for Pensions: A Review of International Experience*, ed., R. Hinz et al. (Washington, D.C.,: Word Bank, 2013), 289-310.

<sup>35</sup> Richard H. Thaler and Cass R. Sunstein, *Nudge* (New York: Penguin Books, 2009).

financial markets<sup>36</sup> and can expect dramatic fluctuations in fortunes between members of a cohort unless they adopt investment strategies that reduce the impact of market shocks.<sup>37</sup> Consideration must also be given to the fact that, as a growing number of Canadians reach retirement age, the expert-advice needs shift to how retirees use their savings and draw down their wealth in retirement.<sup>38</sup>

Hence, the key issues raised by a mandatory unbundling policy are whether their implementation will: (i) bring about the desired change in behaviour; (ii) broaden access to financial advice; (iii) reduce or contain the cost of financial advice and, more generally, (iv) help Canadians accumulate more wealth than would be the case otherwise; and (v) assist retirees make an efficient draw-down of their wealth. That the imposition of such a rule on the Canadian industry would effectively yield the expected benefits is not a foregone conclusion.

### 3. THE SOCIAL BENEFITS OF PROFESSIONAL FINANCIAL ADVICE

In her pioneering work, Lusardi<sup>39</sup> provides strong evidence that wealth holdings were much improved by specific planning activities and, conversely, that households that gave little thought to retirement had far lower wealth than those who planned for it, even after controlling for many socio-demographic factors. Individuals “with a high propensity to plan not only accumulate more wealth, but also save more than those with a low such propensity.”<sup>40</sup>

Venti and Wise have shown that “the differences in saving choices among households with similar lifetime earnings lead to vastly different levels of asset accumulation by the time retirement age approaches.”<sup>41</sup> The capacity to plan for retirement is strongly associated

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<sup>36</sup> Retirement income from DC plans and financial savings are highly dependent on the date of retirement or that of conversion of financial wealth into an income stream since market values are cyclical. According to recent calculations by the OECD, assuming the same percentage of salary as pension contributions, the initial pension as a proportion of final salary of an American worker retiring at the peak of the dot-com boom was about 52 per cent compared to around 20 per cent for those retiring in 2012. Similar gyrations occur in all market economies. Investment schemes said to be more appropriate for retirement savings, such as target-date funds, remain subject to the effects of market volatility. For instance, according to Morningstar, the average value of U.S. target-date funds fell by 23 per cent in 2008 following the collapse of Lehman Brothers. In a nutshell, the glide path to retirement income may be much steeper for some than others depending solely on the state of financial markets at the date of retirement.

<sup>37</sup> P. Antolin, S. Payet and J. Yermo, “Assessing Default Investment Strategies in Defined Contribution Pension Plans” (OECD, 2010).

<sup>38</sup> James Poterba, Steven Venti and David Wise, “The Composition and Draw-Down of Wealth in Retirement,” NBER Working Paper 17536 (October 2011).

<sup>39</sup> Annamaria Lusardi, “Information, Expectations, and Savings,” in *Behavioural Dimensions of Retirement Economics*, ed. Henry Aaron (New York: Brookings Institution/Russell Sage Foundation, 1999), 81-115; Annamaria Lusardi, “Explaining Why so Many Households Do Not Save,” mimeo (University of Chicago, 2000).

<sup>40</sup> John Ameriks, Andrew Caplin and John Leahy, “Wealth Accumulation and the Propensity to Plan,” *Quarterly Journal of Economics* (2003): 1008-1009.

<sup>41</sup> Steven Venti and David Wise, “Choice, Chance, and Wealth Dispersion at Retirement,” NBER Working Paper No. 7521 (2000), 35.

with financial literacy and sophistication<sup>42</sup> and closely tied to working with an adviser.<sup>43</sup> A large proportion of households are unable to determine how current savings are likely to translate into income in retirement on account of limited financial literacy. According to a recent survey, only one-fourth of Canadian adults who are not yet retired have determined the amount of money they will need in retirement.<sup>44</sup> Surveys also show that households substantially underestimate the amount they need to save to achieve their anticipated annual household retirement income.<sup>45</sup>

Sticking to a plan requires a long-term perspective and a disciplined approach that eludes a large proportion of the population. Left on their own, individual investors are more likely to invest inefficiently (inappropriate asset mix, under-diversification, excessive trading, pro-cyclical tendency, etc.) and either not take the investment risk that is needed to achieve at least their long-term savings goals<sup>46</sup> or fall prey to the allure of market-timing and the chase for performance. Kinniry et al. suggest that the counteracting influence of financial advisers to these emotional urges “could be the largest potential value-add of the tools available to advisers.”<sup>47</sup> Their conclusions are supported by numerous academic studies finding that financial advice leads to better investment practices by retail investors.<sup>48</sup>

In terms of adequacy of retirement income, it is the wealth a household needs to accumulate to support the expected level and pattern of consumption at retirement that matters. This is where financial advice makes a difference through the influence it exerts on the establishment of financial goals and the discipline to follow through with appropriate savings and investment practices. Using the 2004 and the 2008 waves of the U.S. National Longitudinal Survey of Youth, Martin and Finkle found that, after controlling for socio-economic status, households that used a financial adviser and calculated retirement needs “saved \$233,617 more in retirement wealth than households that did not have 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.”<sup>49</sup> In Canada, the results of a rigorous econometric study show that, on average, individual investors assisted by a financial

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<sup>42</sup> David, Boisclair, Annamaria Lusardi and Pierre-Carl Michaud, “Financial Literacy and Retirement Planning in Canada,” NBER Working Paper No. 20297 (July 2014).

<sup>43</sup> Mitchell Marsden, Cathleen D. Zick, Robert N. Mayer, “The Value of Seeking Financial Advice,” *Journal of Family and Economic Issues* 32, 4 (2011): 625-643.

<sup>44</sup> Royal Bank of Canada, “Canadians cut their Retirement Savings Goal by more than \$200,000,” News Release (2013).

<sup>45</sup> Gopy Shah Goda, Colleen Flaherty Manchester and Aaron Sojourner, “What Will My Account Really Be Worth? An Experiment on Exponential Growth Bias and Retirement Saving” (NBER, 2012).

<sup>46</sup> David Blake and Alistair Haig, “How Do Savers Think About and Respond To Risk?” (Cass Business School, 2014), 10.

<sup>47</sup> Francis M. Kinniry Jr. et al., “Putting a value on your value: Quantifying Vanguard Adviser’s Alpha” (Vanguard Research, 2014), 16.

<sup>48</sup> These include: With respect to portfolio diversification, M. Kramer, “Investment Advice and Individual Investor Portfolio Performance” (2009); and Marc M. Kramer and Robert Lensink, “The Impact of Financial Advisers on the Stock Portfolios of Retail Investors” (University of Groningen, March 2012). On asset mix and investment conservatism: Blake and Haig, “How Do Savers,” and Cathleen D. Zick and Robert N. Mayer, “Evaluating the Impact of Financial Planners,” in *The Market for Retirement Financial Advice*, ed. Olivia S. Mitchell and Kent Smetters (Cambridge: Oxford University Press, 2013), 153-181; and Joa Cocco, Francisco Gomes and Pascal Maenhout, “Consumption and Portfolio Choice over the Life-cycle,” *Review of Financial Studies* 18 (2005): 490-533. And on the cost of “reckless conservatism”: Laurent E. Calvet, John Y. Campbell and Paolo Sodini, “Down or Out: Assessing the Welfare Costs of Household Investment Mistakes,” *Journal of Political Economy* 115, 51 (2007).

<sup>49</sup> Terrance Martin and Michael Finke, “A Comparison of Retirement Strategies and Financial Planner Value,” *Journal of Financial Planning* 27, 11 (2014): 46-53.

adviser accumulate significantly more financial assets than did non-advised respondents with comparable age, income levels and other socioeconomic 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 2.73 times.<sup>50</sup> The contribution of financial advisers to the propensity to save and, thus, accumulate much larger financial asset balances, is illustrated in Figure 2.

**FIGURE 2 MEDIAN FINANCIAL ASSET LEVELS HELD BY CANADIAN HOUSEHOLDS**

	Non-Advised	Advised
Median financial assets	\$24,000	\$101,000
Mean financial assets	\$93,384	\$193,772

Source: Montmarquette and Viennot-Briot, 2012.

### 3.1. A quantitative assessment

The Conference Board of Canada simulated the economic impact over the long term of a scenario whereby 10 per cent of Canadians without a financial adviser obtained financial advice and adopted the saving pattern of presently “advised” investors. The simulations provide additional evidence of the contribution of financial advice to retirement readiness: a 10 per cent increase in the advised population would cause annual household net savings in 2025 to be \$812 million larger than in 2014, the base year.

**FIGURE 3 INCOME AND SAVINGS CHARACTERISTICS, BY AGE COHORT**

AGE COHORT	25-44			45-54		55-64	
	Proportion sample (%)	Average income (\$)	Savings rate (%)	Average income (\$)	Savings rate (%)	Average income (\$)	Savings rate (%)
With a financial adviser	49	78,622	10.6	87,862	11.4	88,850	13.7
Non-advised	44	63,018	8.5	66,129	8.2	65,882	9.2
Non-advised, active trader	6	77,381	12.6	88,634	14.0	86,653	14.1

Source: The Conference Board of Canada, Boosting Retirement Readiness, 2014.

The Conference Board estimates that five years after the increase in the advised population, real GDP and real disposable income are augmented, “business investment is boosted” and “potential output is higher over the long-term, representing a permanent increase in income and profits in the economy.”<sup>51</sup> These results are consistent with those obtained in Australia. A study of the key economic implications of an additional five per cent of Australians receiving financial advice, concludes that within a five-year period it would result in a 0.3 per cent of GDP gain in national saving compared to what would otherwise be the case.<sup>52</sup>

<sup>50</sup> Montmarquette and Viennot-Briot, “Econometric Models,” 9.

<sup>51</sup> Conference Board of Canada, “Boosting Retirement Readiness and the Economy Through Financial Advice” (2014), IV.

<sup>52</sup> KPMG Econtech, “Value Proposition of Financial Advisory Networks” (January 2011), IV.

The Conference Board simulations provide an indication of the magnitude of the welfare cost caused by a shrinking of the “advised” population. The consequence of a prohibition on embedded and trailing fees is likely to reduce by 20 to 30 per cent the number of individual investors that obtain or will seek professional financial advice.<sup>53</sup> Such a contraction is two to three times the size of the enlargement of the “advised” population postulated for the simulations; it is not unreasonable to suggest that the shrinking of the advised population would have roughly symmetrical economic costs to the estimated benefits stemming from a proportional increase in the advised population.

#### **4. TRUST: A KEY DETERMINANT OF THE DEMAND FOR PROFESSIONAL FINANCIAL ADVICE**

Trust is a key determinant of the engagement by individual investors in financial markets. Consumer surveys reveal that finding a financial adviser that is trustworthy is consumers’ first priority in their search for an adviser (followed by competence and a proven track record). Consumers rely on several mechanisms to gauge the degree of trust they can place in the quality of expert services and confide in an adviser. The brand name, relationship and service-quality factors that are generalizable across products and services offerings have been shown to be salient factors in the choice of financial intermediaries. Securities commissions convey a powerful signal about the quality and professionalism of the financial firms and financial advisers they regulate; an implicit representation that they will be dealt with fairly and in accordance with the standards of the industry. The existence of a regulatory body that provides oversight to a profession is a signal to consumers that they need not spend resources on costly monitoring in order to reduce self-serving behaviour by the adviser and that there is a mechanism for redress if that behaviour were to occur.

Trust is an essential determinant of the quality of a relationship,<sup>54</sup> it generates higher levels of co-operation between a supplier and its customers, leads a supplier to exert more efforts on behalf of his clients, enhances the credibility of the supplier, generates buy-in of recommendations and it shifts the focus of the relationship from the short to the long term.<sup>55</sup> Trust is particularly important in relationships where risk and information asymmetry are present since it mitigates opportunistic behaviours on the part of the supplier and is key to overall satisfaction.<sup>56</sup> Two factors are particularly relevant with respect to retail financial-services-consumption decisions. First, trust has a beneficial impact on a customer’s overall evaluation of a financial services relationship; second, trust plays a key role in reducing perceived risk and simplifying choices. The two are clearly interdependent. Trust — trust

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<sup>53</sup> Nick Chater, Steffen Huck and Roman Inderst, “Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective” (European Commission, 2010).

<sup>54</sup> J. Singh and D. Sirdeshmukh, “Agency and Trust Mechanisms in Consumer Satisfaction and Loyalty Judgments,” *Journal of the Academy of Marketing Science* (2000).

<sup>55</sup> A. Sunikka, L. Kapanen-Peura and A. Rajjas, “Empirical Investigation into the Multi-faceted Trust in the Wealth Management Context,” *International Journal of Bank Marketing* (2010); C. Ennew and H. Sekhon, “Measuring Trust in Financial Services: The Trust Index,” *Consumer Policy Review* (2007); P. Cox, “Should a financial service provider care about trust? An Empirical Study of Retail Saving and Investment Allocations,” *Journal of Financial Services Marketing* (2007).

<sup>56</sup> D. Thom et al., “Patient Trust in the Physical: Relationship to Patient Requests,” *Family Practice* (2002).

in advice and trust in consumer rights — is an essential ingredient that exerts a significant influence on the willingness of people to seek advice even though they are unable to ascertain whether or not the recommendations are the best in the circumstances.

A large European survey provides evidence that “households with lower financial capability need to trust financial advice in order to invest in stocks.”<sup>57</sup> The results of an extensive survey of individual investors who have and do not have a financial adviser are revealing: having a financial adviser significantly increases: (i) the trust towards a financial adviser (about 30 per cent more likely than a similar non-advised respondents); (ii) the confidence levels towards financial advisers (70.8 per cent have high confidence versus 32.1 per cent for non-advised respondents; and, (iii) significantly increases the investor’s confidence that he or she will have enough money to retire comfortably.<sup>58</sup> These results buttress those of annual surveys of mutual fund investors that indicate they trust their adviser to give them sound advice (94 per cent) and believe they obtain better returns on their investments than they would otherwise (90 per cent).<sup>59</sup>

The trust individual investors place in their financial adviser and their firm cannot be dismissed by asserting that “they do not know better” or that we are presented with 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.<sup>60</sup> These results are inconsistent with the argument that the level of trust observed through the surveys simply suggests that financial consumers are naturally trusting and credulous toward their financial adviser. In the discussions on embedded mutual fund fees, the near exclusive focus on answers to surveys of investors concerning their familiarity with the form of remuneration of their financial adviser misrepresents the full extent of the investor-financial adviser relationship. Among the factors that have an impact on the level of trust exhibited by retail investors, the financial adviser’s compensation does not produce statistically significant results.<sup>61</sup> 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 needs to be explicitly recognized. 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.

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<sup>57</sup> Dimitris Georarakos and Roman Inderst, “Financial Advice and Stock Market Participation” (Goethe University, 2014), 1.

<sup>58</sup> Montmarquette and Viennot-Briot, “Econometric Models,” 9.

<sup>59</sup> Pollara, “Canadian Investors’ Perceptions of Mutual Funds and the Mutual Fund Industry” (The Investment Funds Institute of Canada, 2013).

<sup>60</sup> Finke, Huston, and Winchester, “Financial Advice”; Jason West, “Financial adviser participation rate and low net worth investors,” *Journal of Financial Services Marketing* (2012).

<sup>61</sup> Finke, Huston, and Winchester, “Financial Advice.”

## 4.1. The principal-agent conundrum

It is unreasonable to expect no welfare losses from the delegation of decision-making to professional advisers. There is no denying that the principal-agent relationship between a financial adviser and his clients expose them to both adverse selection and moral hazard. The friction inherent to a principal-agent relationship, the incentives embedded in the remuneration structure, whichever its form, and the information asymmetry between the parties combine to dissipate some of the gains from professional financial advice that would accrue under aseptic conditions.

There are myriad situations where professionals face conflicts of interest when they advise clients on whether they should pursue one or another course of action. The most commonly prescribed remedy to mitigate the risks stemming from “conflicted” situations is disclosure. In certain circumstances, this “solution” may have perverse effects. For instance, it has been shown 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.<sup>62</sup> Subsequent studies show that other institutional factors, including sanctions, can effectively mitigate these effects of disclosure.<sup>63</sup>

Clearly, the legal regime that governs the conduct of financial intermediaries and “approved persons” in retail markets, the protection it affords financial consumers and the efficacy of the regulatory apparatus in ensuring compliance with the rules and redress, when needed, greatly influence the beliefs of financial consumers in the fairness of the “rules of the game” and, hence, their level of trust. This explains, in part, why civil and common law standards exemplified by the “shingle theory” under U.S. federal securities law and the “holding out” concept under common law, impose on financial intermediaries more stringent legal responsibilities of care and loyalty to their clients than those that govern ordinary contracts.<sup>64</sup>

Canadian securities legislation and case law 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

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<sup>62</sup> Daylian M. Cain, George Loewenstein and Don A. Moore, “The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest,” *The Journal of Legal Studies* 34, 1 (January 2005): 1-25.

<sup>63</sup> 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).

<sup>64</sup> Alessio M. Paces, “Financial intermediation in the securities markets law and economics of conduct of business regulation,” *International Review of Law and Economics* (2000); Mario Naccarato, “La juridicité de la confiance dans le contexte des contrats de services de conseil financiers et de gestion de portefeuille,” *Revue générale de droit* 39, 2 (University of Ottawa, 2009); Raymond Crête, Marc Lacoursière and Cinthia Duclos, “La rationalité du particularisme juridique des rapports de confiance dans les services de conseils financiers et de gestion de portefeuille,” *Revue générale de droit* 39, 2 (University of Ottawa, 2009); Julie Biron and Stéphane Rousseau, “Pérégrinations civilistes autour de la relation entre intermédiaire du marché et l’investisseur” (Centre de droit des affaires et du commerce international, 2010).

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.<sup>65</sup> Commentators have argued that the “client relationship model” that codifies the duties of Canadian financial advisers and financial intermediaries vis-à-vis their clients is lacking.<sup>66</sup> It remains that, when considered in its totality, the fiduciary duties imposed on financial advisers and intermediaries by Canadian law, regulation and case law are significantly more extensive and exacting than the corresponding regimes in Australia, the United Kingdom and the United States.<sup>67</sup>

The conflict-of-interest criticism levied against the bundling of financial advice with financial products may be preoccupied more with form than with the outcome.<sup>68</sup> The incidence of churning of mutual fund accounts illustrates the point. A common view is that when commissions are paid to a financial adviser on a transaction basis, the remuneration formula incentivizes the adviser to trade more often than is warranted. Hence, the converse should hold that when the remuneration of a financial adviser is on the value of the assets under management (AUM) the incentive to needlessly trade mutual funds or other financial products is eliminated and the risk of account churning substantially reduced.

The evidence does not support these conclusions: fee-for-advice account structures demonstrate higher-than-average asset velocity. Strategic Insights reports that “mutual funds held within commission-based platforms show asset turnover (i.e., redeeming one fund and using the proceeds to purchase another fund) in line with industry averages in recent years. In contrast, fee-for-advice platforms experience higher asset turnover.”<sup>69</sup> A number of academic studies have concluded that higher asset velocity correlates with lower investment results. Accordingly, “this higher asset turnover typical within fee-for-advice accounts raises concerns about investment results, as compared to lower turnover ‘buy-and-hold’ strategies.”<sup>70</sup> 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.<sup>71</sup> Through an analysis of a sample of 12,000 individual investment accounts for a 34-month period at a large retail German bank, Bluethgen et al. conclude that their “empirical

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<sup>65</sup> 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.

<sup>66</sup> Edward Waitzer, “Make advisers work for investors,” *Financial Post*, February 2011.

<sup>67</sup> Laura Paglia, “Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients,” Canadian Securities Administrators Consultation Paper 33-403 (CP 33-403) (Torys LLP, 2013).

<sup>68</sup> The same applies to the Canadian residential mortgage market where mortgage brokers act for the homebuyer but are paid a commission by the lender. Notwithstanding this arrangement, a recent study finds that brokers “help borrowers search for and negotiate better terms” than what borrowers acting on their own achieve. Jason Allen, Robert Clark and Jean-François Houde, “Price Competition and Concentration in Search and Negotiation Markets: Evidence from Mortgage Lending,” Bank of Canada Working Paper 2012-4 (Ottawa, 2012), 26.

<sup>69</sup> Strategic Insight, “A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders’ Total Costs in the U.S. Mutual Fund Industry” (2012), 5.

<sup>70</sup> *ibid.*

<sup>71</sup> Don A. Moore and George Loewenstein, “Self-Interest, Automaticity, and the Psychology of Conflict of Interest,” *Social Justice Research* 17 (2004): 189-202.

evidence is broadly in line with honest financial advice.”<sup>72</sup> Examining the investment portfolios of Canadian households at three large Canadian financial institutions, Foester et al. found that the composition of the advisers’ portfolio “is far and away the strongest predictor of the risk taken in their client’s portfolios even after controlling for advisor and client characteristics.”<sup>73</sup> In a study of 401k plans in the United States, Dvorak reaches a similar conclusion: the composition of client 401k plans was similar to their financial adviser’s plan.<sup>74</sup> No doubt, such a projection of an adviser’s risk preferences on his clients raises questions about the suitability of the advice in all cases; however, it does not support the contention that his advice was driven by ulterior motives.

The above observations are consistent with the findings of several academic studies that there exists little empirical evidence to support the claim that fee-based pricing promotes behaviour more aligned with clients’ interests<sup>75</sup> and it suggests that, when evidence does exist, concerns about commission-based pricing may be overstated and may not be as problematic as predicted.<sup>76</sup> Weinstein 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.”<sup>77</sup> Very little is known “about individual responsiveness to financial advice outside an environment with moral hazard”<sup>78</sup> and what is known about advice taking and receiving does not favour the superiority of the neutral advice hypothesis.<sup>79</sup> One important factor 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.<sup>80</sup> Moreover, the right of investors in mutual funds to demand repayment of their investment at current net asset value at the end of each trading day carries profound and effective governance consequences. Cast in a broader context, Samantha Lee finds that contrary to frequent assertions, advisers provided more optimal advice in asymmetric knowledge contexts than in symmetric knowledge contexts and as task complexity increased.<sup>81</sup>

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<sup>72</sup> Ralph Bluethgen et al., “Financial Advice and Individual Investors’ Portfolios” (March 2008), Abstract.

<sup>73</sup> Foester et al., “Retail Financial.”

<sup>74</sup> Tomas Dvorak, “Do 401k planners take their own advice?” (paper presented at the American Economic Association Conference, 2013), Abstract.

<sup>75</sup> A survey of financial planners concluded that fee-based financial-planner scores on an ethical orientation scale were no different than commission-based planner scores. Kenneth S. Bigel, “The Ethical Orientation of Financial Planners Who Are Engaged in Investment Activities: A Comparison of United States Practitioners Based on Professionalization and Compensation Sources,” *The Journal of Business Ethics* 28, 4 (2000): 323-337.

<sup>76</sup> J. Michael Collins, “A Review of Financial Advice Models and the Take-Up of Financial Advice,” Working Paper WP 10-5 (Center for Financial Security, September 2010), 19.

<sup>77</sup> Edwin Weinstein, “Mutual Fund Fee Research” (The Brondesbury Group, 2015), 7.

<sup>78</sup> 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.

<sup>79</sup> Utpa Bhattacharya et al., “Is Unbiased Financial Advice To Retail Investors Sufficient? Answers from a Large Field Study,” *Review of Financial Studies* (2012).

<sup>80</sup> 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).

<sup>81</sup> Samantha Lee, “Advice Giving: A Theory of Advice Formulation” (University of Sydney Business School, 2010).

## 5. THE PECULIAR ECONOMIC NATURE OF FINANCIAL ADVICE

The success of Canadian households in accumulating enough wealth despite the costs associated with the management of individual accounts 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 are non-advised investors in accumulating and managing their financial assets,<sup>82</sup> 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?

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. 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, for them, the opportunity cost of abstinence is much higher — whereas individuals who are non-financially literate and non-affluent are reluctant to seek financial advice.<sup>83</sup> The latter, a large segment of investors, 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. Their attitude also reflects the fact that non-affluent households tend to equate financial advice with financial risk, which they avoid because they fear it. 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 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.

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<sup>82</sup> The academic literature contains several studies that cast doubts on the value of financial advice. These contradictory results are due, in part, to the failure to control for the self-selection bias in the decision by some individual investors and not others to use financial advisers and endogeneity of the variables used in the statistical analyses.

<sup>83</sup> Finke, Huston, and Winchester, “Financial Advice.”

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.”<sup>84</sup> In the United Kingdom, studies seeking to understand financial consumers’ decision-making behaviour conclude that they are most reluctant to pay upfront for advice.<sup>85</sup> Delmas-Marsalet had obtained similar results in France.<sup>86</sup> 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.<sup>87</sup> 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,<sup>88</sup> 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 suggests 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.<sup>89</sup> 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.

## 5.1. The bundling of financial products with advisory services

The bundling of goods or services is a common practice in retail and industrial markets. A large body of marketing research shows that the complementarity of services offered in a bundle enhances its value for consumers, which far exceeds the strict additivity of individual component prices, particularly when the bundle reduces the real cost in time and efforts needed to select and purchase the items individually.<sup>90</sup> Using paradigms in consumer behaviour, research focused on the psychological effects associated with bundling to empirically determine how it affects their valuation of the bundle and the magnitude of these effects reveals that the value consumers ascribe to bundling is generally

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<sup>84</sup> ASIC, “Access to financial advice in Australia” (2010), 49.

<sup>85</sup> 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).

<sup>86</sup> J. Delmas-Marsalet, “Report on the Marketing of Financial Products for the French Government” (2005).

<sup>87</sup> Chater, Huck and Inderst, “Consumer Decision-Making.”

<sup>88</sup> Pollara, “Canadian Investors’ Perceptions of Mutual Funds and the Mutual Fund Industry,” The Investment Funds Institute of Canada (2013), 5.

<sup>89</sup> Joel S. Demski and David E.M. Sappington, “Delegated Expertise,” *Journal of Accounting Research* 25, 1 (1987): 68-89.

<sup>90</sup> Kathryn M. Sharpe and Richard Staelin, “Consumption Effects of Bundling: Consumer Perceptions, Firm Actions, and Public Policy Implications,” *Journal of Public Policy and Marketing* (2010).

underestimated.<sup>91</sup> These factors take additional prominence in the case of services, which, compared to goods, typically comprise more intangible elements and tend to be both more complex and more varied.

The public goods nature of financial advice is another important characteristic. Since information is costly to produce but cheap to reproduce, a frequent market solution to protect the manufacturer of information-intensive products is tie-in sales where the information is bundled with an exclusive good. Vertical restraint practices, a form of bundling across the value chain common in several industries, are voluntarily adopted as a way to efficiently distribute products that require point-of-sale services.<sup>92</sup> Their purpose is to induce desired dealer services and optimally compensate dealers for increases in sales where explicit contracts regarding detailed quality of services and performance are difficult to design because the heterogeneity of consumers' demand makes it prohibitive for the manufacturer to monitor the conduct of retail activities. The common element in explanations of the efficiency of bundling arrangements is the recognition that the demand for the product or service at the retail level depends on factors other than price, a condition that characterizes the financial "advice" channels.<sup>93</sup> However, if the manufacturer relies on a private-contract enforcement mechanism to ensure dealer adherence, then, a quasi-rent stream must exist to ensure the stability of the relationship.<sup>94</sup>

Five major conclusions stemming from studies of bundling services with products are particularly relevant to the assessment of the practices observed in retail financial markets:

- **Facilitating the investment process:** Most individuals do not spend enough time — or do not want — to actually manage their investments. This behaviour can be explained by the fact that they often have limited financial assets or lack financial sophistication. Bundling saves them a lot of time and effort that, in most cases, they do not want to spend, lowers search costs and simplifies the investment process. It is therefore a rational decision for them to purchase a bundle — that is the financial product and financial advice paid through embedded fees — rather than the individual items separately.<sup>95</sup>
- **Enlarging the market for financial advice:** Individual investors acknowledge the need for and value of financial advice; a large number of them are simply not willing to pay for it outright and want its cost blended with other fees and spread over time. The bundling of advisory services with an investment product such as mutual funds is an effective response to legitimate consumer preferences, which, in addition, yields substantial social benefits in that it encourages and broadens access to professional financial advice.
- **Exercising downward pressure of the price of financial advice:** It is the fund manufacturers' interest to enlarge the number of investors in their funds, an objective

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<sup>91</sup> Steven M. Shugan, "The Cost of Thinking," *Journal of Consumer Research* (1980).

<sup>92</sup> Benjamin Klein and Kevin M. Murphy, "Vertical Restraints as Contract Enforcement Mechanisms," *Journal of Law and Economics* XXXI, 2 (October 1988): 265-297.

<sup>93</sup> G.F. Mathewson and R. A. Winter, *The Economics of Vertical Restraints in Distribution* (1986).

<sup>94</sup> Klein and Murphy, "Vertical Restraints."

<sup>95</sup> Judy Harris and Edward A. Blair, "Consumer Preference for Product Bundles: The Role of Reduced Search Costs," *Journal of the Academy of Marketing Science* (2006).

that differs in an important respect from those of distributors since it implies keeping a lid on the price charged to consumers. Critical for the stability of the arrangement between the two organizations, trailing fees paid to fund distributors is an effective mechanism through which a manufacturer can impose its pricing discipline for the advisory services provided to financial consumers by the distributor. Absent this constraint, the cost of financial advice for a majority of retail clients is bound to increase.

- **Promoting accessibility to financial advice:** The cost function for the distribution of financial products and financial advice activities is convex. In absence of bundling, the unavoidable consequence is that a combination of lower aggregate costs per investor and higher expected fee income will motivate financial firms (and the financial advisers in their employ) to target higher-net-worth investors and shun less wealthy households.<sup>96</sup> This segmentation will be further accentuated by the fact that the potential for cross-selling financial products to retail customers of modest means is limited. The major casualty resulting from such a targeting process is the size of the advised population, which is caused to shrink considerably.
- **Increasing consumer options:** Bundling makes it easy to purchase the whole suite of services, if that is what a consumer is inclined to do. Others prefer unbundled services. Financial consumers who do not value or need financial advice have the ability to purchase mutual funds and other financial products through one or the other of the non-advice channels, including through the ubiquitous bank branches. The competition between distribution channels better serves the distinct needs and preferences of consumers. It also imposes on fund manufacturers the discipline to ensure that their offer responds to the wants of the different customer segments in terms of price, quality and performance.

## 6. THE DYNAMIC EFFECTS OF FINANCIAL ADVICE PRICING STRUCTURES: A SURVEY

Industry pricing structures tend to evolve until they reach an optimal balance between countervailing forces and, from thereon, remain in equilibrium unless a disruptive shock occurs. This has been the case for financial advice. Worldwide, this service has usually been paid for indirectly through embedded fees and commissions. The fact that “advice channels” have retained the dominant share of mutual fund retail markets in the face of robust competition from strong competing channels and credible financial-product alternatives constitutes solid evidence of the optimality of the bundle pricing structure for large segments of the retail market.

The bundling of financial advice with financial products such as mutual funds has a major impact on the structure of the industry, a consideration rarely addressed in the literature and policy debate. The efficiency of the arrangement allows the development and growth of a horizontal industry structure where product manufacturers and distributors are distinct organizations. From an economic and social point of view, the horizontal industry structure where several manufacturers distribute their financial products through unrelated financial

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<sup>96</sup> West, “Financial adviser.”

intermediaries is far superior to a vertically integrated structure where the great majority of financial advisers are limited to “selling” the financial products “*manufactured*” by their employer, in that it promotes market transparency, competition at both the product and distribution levels and a focus on investment performance.

The corporate interests of independent dealers and mutual fund manufacturers are not perfectly aligned. It is the mutual fund manufacturers’ interest to grow the value of the assets in their funds, which, in practice, means increasing the number of investors. To achieve this objective, mutual fund fees must be set at a level low enough, and structured in such a way as to not to discourage non-affluent investors. For their part, dealers need to ensure that the marginal cost of serving a new retail client is covered. The embedded fees with a trailer-commission approach is an efficient arrangement to reconcile these conflicting objectives since this pricing formula circumvents the main resistance of a large segment of retail investors to invest through the advice channel and provides the dealer with a stable and adequate stream of revenues. This equilibrium state can be shattered by major changes in the industry structure or by regulations. This has happened by regulatory fiat in the United Kingdom, Australia and The Netherlands and, as a result of market forces, in the United States.

## 6.1. The United Kingdom

In the United Kingdom, the Financial Services Authority (FSA) issued in March 2010, as part of its Retail Distribution Review (RDR), final rules and guidance on the implementation of the “adviser charging” system with an effective implementation date of Jan. 1, 2013. These rules prohibit the payment of fees or commissions to distributors set by financial-product manufacturers or otherwise embedded in the cost of the product. A companion rule raised the minimum education standards for all actual and future financial advisers. One of the stated aims of the RDR was to increase the number of consumers that sought regulated professional advice, alongside an emphasis on the need to save for retirement. The FSA was warned that, while commission-based firms cross-subsidized between products and customers, fee-based financial intermediaries were more likely to have income or asset thresholds below which they will not accept a new customer, would end unprofitable client relationships and would align and allocate the resources of their business depending on the revenue potential of clients. The expressions of concern that “the outcomes of the RDR will change fundamentally remuneration processes in the market for financial advice, as well as potential access to affordable independent advice for many” were recurrent.<sup>97</sup> Another concern was the increase in the regulatory burden. The total net present value of the incremental compliance costs due to the increased level of monitoring and intervention mandated by the new rules was estimated to lie between £1.4 and £1.7 billion.<sup>98</sup>

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<sup>97</sup> James F. Devlin, “Literature Review on Lessons Learned from Previous ‘Simple Products’ Initiatives” (United Kingdom: HM Treasury, 2011), 29.

<sup>98</sup> Timothy Edmonds, “Reforming Financial Markets V: Retail distribution review” (United Kingdom: House of Commons Library, 2013).

Publication of the RDR rules set in motion three types of dynamic responses, which, combined, had the effect of reducing the number of registered financial advisers from 40,566 at the end of 2011 to 31,132 in December 2012, a level that has not varied much since. Despite a contraction of about 9,400 financial advisers, the average number of clients per adviser has remained close to 200, a good measure of the number of individual investors that were orphaned by their financial adviser during the transition phase.

**FIGURE 4 NUMBER OF REGULATED FINANCIAL ADVISERS (UNITED KINGDOM)**

Date	Financial Adviser	Bank/Building Society	Wealth Manager/ Stockbroker	Discretionary Investment Manager	Other	Total
2011	25,616	8,658	4,044	0	2,249	40,566
31/12/2012	20,453	4,810	2,043	1,435	2,269	31,312
31/10/2014	21,496	3,182	1,906	1,698	2,871	31,153

Source: APFA, *The Financial Adviser Market In Numbers*, Edition 3.0, Figure 6, 2015.

The most impactful response to the RDR rules came from banks and building societies. Their strategic review of the business led them to conclude that, taking into account the reputational risks associated with retail complaints, no cost-effective solution acceptable to mainstream investors would allow them to provide quality financial-advice services and cover the added administrative and compliance costs imposed by the regulatory regime. In the span of a few months following the publication of the adviser charging rule, Barclays withdrew from the retail-investors-advice market, HSBC withdrew advice in its retail bank for those with less than £50,000 in savings or investments with the bank, or £100,000 of annual income, RBS closed its financial-advice arm and Lloyds Banking Group announced that it would offer personal financial advice only to those with more than £100,000 in investible assets, adding that those with fewer investible assets “will be able to access a non-advised service.” In early 2013, Bank Santander and AXA exited the market. The resulting contraction of the number of financial advisers in the retail banking channel during the months preceding the entry into effect of the RDR rule was about 45 per cent of the total adviser complement.

The second response stemmed from a combination of supply and demand factors at the level of financial adviser firms. Unable to afford the additional compliance costs, the independent financial adviser (IFA) firms segmented their client base. The level of assets needed to make a retail account commercially viable for a financial adviser under the new regime was estimated at about £100,000. They then proceeded to systematically prune smaller retail accounts for which the cost of advice was too expensive for the client or unprofitable to service. This was accompanied by a concomitant reduction in the number of financial advisers in their employ. This contraction was further accentuated by the reaction of many individual investors who chose to eschew financial advice rather than pay upfront for the service. Industry data reveal that the opening of investment accounts with assets of less than £100,000 dropped by half between 2011 and 2014.<sup>99</sup>

The third response was the decision by a significant number of older advisers to exit the trade rather than submitting to the new certification requirements. Seeking “to maintain

<sup>99</sup> GfK NOP Ltd., “Financial Research Survey” (2014).

standards of professionalism that inspire consumer confidence and build trust” is a legitimate and important policy objective. The effectiveness of such a policy does not depend on severing the financial link between product manufacturers and distributors and the disallowance of embedded fees. The Financial Conduct Authority (FCA) no doubt accentuated the retirement wave by banning embedded fees.

The financial intermediaries’ response to the unbundling rule led to the creation of an “advice gap,” considered to be “the biggest failing of the RDR.”<sup>100</sup> Testifying before the U.K. House of Commons work and pension committee, the chief executive of the FCA admitted that the “advice gap” and the number of people being orphaned by their advisers was a “concern.” In his words, trying to measure “something that consumers are not doing” is a difficult task! The FCA commissioned two independent studies<sup>101</sup> to estimate the “advice gap” arising from the RDR. The analyses relied on narrow definitions of the demand for and the nature of financial advice. The need for financial advice does not necessarily translate into demand for or supply of such services. For demand to crystalize, willingness to pay is paramount; conversely, for supply to rise to satisfy demand, adequate revenues are necessary. The analyses’ conclusion that the co-called “advice gap” was overblown is contradicted by subsequent developments.

The growth of the “advice gap” was acknowledged by Her Majesty’s Treasury and the FCA in the terms of reference of Financial Advice Market Review launched in August 2015 to examine, among its five objectives, “the advice gap for those people who want to work hard, do the right thing and get on in life but do not have significant wealth.”<sup>102</sup> In October 2015, the FCA parliamentary oversight committee issued a report stating that the range of financial advice support on offer “in the affordable middle ground is woefully inadequate.”<sup>103</sup> Fundscape estimates that the percentage of the U.K. population receiving financial advice fell from between 10 and 13 per cent in the pre-RDR environment to seven to 10 per cent in the post-RDR advice model.

In the final analysis, the net result of the U.K. policy to ban the bundling of financial advice with financial products is a market where a larger number of consumers do not “have their needs and wants addressed,”<sup>104</sup> where access to regulated financial advice by non-affluent individuals is priced out of the market and where the less financially sophisticated individuals are pushed towards the execution-only channel. The proportion of financial-product sold on a non-advised basis has grown from 33 per cent pre-RDR to 67 per cent.<sup>105</sup> Individuals “going the non-advised route” lose not only the benefits of personal advice, they also forego the protection available to individuals relying on financial advice who have mechanisms to complain and seek redress if they believe the financial products they

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<sup>100</sup> Fundscape, “Navigating the post-RDR landscape in the UK” (2014), 14.

<sup>101</sup> Towers Watson, “Advice Gap Analysis: Report to FCA” (December 2014); and Europe Economics, “Retail Distribution Review, Post Implementation Review” (December 2014).

<sup>102</sup> HM Treasury, *Financial Advice Review: Terms of Reference* (October 2015).

<sup>103</sup> U.K. House of Commons, *Pension Freedom Guidance and Advice*, Work and Pensions Committee First Report of Session 2015-16 (October 2015).

<sup>104</sup> On this dimension, what has been achieved is the opposite of the desired outcome, which was “a market that allows more consumers to have their needs and wants addressed.” Financial Services Authority Discussion Paper FSA DP07/1 (June 2007).

<sup>105</sup> APFA, “The Advice Market Post RDR Review” (2015).

bought are not suitable for their goals and circumstances. Such recourse is not available for “self mis-selling.” This in turn has prompted the Financial Services Consumer Panel (FSCP), a U.K. Government agency, to call on the FCA “to take immediate action to protect consumers who buy their retirement products through *non-advice* sales.”<sup>106</sup>

The “advice gap” is bound to further expand since, come 2016, firms (and advisers) will need to sever the trailing-fees arrangements they are earning on the assets investors have acquired prior to 2013. Industry sources report that in 2014, pre-RDR ongoing fees accounted for 20 per cent of IFA income. In many cases, these accounts are not large enough to be commercially viable in the new environment but continue to be served because of the recurring trail income they generate.<sup>107</sup>

## 6.2. Same Policy, Same Effects: Australia and The Netherlands

The adoption of Australia’s Future of Financial Advice (FOFA) legislation prohibiting embedded and trailing commissions on investment and superannuation products (except for life insurance products, which are not subject to the rules) that became compulsory on July 1, 2013, had effects similar to those observed in the United Kingdom. Following FOFA, financial intermediaries proceeded to segment the retail market, the number of financial advisers declined and there has been an increase in fixed fees paid by retail clients.<sup>108</sup> According to John Brogden, chief executive of the Financial Services Council of Australia, “there has been a concentration and that concentration will only continue.”<sup>109</sup> The reason given by Australia’s Financial System Inquiry to exempt life insurance from the ban is highly relevant to the situation that characterizes the Canadian market for retirement savings: “At this stage, the Inquiry does not recommend removing all commissions, as some consumers may not purchase life insurance if the advice involves an upfront fee.”<sup>110</sup>

It is significant that these structural adjustments to the new regulatory regime have occurred despite the fact that trailing commissions and incentive payments for business written prior to July 2013 were grandfathered and can continue into the future unless the arrangement is terminated by either the client or the adviser.

In the Netherlands, the prohibition on tied commissions applied to a broad range of “financial” brokers. In the retail financial advice market, a pattern similar to the one in the United Kingdom was observed: banks have moved upmarket, leading to the creation of an “advice gap” as a result of low- and middle-income investors orphaned by their adviser withdrawing from the market because of their reluctance to pay upfront for advice. The Financieele Dagblad, a financial-services expertise centre that has been involved in the

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<sup>106</sup> Financial Services Consumer Panel (FSCP), “Consumer Panel urges FCA to act on non-advised sales of retirement products,” news release (March 2015).

<sup>107</sup> Andrew Clare et al., “The Impact of the RDR on the UK’s Market for Financial Advice, Challenge and Opportunity” (Cass Business School, City University London, June 2013).

<sup>108</sup> Australian Government, Department of the Prime Minister and Cabinet, *Future of Financial Advice Amendments — Details-Stage Regulation Impact Statement* (Canberra: Office of Best Practice Regulation, Department of the Treasury, 2014).

<sup>109</sup> Barry Critchley, “Aussie Rules Advice,” *Financial Post*, July 3, 2013.

<sup>110</sup> Government of Australia, *Financial System Inquiry, Final Report* (Canberra: November 2014), 220.

elaboration of the regulations, anticipated a large reduction in the number of independent financial intermediaries. The full impact of the restrictions on commission payments remains to be assessed, the Authority for the Financial Markets having decided to wait until 2017 to conduct its post-implementation review.

### **6.3. The United States**

In the United States, the top five investment banks (i.e., the distributors), account for about 18 per cent of the total assets under management (AUM) of the U.S. adviser-sold fund industry.<sup>111</sup> This gave them enough market power to discard the embedded-fees arrangement in favour of an asset-based compensation model. A direct consequence of this corporate policy is to prevent fund manufacturers from establishing fees at levels below the ones large fund distributors can command on the basis of their strong retail market position. The asset-based-fee approach also serves their strategic intent to dampen the volatility of revenues arising from a business model based on point-of-sale commissions. It allows the adoption of a pricing strategy calibrated to weed out smaller accounts and grow the business with more affluent financial consumers owning large AUM accounts. As the value of AUM is much more stable, tying financial advisers compensation to the value of assets serves corporate purpose well as an incentive to grow the core AUM and stability of revenues.

The U.S. market provides a strong indication that individual investors have a propensity to shun upfront fee-only compensation for financial advice. Created in 1983, the National Association of Personal Financial Advisers (NAPFA) admits only financial advisers working exclusively on a direct-fee-compensation basis.<sup>112</sup> NAPFA counts 2,400 members compared to about 150,000 financial advisers in the securities industry.

### **6.4. The effect of unbundling on market transparency and price competition**

The contention that unbundling the price of financial advice from that of funds is necessary to inform individual investors about the main characteristics and costs of the financial products and services they purchase and to enable investors to judge if those products and services are suitable for them overlooks essential points. First, shopping and investment is about choices between options, which implies comparisons and induces search costs. Regulations should aim at reducing the latter in order to facilitate comparisons and lead to better-informed decisions. Experience shows that unbundling the cost of financial advice

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<sup>111</sup> The top five U.S. firms are J.P. Morgan & Co., Bank of America Merrill Lynch, Goldman Sachs, Morgan Stanley Smith Barney and Citigroup.

<sup>112</sup> NAPFA defines a fee-only financial adviser as one who is compensated solely by the client with neither the adviser nor any related party receiving compensation contingent on the purchase or sale of a financial product, such as commissions, rebates, awards, finder's fees, bonuses or other forms of compensation from others as a result of a client's implementation of the individual's planning recommendations.

from that of financial products produces the opposite effect as it makes accurate comparisons of total cost of ownership between financial intermediaries inaccessible to individual investors. Comparability is a necessary condition for market efficiency.<sup>113</sup>

Second, industry-wide cost transparency is required to exert effective price competition and reduce price distortion. Even when well informed about the price charged on their individual accounts, retail investors do not possess enough influence on an individual basis to bend the sales and pricing policies of well-established financial organizations. The content of industry-wide reports on mutual fund fees and expenses between Canada and the United States and the recent experience in the United Kingdom following the adoption of the “adviser charging” rule confirm the general validity of this observation.

In retail markets, competitive pressure is exerted by the combined effect of customers and competitors seemingly acting in concert in reaction to public information concerning the price and quality of services (or products) of a given firm. This was recently demonstrated in a study concerning health-care pricing in the United States. Even though patients with health insurance are mostly insulated from actual medical costs and individuals generally feel that more expensive care reflects better quality, price transparency is shown to exert effective market pressure on prices, reducing the average price of care by about seven per cent. The decline occurred soon after the pricing information became publicly available online and remained relatively constant thereafter.<sup>114</sup> Similarly, in the financial advice market, “supply-side competition through commissions adds efficiency” that benefits financial consumers.<sup>115</sup>

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 and, except for the portion paid through a 12b-1 fee, are not included in the total expense ratio (TER) of the funds. In contrast, the total embedded fee structure (including trailing commissions and applicable taxes) incurred by Canadian investors is included in the management expense ratio (MER). The assessment of Strategic Investor is unambiguous: “the asset-based charges levied within fee-based programs, at times an overlooked component of total shareholder cost for mutual fund investors, are disclosed to and paid by each individual investor, but are not easily compared across the industry. In comparison, mutual fund expenses are transparent, publicly disclosed, and easy to compare across the industry for similarly invested funds.”<sup>116</sup> Consequently, the TER widely distributed by third parties such as Morningstar considerably underestimates the total

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<sup>113</sup> The new set of cost-disclosure and performance-reporting requirements introduced by the CSA — generally known in the industry as CRM2 — is lacking in this regard. The charges and compensation information to be provided to individual clients is limited to the amount paid directly or indirectly by an investor to the dealer firm. The report does not provide a breakdown of how much is paid to the adviser or for the different services rendered by the firm, it does not include the amount paid by the investor to the investment manager of the mutual funds or ETFs in his or her portfolio, thus blurring transparency on total fees, nor does it address industry-wide transparency.

<sup>114</sup> Hans B. Christensen, Mark G. Maffet and Eric Floyd, “The Effects of Price Transparency on Prices in the Healthcare Industry,” Working Paper (Chicago Booth Business School, 2014).

<sup>115</sup> Roman Inderst and Marco Ottaviani, “Competition through Commissions and Kickbacks,” *American Economic Review* 102, 2 (April 2012): 780-809.

<sup>116</sup> Strategic Insight, “A Perspective,” 22.

cost incurred by U.S. investors. Morningstar's proviso that "the investor in a lower-cost fund may pay an additional fee to an adviser which is not considered in Morningstar's calculations" does not eliminate the problem but rather confirms that essential information is truncated from the public information it conveys with regard to the total cost that U.S. individual investors incur when purchasing mutual funds through the "advice" channel. But this is precisely the point; market transparency is compromised.

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.<sup>117</sup> 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."<sup>118</sup> 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."<sup>119</sup>

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.<sup>120</sup> Market pricing is now blurred, rendering it very cumbersome — if not impossible — to make comparisons between firms.

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 or less offset by increases in advice costs."<sup>121</sup> In Canada, we know that between 2011 and 2014, the asset-weighted MER of long-term funds, which includes the commission paid to financial advisers, declined from 2.08 per cent to 2.03 per cent.<sup>122</sup>

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<sup>117</sup> Bolton, Freixas and Shapiro, "Conflicts of Interest."

<sup>118</sup> Strategic Insight, "A Perspective," 5.

<sup>119</sup> 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.

<sup>120</sup> APFA, "The Advice Market."

<sup>121</sup> Financial Conduct Authority (FCA), *Post-implementation review of the Retail Distribution Review — Phase 1* (December 2014), 2.

<sup>122</sup> Investor Economics, "Monitoring Trends."

The powerful influence of industry-wide price transparency on the structure of an industry should not be overlooked. Mutual fund expense ratios vary inversely with fund assets. The sheer size of the U.S. mutual funds industry provides fund manufacturers and distributors opportunities to reap the benefits of economies of scale that are generally out-of-reach for the Canadian industry. Despite this handicap, net of taxes, comparisons of the average total cost of ownership of mutual funds in Canada and the United States in the “advice” channels are similar (i.e., 2.02 per cent versus 2.0 per cent), except for accounts with less than \$300,000 in assets where “the average Canadian mutual funds cost of ownership in advice channels can be lower than the U.S.”<sup>123</sup> The Canadian practice where distribution and financial advice costs are included in mutual fund fees (MER) and widely disseminated provides much better and more complete industry-wide cost information. The result is a more transparent and competitive marketplace and a socially superior arrangement.

## 7. A CHANGING MARKET ENVIRONMENT

Large Canadian financial intermediaries are, like their American brethren, shifting to wealth management in order to transform their retail revenue profile away from volatile trading commissions towards more stable asset-based fees. Responding to these changes, fund manufacturers have re-priced the Series F version of their mutual funds to account for advice services being already paid through the distributor charges on the AUM of client portfolios. These developments bring to the fore the “advice gap” issue and, consequently, do not dispose of the bundling of financial advice with financial products from the policy debate. Under an AUM-based pricing model, the minimum asset threshold to maintain a “finance-advised” account in Canada is estimated to be \$150,000.<sup>124</sup> The attractiveness of the AUM-based pricing policy for full-service brokerages owned by a Canadian bank is undeniable in view of the average value of assets held by their clients standing at about \$430,000. This clientele is atypical of the broad retail market.

Investor surveys consistently report that a large majority of Canadian retail investors opened an account with a financial adviser when they had only modest amounts of investable assets (i.e., less than \$25,000).<sup>125</sup> They access financial advice services through distribution channels other than bank-owned securities and mutual funds brokerage firms. In 2014, the average account at a small and mid-size (SMB) mutual funds dealer was \$44,000 (and \$109,000 at branch-based firms), while clients at SMB full-service securities brokerages have an average of \$169,000 in investible assets.<sup>126</sup>

As long as the transition towards an AUM-based pricing model is the result of market forces, one would expect the structure of the industry to evolve towards another competitive equilibrium. However, if the payment of embedded fees or commissions by fund manufacturers were prohibited, the process would not unfold in an orderly manner.

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<sup>123</sup> *ibid.*, 5.

<sup>124</sup> Scotiabank, “Market Segmentation, Evolution of Advice and Regulatory Change,” *Daily Edge*, August 2015.

<sup>125</sup> Ipsos Reid, *Canadians and Financial Advice Study* (2011); Pollara, “Canadian Investors’ Perceptions of Mutual Funds and the Mutual Fund Industry” (The Investment Funds Institute of Canada, 2013).

<sup>126</sup> PwC, “Sound Advice: Insights into Canada’s Financial Advice Industry” (2014).

It would most likely result in the opening of a wide “advice gap” whereby modest- and middle-income Canadians would be either orphaned by financial firms because their financial assets or regular income do not meet the high thresholds typical of AUM-based pricing models, or repelled by the obligation to pay upfront for financial advice rather than spreading its cost over time.

Confronted with an actual or potential “advice gap”, many observers show little concern, convinced that entrepreneurial spirit and ingenuity will lead some firms to see it as an opportunity rather than a problem. Economists in particular are prone to reducing the nature and scope of the phenomena to simple issues of costing and pricing levels. The comments of the U.S. Council of Economic Advisers are illustrative of this attitude: “The cost of advice depends primarily on the resources necessary to provide it — the adviser’s time, IT infrastructure, and other inputs — rather than the form of the adviser’s compensation. Thus, an adviser receiving payment through non-conflicted structures should be able to provide advice at the same cost as an adviser receiving conflicted payments, as long as the inputs in time and infrastructure are equal. If advisers serving moderate-income Americans can remain profitable regardless of whether they receive conflicted or non-conflicted compensation, one would expect the number of advisers working with lower-balance savers to remain the same regardless of whether conflict-based payment systems remain in use.”<sup>127</sup> Consumers and industry responses to the unbundling of financial advice from financial products indicate that the matter is much more complex and that it does not lend itself to simple adaptations, at least not without collateral costs in terms of wealth accumulation by non-affluent households.

An emerging industry response to the banning of embedded commissions is the resurgence of direct sales forces by large asset managers and financial companies. In the United Kingdom, Prudential began implementing the strategy in 2012. Other large financial institutions are following suit. Barclays, HSBC and Santander have all announced plans to expand their direct-to-financial-consumer offerings and self-directed execution-only platforms.

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. The first pertains to the breadth of advice provided in a captive setting. 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.”<sup>128</sup> Synovate finds that EU banks tend to recommend their proprietary

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<sup>127</sup> Council of Economic Advisers, “The Effects of Conflicted Investment Advice on Retirement Savings” (2015), 21. The council’s conclusions have been the object of serious challenges suggesting that its approach was “flawed in multiple ways,” and that the assumptions used to compute aggregate losses were not valid. See Jeremy Berkowitz, Renzo Comolli and Patrick Conroy, “Review of the White House Report Titled ‘Effect of Conflicted Investment Advice on Retirement Savings’” (NERA Economic Consulting, March 2015). In response to the council’s report, the U.S. Department of Labor has proposed a conflict-of-interest rule whereby some investment advisers will be treated as fiduciaries under the Employee Retirement Income Security Act and the 1986 International Revenue Code.

<sup>128</sup> Edwin Weinstein, “Mutual Fund Fee Research” (The Brondesbury Group, 2015).

products more than 80 per cent of the time.<sup>129</sup> A similar bias was documented in U.S. firms with proprietary funds.<sup>130</sup> In the U.K., observers were prompted to note that “a significant growth in direct sales forces would seem to be counter to everything the FCA have been trying to achieve with RDR,”<sup>131</sup> an issue that did not go unnoticed in Brussels. The new MiFID II distinguishes between “independent” and “tied” advice. In particular, firms must disclose to their clients whether or not the advice considers products from a range of providers and if that advice is based on a broad or restricted consideration of different types of financial instruments. The directive does not prevent financial advisers providing “tied” advice from receiving embedded commissions from the manufacturer.

The presence of vertically integrated financial-product “manufacturers” in the retail market may not be a major cause for concern in and of itself as long as these manufacturers have a large range of products on offer, this structure is not the dominant form of organization — so that financial consumers are left with “real” choices — and there is full disclosure to clients. Vertically integrated firms may also deliver additional benefits to the market if they are successful in reaping synergistic economies from their structure. For instance, Scotiabank reports that the minimum asset threshold for receiving financial advice from an adviser at Investors Group was much lower than the industry norm.<sup>132</sup>

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.<sup>133</sup> Among OECD members, Canada stands out for the high level of concentration in its banking sector: six banks control about 90 per cent of bank assets. Canadians treat their primary bank as a “one-stop shop” where they purchase the majority of their financial services. The funds industry is an exception: firms independent of deposit-taking institutions still account for a majority of the sales of mutual funds and hold about 40 per cent of Canada’s mutual fund assets. The horizontal structure of the industry, where strong financial-product manufacturers compete to serve independent retail distributors, has shown its efficacy by allowing the financial advice industry to resist the powerful gravitational pull of Canadian banks. The unbundling of advice from financial products, coupled with the heavier regulatory and compliance costs that typically accompany it, would put significant pressure on the industry, tilting the balance of forces towards a vertical industry structure and the segmentation of clients that ensues. This, in turn, forces independent fund manufacturers to build channels to deal directly with financial consumers rather than through financial intermediaries, further accelerating the transformation of the financial advice industry towards a “captive” structure.

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<sup>129</sup> Synovate, *Consumer Market Study on Advice Within the Area of Retail Investment Services* (European Commission, Director General Health and Consumer Protection, 2011).

<sup>130</sup> Michael A. Jones, Vance P. Lesseig and Thomas I. Smythe, “Financial advisers and multiple share class mutual funds,” *Financial Services Review* 14, 1 (2015).

<sup>131</sup> Andrew Clare et al., “The Impact of the RDR on the UK’s Market for Financial Advice, Challenge and Opportunity” (Cass Business School, City University London, June 2013), 9.

<sup>132</sup> Scotiabank, “Market Segmentation.”

<sup>133</sup> Douglas Cumming, Sofia Johan and Yelin Zhang, “A Dissection of Mutual Fund Fees, Flows, and Performance” (Canadian Securities Administrators, October 19, 2015).

It is no coincidence that the dominant 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 a very low cost. Using sophisticated algorithms, “robo-advisers” help individual investors build portfolios constituted of ETFs based on the investor’s age, risk aversion, income requirements, investment timeframe, income, savings and assets. Robo-advice leaders include: Personal Advisor Services (Vanguard), FutureAdvisor (BlackRock), Charles Schwab’s Schwab Intelligent Portfolios, Betterment, and Wealthfront in the United States; Nutmeg (Schroders) in the United Kingdom; and Wealhsimple (Power Financial) in Canada. While some platforms are fully automated others combine the system with an adviser, thus providing a hybrid service to clients by telephone, video link, e-mail or Internet chat. The latter is the rule in Canada, and CSA guidance regarding online advice is clear that fully automated systems as operated in the United States would not conform to Canadian regulations. Although the success of “robo-advisory” platforms in capturing meaningful market share is subject to debate and their regulation is bound to raise questions about the profiling of clients, the appropriateness of the recommendations in individual cases and the recourse offered clients in cases of “mis-selling,” there is no doubt that “robots aren’t going to go away.”<sup>134</sup> Drawing on the experience of the discount brokerage industry, it is unlikely that automated digital wealth-management platforms will close the “advice gap” that would be created by a regulatory regime prohibiting the bundling of advice with financial products. Hence, the importance of ensuring that the proficiency and competitiveness of the traditional financial advice industry is continually improved, to ensure that its contribution to the accumulation and efficient management of wealth by individual households is strengthened, not needlessly diminished.

## 8. CONCLUSIONS AND POLICY IMPLICATIONS

Structural changes in the retirement income system mean that, for a growing majority of Canadians, the adequacy of retirement income will depend on the amount of savings made during their active working life and the wealth accumulated at retirement. The changes also mean that retail financial markets gain importance. As the range of financial products has expanded, complexity has followed, taxing individual investors’ aptitudes to make informed financial decisions. In this context, individual investors’ savings and investment practices become increasingly critical to wealth accumulation and easy access to professional financial advisers must be seen as a critical component of the broader financial capacity-building system available to individual investors. Obviously advisers increase investment costs. The evidence is compelling that investors who use advisers exhibit greater rationality and make more efficient asset allocation decisions, have higher savings and a more diversified portfolio and, thus, accumulate greater financial wealth than most of those who do not use an adviser.

To profit fully from these socio-economic benefits, public policies must acknowledge the prevalence of cognitive fallibilities among individual investors and favour easy and affordable access to professional financial advice on terms that meet their preferences.

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<sup>134</sup> Paul Resnik, “Robo-advice: Why resistance is futile,” *Professional Adviser* (July 2015): 5.

A compelling body of empirical research demonstrates that regardless of their level of financial education and wealth, left to their own devices, individuals' investment and savings decisions are, as a rule, sub-optimal compared to the results obtained by "advised" investors. It is demonstrated that the propensity to plan leads to greater wealth accumulation and psychological findings indicate that an individual's propensity to plan can be changed through minor nudges.<sup>135</sup> Other studies demonstrate that financial literacy can be taught but that it will only be effective in influencing decision-making when combined with timely decision support.<sup>136</sup> Financial literacy does not carry with it an incentive to act. Without the help of professional advice, there exists scant evidence that improvements in the levels of financial knowledge and skills will lead by itself to better financial decision-making and more wealth at retirement. In fact, the main value of greater financial literacy may be to increase the propensity to seek financial advice. For instance, employer-based retirement education programs in the workplace appear to displace non-professional sources of information and guidance rather than professional financial advisers.<sup>137</sup>

The idea that it is possible to "sterilize" an environment so that individual investors are not influenced whatsoever is misconstrued. Whether intended or not, the setting affects what individuals choose. It is manifest that embedded commissions, whether fully disclosed or not, facilitate the choice of the financial-adviser option, whereas a prohibition of the practice would lead a large segment of investors to forego or be denied the service. These two policy options channel individual investors towards a different end game; they are not neutral. 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.

The fundamental role of the financial-intermediation function is to facilitate savings and promote the sound management of financial assets. Individual investors want trustworthy, qualified and experienced financial advisers; they expect financial advisers to deliver much more than strict compliance with the norms and standards of the industry. Drawing on the experience of other jurisdictions, the transparency of distribution fees and investment returns brought about by the full implementation of the Client Relationship Model-2 rule (CRM2) to complement the wide distribution of the MER should lead the industry to place a stronger emphasis on standards, continuous education programs and other means to improve the competencies and proficiency of financial advisers and increase professionalism in retail financial advice.

A common tool used in retail industries to ascertain the quality of service at the point of sale is mystery shopping. Several academic studies have applied the method to assess the quality of financial advice and a few regulators (Australia, Hong Kong, United Kingdom, Singapore) have used the approach to collect first-hand information to inform their regulatory and compliance policies. For instance, ASIC, in co-operation with the Australian financial industry, used the method to investigate the quality of retirement

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<sup>135</sup> Saul Schwartz, "Can Financial Education Improve Financial Literacy and Retirement Planning?" IRPP Study No. 12 (Institute for Research on Public Policy, 2010).

<sup>136</sup> Bruce Ian Carlin and David T. Robinson, "What Does Financial Literacy Training Teach Us?" (National Bureau of Economic Research, August 2010).

<sup>137</sup> B. Douglas Bernheim and Daniel M. Garrett, "The effect of financial education in the workplace: evidence from a survey of households," *Journal of Public Economics* (2003).

advice provided and retail investors' experience when interfacing with a financial adviser, and then published the findings.<sup>138</sup> In Canada, the Ontario Securities Commission, in co-operation with IIROC and the MFDA, conducted in 2014 a mystery shop of advisers across Ontario. Overall, advisory practices and investor experience were commendable, with 84 per cent of shoppers stating that their experiences were positive.<sup>139</sup> Clearly, there remains room for improvement. But that is precisely the point of the exercise: to identify the areas that need focused attention and to provide practical input for the development of advisory best-practice guidance. Adopted by the Canadian industry with the support of the CSA and conducted on a regular basis, such an approach devoid of the dysfunctional aspects of intrusive regulations would have a powerful and lasting influence on the conduct of the financial advice industry.

Trust in the financial advice industry would certainly be enhanced if there were more discipline and standardization on the use of titles, which, in addition, would facilitate compliance with proficiency requirements. This issue is not peculiar to Canada. In the United States, the Rand Institute for Civil Justice formulated similar comments in its 2008 report on investors' perceptions of financial advisers and broker-dealers.<sup>140</sup> The fact that, at present, there is no professional accreditation (beyond basic registration) for financial advisers complicates the matter. Nevertheless, the need to ensure titles are not misleading and reflect accurately the nature and scope of the services provided should be self-evident to the industry's self-regulatory bodies. Active consideration should also be given to the benefits that would accrue from the establishment of a professional designation for financial advisers, which, as for other professions, would entail formal training with an agreed curriculum and more extensive continuing education requirements than what presently exists.<sup>141</sup>

The evidence presented in this paper suggests that the operation of the Canadian market for financial advice has, heretofore, been successful in producing beneficial outcomes for households that obtain the service, and for society as a whole. Countries where financial advice has been unbundled from financial products, either as a result of market forces or regulatory fiat, have seen the opening of a large "advice gap" and an increase in the total cost of the services for a large proportion of retail customers. A large number of middle-income individuals who need the advice but do not own enough financial assets to make the provision of regulated financial advice an economic business proposition under a fee-for-advice pricing policy were effectively denied access to affordable financial advice<sup>142</sup> and led to engage in financial transactions without the protections afforded to investors dealing through a regulated financial adviser.

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<sup>138</sup> ASIC, *Shadow Shopping Study of Financial Advice* (2012).

<sup>139</sup> Ontario Securities Commission (OSC), *Mystery Shopping for Investment Advice*, Joint report with IIROC and MFDA (September 2015).

<sup>140</sup> Angela A. Hung et al., "Investor and Industry Perspective on Investment Advisers and Broker-Dealers" (RAND Institute for Civil Justice, 2008).

<sup>141</sup> Henri-Paul Rousseau has formulated such a proposal in his speech "Is there any value in financial advice" (November 2015), [https://www.powercorporation.com/media/upload/presentations/Remarks\\_HP\\_Rousseau\\_PCC\\_Canadian\\_Club\\_2015-11-19\\_Final.pdf](https://www.powercorporation.com/media/upload/presentations/Remarks_HP_Rousseau_PCC_Canadian_Club_2015-11-19_Final.pdf).

<sup>142</sup> Clare, "The Guidance Gap."

Under the current remuneration arrangements, access to and affordability of financial advice for Canadians is augmented, the advised population is much larger than would otherwise be the case under other remuneration structures, the propensity to save is increased and the accumulation of wealth is enhanced through better saving habits and investment practices. These considerations call for policies that recognize explicitly: that affordable and broadly accessible professional-quality financial advice produces a public good in the form of greater individual wealth accumulation for which there is no substitute; that embedding fees and commissions is an efficient arrangement to achieve this social objective; and that the principle of full transparency is paramount, both in the context of the relationship between financial advisers and their individual clients and on an industry-wide basis. It is difficult to think of any measure more cost-effective than broad access to financial advice capable of producing a rise of similar proportion in the financial wealth of the large and growing population segment of Canadians who depend on their private savings to maintain their quality of life in retirement.

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**Pierre Lortie** is a Senior Business Advisor at Dentons LLP. He is Executive Chairman of Quest Rare Minerals Ltd., Director of group Canam and Element Financial Corporation.

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Pierre served as Chairman of Canada's Royal Commission on Electoral Reform and Party Financing, has representative of the Prime Minister of Canada on the APEC Business Advisory Council as well as Vice Chairman of Canada's National Advisory Board on Science and Technology and as Chairman of the Centre for Information Technology Innovation.

Mr. Lortie received an MBA with honours from the University of Chicago, a license in applied economics from the Université Louvain in Belgium, and a Bachelor's degree in applied sciences (engineering physics) from Université Laval. He was awarded a Doctorate Honoris Causa in civil law from Bishop's University. He was elected Fellow of the Canadian Academy of Engineering in 1988 and appointed Member of the Order of Canada in 2001.

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