Banning Trailer Commissions Could Give Canadian Investors a Wealth of Lower-Cost Products

Description

It's been talked about for literally decades, but the prospect of Canada's securities regulators actually banning trailer commissions (a.k.a. embedded compensation) on mutual funds and other investment funds seems an even more likely prospect, following Tuesday's consultation paper by the Canadian Securities Regulators (CSA).

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In fact, some investment counselors argue it's simply a matter of HOW an outright ban on trailer commissions will be implemented, not WHETHER or not it will occur. Similar bans have already occurred in the U.K., Australia, and the Netherlands.

To be sure, nothing will happen for sure in the next half year; the consultation period will last 150 days to make sure the concerns of the financial industry and its customers are fully heard. If the public feedback is positive, Ontario Securities Commission chair Maureen Jensen told the media "a new rule" could be ready for public comment "within a year."

The concern isn't so much commissions themselves, but the extent to which consumers are aware they exist. No one disputes that financial advisors need to be compensated for their expertise; it's how fees are charged and whether or not they are visible to customers that are the main concerns.

Often, in the case of mutual funds, so-called embedded compensation appears almost invisible, leading to the misapprehension that such funds are fee-less. Jensen wants to make sure that any fees associated with the dispensation of financial advice are charged separately, so clients are completely aware of the existence of the commissions they will be paying.

As things stand, embedded commissions (such as trailer commissions or fees on mutual funds) may provide incentives to advisors to mis-sell products or recommend products that aren't suitable for their clients.

In a blog, investment counselor Graham Bodel of Vancouver-based Chalten Fee-Only Advisors Ltd. said there is "an increased likelihood we'll be seeing a ban on embedded commissions in Canada. The debate is moving past whether or not a ban would work and is now focusing on the potential adverse consequences for investors that might arise and the best way to mitigate those consequences."

Bodel focused on three of the CSA's concerns about conflicts of interest: that embedded commissions raise conflicts of interest that misalign the interests of investment fund managers, dealers and representatives with those of investors; that they limit investor awareness, understanding, and control of dealer compensation costs; and that "[e]mbedded commissions paid generally do not align with the services provided to investors."

Of course, the established industry — chiefly the MFDA (Mutual Fund Dealers Association), Advocis, and IFIC (Investment Funds Institute of Canada) — continues to bristle at any restrictions on embedded fees. After all, in 2015, a CSA paper found trailing commissions make up more than two-thirds (67%) of industry assets under management.

The perils of tainted advice were outlined fully 22 years ago this month by former OSC commissioner Glorianne Stromberg; she famously recommended eliminating trailer commissions all together, but only now, a generation later, have tentative steps been taken in that direction.

On Tuesday, IFIC (the mutual fund industry association) expressed its "disappointment" that the CSA is leaning to prohibiting embedded compensation and raised the spectre of making financial advice less accessible to consumers.

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But financial advisor John De Goey — who has just published the fourth edition of his book, *The Professional Financial Advisor: Putting Transparency and Integrity First* — told me in an interview that it would be a good thing if a trailer ban led to a drop of 25% in the advisor population in Canada. "It's a very good thing as long as they get rid of the right 25%, which is the bottom 25%. It's addition by subtraction."

It's not as if embedding invisible compensation is the only possible way to dispense advice. Far from it, but evidently the bottom 25% of advisors fear clients would perceive a gap between the value of the advice they're getting and what they're actually paying. In fact, most clients will find out next week, when under the new CRM 2 regime (See my most recent Motley Fool special report on this subject), investors receive their December statements.

Increasingly, advisors like De Goey and Bodel use a fee-based model in which visible fees are charged to clients as a percentage of assets; it's not that dissimilar from fund trailer commission, except for the critical difference that clients are well aware of their existence and may actually cut cheques for the resulting advice. Even do-it-yourself users of discount brokerages can arrange to pay for advice on a fee-for-service basis; an example is Fred Kirby of Dimensional Investment Planning, based in Armstrong, B.C., who charges a flat annual fee rather than a fee based on assets under management.

As for the related industry concern that newer investors with only modest sums to invest will be left with no advice, that too is a bogus concern in light of the growing success of so-called robo-advisors, a.k.a. automated online investment advice.

Most of these services provide a portfolio of low-cost exchange-traded funds (ETFs) typically for an annual fee of about 0.5% (on top of the fees of the underlying ETFs). In fact, on the same day the CSA released its paper, Toronto-based robo-advisor Wealthsimple announced a premium service that dropped the fee threshold from 0.5% to 0.4% for clients with $100,000 rather than the previous threshold $250,000. Plus, it charges nothing at all on the first $5,000 of assets, so even a rank beginner can get some advice for nothing.

Canada famously sports the highest mutual fund fees in the world — a fact acknowledged by the CSA's Jensen. The CSA expects a trailer ban would cause fees on passive investment funds to drop by 0.4% and on actively managed funds by 0.75%. And it foresees more price competition as a flood of lower-cost products hits our shores. That in turn would increase redemptions or "reallocation pressure" of actively managed mutual funds that could run as high as 44%.

Surely that would be a good thing?

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