

Le 13 décembre 2012, les Autorités canadiennes en valeurs mobilières (les « ACVM ») ont publié le Document de discussion et de consultation 81-407, *Les frais des organismes de placement collectif* (le « document de discussion ») qui abordait les questions de protection des investisseurs et d'équité que pouvait soulever la structure actuelle de tarification des OPC au Canada. Plus particulièrement, les ACVM se sont penchées sur la façon dont le système de rémunération intégrée des conseillers et d'autres formes de rémunération intégrée pouvaient donner lieu à des conflits d'intérêts réels ou apparents.

Une fois les commentaires sur le document de discussion reçus, les ACVM ont mené de vastes consultations avec les intervenants du secteur, notamment une table ronde tenue le 7 juin 2013 et des forums de discussion à l'été et à l'automne 2013. En réponse aux commentaires reçus durant ces consultations, elles ont décidé de demander et de publier une recherche indépendante pour les aider à juger de la nécessité de mesures réglementaires.

Plus particulièrement, les ACVM ont commandé à des tiers indépendants une recherche sur les deux aspects suivants :

1. au moyen de données obtenues directement des gestionnaires de fonds d'investissement canadiens, les chercheurs évalueraient dans quelle mesure, le cas échéant, les commissions de vente et de suivi influencent la vente de titres d'OPC.
2. les chercheurs effectueraient une revue de la littérature afin d'évaluer dans quelle mesure, le cas échéant, l'utilisation d'une rémunération tarifée par rapport à une rémunération à la commission viendrait modifier la nature des conseils et les rendements des placements à long terme.

À l'issue d'une demande de propositions présentée par les ACVM, le Brondesbury Group a été retenu pour effectuer la deuxième portion de la recherche. Celui-ci a mis la dernière main à ses travaux et présente ses conclusions dans le rapport de recherche sur les frais des OPC ci-joint.

Cette recherche, les commentaires reçus lors de la consultation précédente ainsi que la recherche qui sera publiée prochainement sur l'influence des types de rémunération intégrée sur la vente de titres d'OPC constitueront des éléments sur lesquels les ACVM appuieront leur décision d'effectuer ou non certaines modifications réglementaires.

Nous rappelons aux lecteurs que les points de vue et les opinions exprimés dans le rapport ci-joint sont ceux des auteurs et ne reflètent pas nécessairement l'opinion des ACVM.

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MUTUAL FUND FEE RESEARCH

PREPARED FOR
ONTARIO SECURITIES COMMISSION
ON BEHALF OF THE
CANADIAN SECURITIES ADMINISTRATORS

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OSC

ONTARIO
SECURITIES
COMMISSION

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Executive Summary

The Ontario Securities Commission (“OSC”), acting on behalf of the Canadian Securities Administrators (“CSA”) commissioned The Brondesbury Group (“TBG”) to review existing research on mutual funds compensation. The objective of the literature review is “...to evaluate the extent, if any, to which ...The use of fee-based versus commission-based compensation changes the nature of advice and investment outcomes over the long term” (RFP, OSC 201314M-93, page 1). By commission-based compensation, we mean transaction-based compensation (various sales loads paid under front end and deferred sales charge arrangements) and asset-based compensation paid by the product provider to the advisor’s firm such as trailer fees in Canada and 12b-1 fees in the US.

Using respected sources of research on securities markets, the aim of this research is to determine how the nature of compensation materially affects investor outcomes, when all other things are equal. In addition to reviewing the relevant literature and other associated evidence, we also reviewed changes in compensation structure in other jurisdictions, focusing primarily on the impact of such changes.

In order to achieve the overall objective of the study, the research needed to satisfy three sub-objectives to the extent possible.

1. Identify whether the evidence on the impact of compensation is conclusive enough to serve as a basis for policy formation;
2. Assess the weight of the evidence and formulate conclusions about its meaning, potentially including the conclusion that there is insufficient evidence to form a balanced conclusion; and
3. Identify gaps in the research that would improve policy formulation regarding compensation practices.

It is important to state what the research will not do.

- It will not advocate a policy, but rather it will summarize and interpret the evidence in a balanced manner.
- It will not weigh in on the topic of the value of advisors.
- It will not report on papers that are ostensibly research, but are in fact nothing more than opinion.

1. Identify whether the evidence on the impact of compensation is conclusive enough to serve as a basis for policy formation

Evidence on the impact of compensation is conclusive enough to justify the development of new compensation policies. All forms of compensation affect advice and outcomes. There is conclusive evidence that commission-based compensation creates problems that must be addressed. Fee-based compensation is likely a better alternative, but there is not enough evidence to state with certainty that it will lead to better long-term outcomes for investors.

Evidence from academic research is sufficient to form several clear conclusions about investor impacts of compensation.

- Funds that pay commission underperform. Returns are lower than funds that don’t pay commission whether looking at raw, risk-adjusted or after-fee returns.
- Mutual fund distribution costs raise expenses and lower investment returns.
- Advisors push investors into riskier funds.
- Investors cannot easily assess what form of compensation is best for them and readily make sub-optimal choices.

Academic research also shows several important facets of advisor behavior related to compensation.

- Compensation influences the flow of money into mutual funds. Higher embedded commissions stimulate sales.
- Advisor recommendations are sometimes biased in favour of alternatives that generate more commission for the advisor.
- Commission is only one form of inducement that influences sales. Other inducements (e.g., advancement, recognition, etc.) can also influence sales.
- Compensation affects the effort made by advisors to overcome investor behavioral biases, including biases that may lead to sub-optimal returns.

Where regulation has been changed to ban or limit commission, there is evidence that this change impacted investor outcomes.

- In the absence of embedded compensation, advisors recommend lower cost products. These typically have better returns because of lower expenses.
- While removing commission lowers product cost, advisory fees may rise as a means of paying for the cost of service. There may also be new or increased administrative fees, higher costs on margin accounts and lower payments on cash balances.
- 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.

2. Assess the weight of the evidence and formulate conclusions about its meaning

Based on the research cited, we can formulate some high level conclusions that are backed by substantial evidence. In addition to compensation, we identify some related issues that affect investor outcomes.

- Investors are easily confused about charges. To the extent that legacy commission-based compensation persists alongside asset-based fees, confusion is likely to continue. New fees and charges (e.g., administration, paper-based reporting, etc.) can deepen the confusion.
- Investor behavioral biases are unlikely to be overcome as a result of changing compensation schemes alone; although it is possible they can be moderated.
- In jurisdictions that have moved to fee-based compensation, people with less wealth and less income find it harder to get advisory service than others. We do not know whether it is more difficult with fee-based compensation than it was before the change in compensation regime. Alternative advisor methods (e.g., robo-advisors) are developing to fill the advisory gap.
- Mis-selling of investments based on improper match between risk propensity and the risk of the investment will not be eradicated by a change of compensation regime, but it will likely be diminished.

3. Identify gaps in the research that would improve policy formulation regarding compensation practices

There are a number of important questions that existing research does not answer which bear on the impact of compensation. We focus on four areas of research below.

The ideal study for any number of these would involve comparison of individual clients and advisors over time spans of a few years, with a sample that included clients served through different compensation regimes. The regimes to be compared should include: commission, asset-based, salary, and transaction fee (discount broker). To be effective, any study would also need to consider the income, wealth and sophistication of the client. It should also consider the registration category and experience of the advisor.

With this general approach as a background, the major research questions that would improve policy formulation on compensation include the following.

- **Investment returns after all costs:** Considering all sources of cost including administrative fees, below market interest paid on free account balances and other relatively subtle costs, how do investment returns differ by compensation regime?
- **Product advice:** How does product advice differ by compensation regime considering cost, risk, and effect on remediating biases in the investor's portfolio? To what extent is there evidence of mis-selling in the product advice?
- **De-biasing investors:** How does compensation relate to the behavioral bias in an investor's portfolio over time? Is there

evidence that some compensation regimes are more likely to de-bias investors? When evidence of de-biasing is absent, what factors deter the advisor and the investor from acting?

- **Intangible benefits:** What do investors want in addition to money? Do they want peace of mind, time for more economically valuable pursuits, time for more pleasurable pursuits, or just the sense that someone else is looking after their needs? How well do different forms of compensation deliver on these intangibles?

In summary, the evidence on compensation is conclusive enough to serve as a basis for policy formulation. Nonetheless, there are questions about the impact of new compensation schemes and their impacts that need to be addressed to ensure that undesirable and unintended outcomes are minimized.

1. Introduction

The Ontario Securities Commission (“OSC”), acting on behalf of the Canadian Securities Administrators (“CSA”) commissioned The Brondesbury Group (“TBG”) to review existing research on mutual funds compensation. The objective of the literature review is “...to evaluate the extent, if any, to which ...The use of fee-based versus commission-based compensation changes the nature of advice and investment outcomes over the long term” (RFP, OSC 201314M-93, page 1). By commission-based compensation, we mean transaction-based compensation (various sales loads paid under front end and deferred sales charge arrangements) and asset-based compensation paid by the product provider to the advisor’s firm such as trailer fees in Canada and 12b-1 fees in the US.

Using respected sources of research on securities markets, the aim of this research is to determine how the nature of compensation materially affects investor outcomes, when all other things are equal. The investor outcomes contemplated include both intermediate (process) and ultimate (returns) outcomes. Potential outcomes discussed in this report include but are not limited to:

- The nature of advice given (type, scope, quality, cost, content);
- Portfolio allocation and product selection;
- Managing investor behavioral biases;
- Investment returns (raw, risk-adjusted, cost-adjusted); and
- Demographic and other relevant factors that materially affect these outcomes.

In addition to reviewing the relevant literature and other associated evidence, we also review changes in compensation structure in other jurisdictions, focusing primarily on the impact of such changes.

Based on comments and communications we have received during our literature review, we believe it is important to clarify what this report aims to do in more concrete terms.

There are three main aims.

- Identify whether the evidence on the impact of compensation is conclusive enough to serve as a basis for policy formation;
- Assess the weight of the evidence and formulate conclusions about its meaning, potentially including the conclusion that there is insufficient evidence to form a balanced conclusion;
- Identify gaps in the research that would improve policy formulation regarding compensation practices.

It is important to state what the research will not do.

- It will not advocate a policy, but rather it will summarize and interpret the evidence in a balanced manner.
- It will not weigh in on the topic of the value of advisors.
- It will not report on papers that are ostensibly research, but are in fact nothing more than opinion.

Assumptions Underlying This Report

The senior author of this report is a licensed Industrial Psychologist, who also holds a Ph.D. in Measurement & Evaluation (Applied Statistics). He has worked for 30 years in financial services and carried out more than 600 studies over that time. From that base of education and experience, there are a few assumptions that guide the commentary in this report.

Industrial Psychologists often work on compensation issues. It is important to understand that **there is no such thing as a**

“behaviorally neutral compensation scheme”. Every method of compensation affects the behavior of those who are compensated. While some of the behaviors affected are intended, there are inevitably some unintended consequences of compensation schemes. It is important to understand that compensation schemes can de-motivate some desirable behaviors while encouraging others.

Identifying a problem with one form of compensation does not automatically imply that one specific alternative form of compensation is better. To make a balanced judgment, one needs to have empirical evidence on the intended and unintended consequences of the major compensation schemes considered. The logic of “If not A, then it must be B” is too limited as a basis for sound judgment.

This principle is commonly recognized in other domains like medicine. As an example, knowing there are undesirable side effects of a medication in no way implies that a newer medication is inherently better. Often the new medication only looks better because we have not had the opportunity to see its unintended side effects over the longer term.

Finally, we must recognize that **advisors must be compensated and financial institutions must be profitable.** There are legal and regulatory requirements that make this so. **If one source of compensation is removed, it is likely that a financial institution will find other methods of compensation to pay its advisors and maintain its profitability.**

Method

The RFP for this project included an extensive literature review. This was a starting point for our own literature review. Many of the articles cited in the RFP are included in this report, albeit not necessarily for the same purpose.

In the early part of this research, we looked through many of the articles mentioned in the RFP. The aim of this initial search was to identify the best search terms to use at the start of our own search for relevant studies. We rapidly modified the initial search terms as we reviewed new material, especially in terms of identifying the search terms that yielded the most useful results. Successful search terms varied by search engine, but it is safe to say that we searched using dozens of variations.

We relied on several specialized search engines to help us identify suitable academic literature for review. Our starting point was the Google Scholar and Microsoft Academic search engines. These two search engines yielded comparable results with a distinctly US emphasis.

To expand the range of countries and journals in our search, we turned to the German academic search engine called BASE (“Bielefeld Academic Search Engine”). While BASE is not well known to the public, it is “the world’s most voluminous search engine for academic open access web resources” and also excellent for other research. BASE broadened the range of articles considerably. Subsequently, in our search for articles using the University of Toronto Online Library Access System (UTLAS), we further expanded the range of search engines used to include ProQuest. An additional source of new articles was the bibliography of the best articles that we read and reviewed from these search engines.

In addition to the sources we found using search engines, both the OSC and other sources identified articles that they believed merited our attention. We responded to these suggestions while ensuring independence and objectivity in research methods.

Given the large volume of potential sources, we approached each potential research report with a “triage” mindset. Based on reading the abstract and scanning article text, we classified articles as: Definitely relevant; possibly relevant; and definitely NOT relevant. We kept no record of those deemed “definitely NOT relevant”, but it is safe to say this was the majority of the articles we encountered.

In our review, we also decided to exclude articles written before 1999 that have been updated and referenced in later work. Given the continuity of interests in the academic community, this helps ensure that the findings we report are as current as possible and reflect what authors have learned since their earlier work. This affected the designation of an article as ‘possibly relevant’.

The ‘possibly relevant’ articles were the subjects of more intense scrutiny. These articles had to be read more closely to assess their value for this review. While many of the articles were interesting for other reasons, they were not suitable for this review. Many turned out to be legal or professional opinion without the benefit of new independent empirical research. Other reports dealt with issues like the value of advisors without referencing compensation issues. With few exceptions, these articles are not included in the annotated bibliography appended to this report.

All of the ‘possibly relevant’ articles that were subsequently deemed to be relevant were summarized, along with all of the ‘definitely relevant’ articles. We created an annotated bibliography describing each useful research report, including the methods used

in the research. We also included an abstract of the study, typically using a subset of the author’s abstract. The identification of key findings for each study was typically our own. We used this to guide our writing.

Within the group of articles that are relevant to this literature review, there are a select set of articles that are extraordinarily high quality and relevance. These received greater scrutiny than articles with less impact on findings, because it was important to assess the technical quality of the work and the basis for the conclusions before placing heavy reliance on the findings. In some cases we found that the methods implied limits to the conclusions that were not identified in the research itself.

As a working strategy, we looked at relevance in terms of type of impact: Performance; macro-level Flow of funds; Portfolio allocation; and Investor behavior. An additional category was used for studies focusing on regulation in other countries and its impact, and of course, we always need a category for material findings that don’t fit in the other categories.

Turning back to an issue we mentioned earlier, a primary question we address is whether there is balanced and complete evidence on compensation. To improve on the range of evidence available, especially with regards to fund flows, the OSC subscribed to the comprehensive Lodestar Intermediary database developed and maintained by Cerulli Associates in Boston. With access to this database, we have carried out a number of independent analyses to supplement the information in the research literature. The findings from this work will be amalgamated with the literature review.

Structure of the Report

The report contains seven chapters plus an Executive Summary and a Glossary. Chapter 1 is this Introduction. Chapters 2 through 6 each summarize research for a related set of impacts. Chapter 7 contains our final summary and conclusions.

For a full understanding of the findings, the chapters must be read sequentially. **There are often questions left unanswered by evidence in earlier chapters, which are then answered in later chapters.** We took this approach in order to present the evidence in coherent themes. In particular, we note that many questions about impact are at least partially answered in the final two chapters.

2. Impact of Compensation – Investment Returns

Highlights

There are three major conclusions about advisor compensation and investment performance that we can draw from the research literature.

1. Funds that pay commission underperform.
2. Distribution costs raise expenses and lower investment returns.
3. Advisor recommendations are sometimes biased in favour of more compensation for the advisor.

Based on the research in this chapter, there is no conclusive evidence that investors will have greater after-fee investment returns with asset-based compensation instead of commission. Additional evidence will be presented in later chapters.

The weight of evidence suggests that the biases engendered by other forms of compensation are likely to be smaller than those fostered by embedded compensation, but we do not have adequate evidence to assert that conclusion based solely on the research related to investment returns. A full proof will require the evidence presented in later chapters.

2.1 Background

There is more than ample academic research that addresses the impact of compensation on fund performance, but almost all of it focuses on commission-based compensation¹. Most research also focuses on US mutual funds, and especially US equity funds. The typical research report relies on aggregated data about mutual funds drawn from publicly available sources. Regression analysis (e.g., ordinary least squares, probit, etc.) at the level of the mutual fund is the most common method for doing research, being both convenient and informative. There are few studies that comprehensively look at the portfolios of individual mutual fund investors and how they are affected by advisor compensation.

The literature on compensation deals with compensation of investment managers, distribution firms and financial advisors. Our focus is primarily compensation for retail financial advisors, whether acting on a one-to-one basis or providing advice to members of a collective retirement savings plan of some kind. Nonetheless, it is necessary to discuss revenue-sharing agreements between mutual fund companies and distributors, since these can potentially affect advice at the advisor level too. While revenue-sharing agreements are prohibited in Canada, it is possible that other incentives (e.g. proprietary products) can have a similar effect.

There are many ways that advisors can get paid. Cerulli and Associates, the leading provider of information about US mutual

¹ “Unless otherwise stated, “Commission” should be understood as referring to transaction-based compensation (various sales loads paid under front end and deferred sales charge arrangements) and asset-based compensation paid by the product provider to the advisor’s firm such as trailer fees in Canada and 12b-1 fees in the US.

fund distribution, highlights six main methods of advisor compensation: commissions; asset-based fees; salaries; annual or retainer fees; fees for financial plans; and hourly fees. Advisors may be paid commissions for sales (e.g., loads, sales charges) and/or asset-based compensation for distribution costs and ongoing service provided to clients of a mutual fund (e.g., trailer fees in Canada, 12b-1 fees in the US). Cerulli's definitions can be found in the Glossary at the end of this report.

What makes commissions a subject of particular scrutiny is that the amounts paid by mutual fund companies differ by company, type of fund, asset class, share class, amount of active management and more. There are concerns that material differences in fund compensation to advisors create a conflict between the best interests of the advisor and the client. This chapter focuses on how this potential conflict of interest may affect the investment outcomes of the client, regardless of whether these outcomes are due to the costs of the compensation arrangement or the advice given by the advisor.

The major competitor to commissions is a fee based on client assets under management (AUM). The firm that employs the advisor typically levies these fees directly on the client's account so they are visible to the investor. The most common arrangement is a fee based on a percentage of the assets under management, often with the percentage scaled to the size of the portfolio. Because this fee is applied regardless of the assets held in the portfolio, common wisdom suggests that conflicts of interest are avoided in the selection of investments. As we will discuss, conflicts of interest in investment recommendations still exist but their nature is changed. Further, there is no guarantee that the total costs to the investor are materially better.

We are aware that there are many hybrid forms of compensation and many variations on each alternative we mention. The use of regression techniques allows researchers to isolate their relative influence upon fund performance and consequent returns to the investor.

Fund performance is discussed in different ways in the research literature. At its simplest, fund performance is simply gross return on investment. More commonly the literature refers to fund performance as return on investment (ROI) after paying out fees and expenses (net ROI). Some research reports also discuss risk-adjusted return on investment, both gross and net of fees and expenses. Findings are consistent but not identical across these measures of fund performance.

As we mentioned earlier, most research on fund performance is based on US markets between 1980 to the present. Despite the US bias, we reviewed research from Canada, Spain, India, Scandinavia and other markets. These smaller markets did not always yield results as clear as the US research since they necessarily relied upon smaller sample sizes. Nonetheless, they did not contradict US findings either.

2.2 Findings

Our approach is to look for consistent findings and focus on them. We have grouped our findings under a series of headings that highlight the conclusions drawn by the researchers in those studies.

There are three major conclusions about investment performance that we can draw from the research literature.

1. **Funds that pay commission underperform.**
2. **Distribution costs raise expenses and lower investment returns.**
3. **Advisor recommendations are sometimes biased in favour of more compensation for the advisor.**

Funds that Pay Commission Underperform

Funds that pay commissions to brokers underperform compared to funds that do not have these expenses. This important finding is repeatedly demonstrated in some fifteen studies we reviewed [Barber, Odean & Zheng, 2000; Bergstresser, Chalmers & Tufano, 2009; Chalmers & Reuter, 2010; Christoffersen Evans & Musto, 2010; Cooper, Halling & Lemmon, 2013; Cuthbertson, Nitzsche & O’Sullivan, 2006; Del Guercio & Reuter, 2011; Downen & Mann, 2007; Gil-Bazo & Ruiz-Verdu, 2009; Hooks, 1996; Matalin-Saez, Soler-Dominguez & Tortosa-Ausina, 2011; Mullainathan, Noeth & Schoar, 2012; Nanda, Wang & Zheng 2004; Tower & Zheng, 2008; Van Campenhout, 2007; and Walsh, 2004]. Underperformance on raw returns is found in virtually all of these studies, but in addition, several studies reported lower risk-adjusted return on investment too [Bergstresser, Chalmers & Tufano, 2009; Chalmers & Reuter, 2010; Del Guercio & Reuter, 2011; Downen & Mann, 2007].

Funds with commissions often underperform by the amount of those commissions or more [Bergstresser, Chalmers & Tufano, 2009; Chalmers & Reuter, 2010; Matalin-Saez, Soler-Dominguez & Tortosa-Ausina, 2011].

Three key studies show that funds sold in the broker channel (commission-based) underperform direct channel funds (no commission) even before deducting any distribution-related expenses [Bergstresser, Chalmers & Tufano, 2009; Chalmers & Reuter, 2010; Gil-Bazo & Ruiz-Verdu, 2009]. *Bergstresser et al* demonstrates that brokerage customers pay substantially higher fees and buy funds that have lower risk-adjusted returns than directly placed funds (i.e., funds with no advisor payments). No study compared net returns for fee versus commission-based.

Distribution Costs Raise Expenses & Lower ROI

Research studies repeatedly find that commissions (load, 12b-1, etc.) and expenses are key drivers of relative fund performance. Quite simply, any payment that raises costs tends to lower return on investment [Barber, Odean & Zheng, 2000; Berkowitz & Kotowitz, 1997; Chen, Lai & Wu, 2010; Christoffersen Evans & Musto, 2010; Cooper, Halling & Lemmon, 2013; Cuthbertson, Nitzsche & O’Sullivan, 2006; Downen & Mann, 2007; Foerster, Linnainmaa, Melzer & Provitero, 2014; Gil-Bazo & Ruiz-Verdu, 2009; Hooks, 1996; Matalin-Saez, Soler-Dominguez & Tortosa-Ausina, 2011; Tower & Zheng, 2008; Van Campenhout, 2007; and Walsh, 2004]. And just to make this clear, funds with 12b-1 costs have higher management fees and expenses [Hillman, 2004].

While most of the studies just mentioned rely on US data, the result is replicated elsewhere. Studies done in the UK [Cuthbertson, Nitzsche & O’Sullivan, 2006] and Spain [Matalin-Saez, Soler-Dominguez & Tortosa-Ausina, 2011] have reached comparable conclusions.

Several studies directly attribute underperformance of commission-paying funds to the increase in expenses that results from paying

more for distribution. A recent study that compared comparable funds differing mainly in their distribution costs states “Fees are an important determinant of underperformance” [Cooper, Halling & Lemmon, 2013], potentially lowering returns by nearly one-third. As further evidence, Downen & Mann [2007] looked solely at no load funds with 12b-1 fees and found that 12b-1 fees alone were enough to raise expenses and lower performance.

Funds paying more to brokers realize lower returns than comparable funds that pay less [Christoffersen, Evans & Musto, 2010]. One early study linked 12b-1 fees to increases in MER that result in lower net performance [Berkowitz & Katowitz, 1997]. Disturbingly, this study further concluded that managers sometimes increase their 12b-1 fees as their performance deteriorates. Berkowitz & Katowitz concluded that better performing funds have both lower 12b-1 fees and less variance in their fees over time. Another study found that better performing funds pay lower and more consistent costs for distribution, suggesting that better performers may not need to pay as much [Barber, Odean & Zheng, 2000].

Underperformance resulting from expenses is not limited to retail investors. It is also observed in 401k plans. In a study that focuses on performance for individual participants in the Oregon University System, broker clients underperformed direct clients by 92-143 basis points (bps). Underperformance exceeded the amount of the brokerage fees [Chalmers & Reuter, 2010]. Using risk-adjusted after-fee returns as a basis for comparison, the underperformance was 224-263 bps per year. The difference was particularly striking because all of the investors were university faculty and administrators, making this a more educated sample than the typical random sample of investors. Potentially, the “literacy” of the

sample limits the ability to generalize from these findings, yet we still find profound differences.

Confirming this trend, *Chen et al* [Chen, Lai & Wu, 2010] showed that funds with greater dollar amounts of 12b-1 fees are more likely to be selected by plan providers, yet they demonstrate lower 1-year and 3-year returns. *Berkowitz & Katowitz (1997)* also observed that funds with a deferred sales charge (DSC) incurred much higher 12b-1 fees resulting in lower net performance.

It is important to note that expenses are the culprit for lower returns, regardless of whether they arise from compensation or from other sources. Hooks [1996] makes the point that “load alone is not the determinant of performance”, but load contributes to lower performance by raising expenses. In Canada, we note that higher trailer fees have an extra impact on performance, because funds with higher trailer fees also have higher management fees even after the trailer fees are excluded².

Following this line of thinking about expenses, *Cooper et al* [2013] comments on the difficulty of comparing funds on “after-fee” performance. While fees are visible and so is performance, the variability in fund performance “makes it difficult for investors to distinguish good from bad investments” (p. 32). Their discussion prompted us to recognize an important fact. **Whether the expenses deducted from investment returns are embedded commissions or asset-based fees, the net return to the investor should be reckoned after all expenses are deducted.** The real question for return on investment is “What does the investor ultimately get to keep?”

² CSA Discussion Paper 81-407 (Mutual Fund Fees), December 2012.

Finally, when discussing the issue of distribution costs for mutual funds, it is helpful to look back at the original introduction of 12b-1 fees in the US. At the time, the argument was made that by fostering fund growth, distribution fees would lead to economies of scale that ultimately benefitted the fund holder. Walsh [2004] in a report from the Office of Economic Analysis of the US Securities and Exchange Commission (SEC) concluded that no shareholder would be better off investing in a small fund with 12b-1 fees in the hope of gaining economies of scale. This might be theoretically possible, but in practice the time it takes is too long to make a difference to the ultimate return on investment. In the next chapter on fund flows, in fact, several other articles are cited that yield similar conclusions.

Advisor Recommendations are Sometimes Biased due to Compensation

The Bergstresser et al [2009] study speaks to the topic of economic impact. They found that broker customers pay substantially higher fees and buy funds with lower risk-adjusted returns. They further comment that the choice of individual funds is “consistent with the notion that paying more to the sales force may influence broker recommendations” and lower return to the investor.

Christoffersen et al [2010] make a distinction between ‘captive’ and ‘unaffiliated’ brokers (relative to a fund) and similarly concludes that “commissions deflect unaffiliated brokers, not captive, from the best destination for their clients’ funds”. They then link this to lower returns.

Advisor bias is not solely commission-driven. Commenting on what Christoffersen would call ‘captive’ sales in the Spanish mutual fund market, Gil-Bazo [2003] concludes that “Bank customers are more

vulnerable to marketing or advice from their bank and therefore more likely to invest in bank-managed mutual funds than to shop for better quality or cheaper funds.”

Mullainathan, Noeth & Schoar [2012] is probably the best parallel to the real world in its method. The study is compelling, direct, and also quite conclusive. This study relied on mystery shopping of advisors using four well-selected and tightly controlled scenarios. Trained auditors met with financial advisors and presented different types of portfolios. Mullainathan et al [2012] concluded “In some cases the advice pushed clients towards funds with higher expected fees with little change in portfolio diversification and thus reduced the expected returns on their portfolios.” They also stated **“Advisors have no problem discouraging clients from investing more in their current strategies if this is not in the interest of generating fees for the advisor”**. As we will see in Chapter 5, however, this is likely to be effective when it is in accord with pre-existing investor biases.

Advisors can also be influenced indirectly through revenue-sharing agreements. Hillman [2004] discusses the potential conflict of interest generated by “revenue sharing agreements”. As noted in this paper, some broker-dealers narrow their offering of funds to a handful of dealers. In order to be selected as a preferred fund family, mutual fund companies must pay a share of revenue to the advisors’ company. Hillman posits, “By receiving compensation to emphasize the marketing of particular funds, broker-dealers and their sales representatives may have incentives to offer funds for reasons other than the needs of the investor”.

Advisor bias based on compensation is an issue in other forms of brokerage. Jackson & Berry [2002] looked at the impact of yield spread premiums (YSP) in the mortgage brokerage market. YSP are

a form of embedded compensation, whereby a broker receives higher compensation if their client agrees to pay a higher rate of interest on their mortgage than is required by their credit risk. As an example, let us suppose that the standard mortgage rate shown in promotional material is 4.00% for a typical applicant. While not published, good credit risks can get the mortgage for 3.75%. If the borrower agrees to pay 4.00%, the broker receives extra compensation. The same could happen with a poor credit risk that would normally be charged 4.75% but agrees to pay 5.00%.

The authors looked at the impact of embedded compensation in a sample of more than 3000 loans from three different sources. **Using regression techniques, they definitively found that recommendations were biased in favor of broker compensation and that advice given to the borrower was not in the borrower's best interest.** Total mortgage broker compensation was higher for mortgages where the vendor offered YSP than for other mortgages.

Total buyer costs were higher with YSP – typically 1% of mortgage cost (e.g., \$4k higher on a \$400k mortgage). Differences in fees could not be explained by demographic or geographic variables, nor by mortgage-related variable or borrower creditworthiness. As further evidence of materiality, **embedded compensation was the major source of income for mortgage brokers and exceeded compensation that was visible to the borrower.** This research, along with the work by Mullainathan et al (2012), suggests that when the compensation of the product provider and the distributor are aligned, the result is not likely to be good for the client.

An Indian study on the advice of Life Insurance brokers [Anagol, Cole & Sarkar, 2013] also found evidence that commissions distorted advice and reduced returns. Their study compared willingness to advise on term insurance plus saving rather than

whole life insurance. In their study, agents recommended the most expensive product the majority of the time, even when unsuitable for the client. Their conclusions are in part based on a debatable assumption that term + investment is always better than whole life, yet other parts of the research clearly demonstrate that there is marked bias induced by commissions even if one does not fully accept this underlying assumption.

2.3 Discussion of Findings

Our discussion of findings is in two parts. The first part is a discussion of technical issues. The second part discusses the meaning of the findings in the context of the objectives of this research.

2.3.1 Technical Issues

The majority of studies on impact are based on regression analysis of aggregated data relating to US equity funds. While different studies look at this data over different time periods and slightly different qualifications, the common method and data sources means that confirmation of findings is the norm. Nonetheless, both aggregated data and regression analysis need to be understood.

It should also be understood that studies of aggregated data are easier to do because the data is available from public sources. High quality data at the individual level is much harder to obtain, usually requiring the cooperation of the financial institution that records and maintains the information.

Aggregated data are known to suffer from some biases. Most notably, people sometimes make conclusions about individuals based on grouped data. For example, finding that funds with 12b-1 fees are higher risk does not indicate that ALL such funds are higher risk. In fact, it is possible that a small number of extreme performers are dominating the aggregated results. In the case of the findings discussed in this chapter, however, most findings have been replicated in multiple samples at different times and with different mixes of mutual funds. Under these circumstances, while caution may be needed when looking at a single study, overall conclusions should be robust.

Regression analysis also has its limitations. This is a technical discussion beyond the scope of this paper but those interested can pursue the issues of ‘capitalization on chance’ and the assumptions underlying ‘variance partitioning’ methods of regression when compared to methods like maximum likelihood or ridge regression. Variance partitioning methods sometimes create ‘suppressor variables’, which are difficult to explain logically even though they are easy to explain mathematically. Suffice it to say that the consequence of these limitations is that variables identified as most important in a single study do not always hold up in subsequent analysis.

While many of the studies discussed here use ordinary least squares, we note that other studies use alternative methods like logit or probit analysis. The fact that the most important findings hold up across a range of studies and methods suggests they are robust and not easily dismissed because of these issues.

Having said that, we point out that a study comparing the impact of different forms of compensation on individual investors provides stronger and more compelling evidence than those based on aggregated data. There are a few of these studies in the literature we reviewed [Chalmers & Reuter, 2010; Hackethal, Haliassos & Tullio, 2009; Ivkovich & Weisbenner, 2008; Mullainathan, Noeth & Schoar, 2012], but they are a minority and only a few are mentioned in this chapter.

2.3.2 Discussion: Impact of compensation on ROI

The literature on compensation and performance is largely one-sided in that it focuses on brokerage/distribution fees, especially in the US. There is little research that bears on “after-fee” returns based on different models of compensation nor is there much discussion of incentive payments made directly to firms that distribute funds.

A facile conclusion that one can easily reach from these findings is that investors will end up with more money in their pockets if both sales commissions and trailing commissions are eliminated. The conclusion is based on two premises. First is that elimination or lowering of distribution costs will result in an improvement in net return on investment. The second premise is that by eliminating embedded compensation, advice on which funds should be used will be better because it will not be tainted by considerations of advisor compensation.

Let us look at the first premise, namely that lower distribution costs will result in more money for the investor. In doing this, let us consider return on investment after all fees, bearing in mind that both brokerage firms and advisors must be paid if investors are to get advice from them. If service providers can't be paid from commissions, they must necessarily be paid from other revenue sources. There is no guarantee that these other methods will yield a net financial benefit to the investor nor is there disconfirming evidence. This is largely due to the absence of research on fee-based compensation arrangements.

In our view, **no empirical studies have been done to document whether investors have greater after-fee investment returns with**

fee-based compensation instead of commission-based compensation.

There is no doubt that commissions dampen fund performance and investment returns, but that is not sufficient evidence to conclude that the absence of commissions will create a net benefit. We have not seen any studies that make such a comparison in the Canadian environment (or any other), and in their absence, we cannot be certain that the after-fee returns will be better with asset-based fees than commissions, particularly for smaller investors who are likely to pay higher fees³. As we will see later, some experience in jurisdictions that have banned commissions suggests that the net benefit for investors remains elusive.

The second premise is that eliminating commissions each fund pays will eliminate the conflict of interest they create for advisors making investment recommendations to clients. In our view, the weight of evidence clearly indicates that embedded compensation influences advice to the detriment of the client and the benefit of the advisor and the product provider. While we have no clear cut evidence about whether the problem is endemic or localized to a few advisors, both the Mullainathan et al [2012] and the Jackson & Berry [2002] studies suggest that the problem is widespread.

While there is no doubt that commissions engender biased advice, there is ample evidence that other types of compensation can lead to biased advice as well (e.g., faster promotion for advisors selling more proprietary products). Revenue-sharing agreements at the firm level are the most egregious form of bias, practically limiting the advisor to the “preferred families of funds” if they want to be

³ See Cerulli Associates & Research Partners, “Advisory Fees Charged for Specific Managed Account Balances”, 2014

fully compensated. While revenue-sharing agreements are prohibited in Canada, it is possible that other incentives (e.g., firms limiting the product shelf to proprietary products) can have a similar effect. Some research we reviewed from the EU and Australia [Gil-Bazo & Martinez, 2004; Synovate, 2011; ISA, 2014] shows that in a salaried bank environment there is bias in the form of promoting funds either owned by the bank or a related company. The same problem would likely result after a switch to a fee-based arrangement.

In addition, an unintended consequence of fee-based compensation is a propensity to keep the portfolio stable rather than seek better opportunities (reverse churning)⁴. In theory the advisor is incented to grow the portfolio because they will earn more. For well-established advisors with a full slate of clients this is likely the case. For those still developing their practice, even though keeping a client is the most cost-effective strategy for an established advisor, the incremental amount that a 'developing advisor' will earn through asset growth is smaller than the assets that a new client can offer. As an example, let us assume a portfolio of \$100k with a 2% asset-based fee. If an advisor grows that portfolio by 20%, their revenue will increase by \$400. If they bring in another \$100k client instead, their revenue will increase by \$2000. We have no evidence that this happens, but from the perspective of an industrial psychologist, this type of unintended consequence needs to be investigated in future research.

The weight of evidence suggests that the biases engendered by other forms of compensation are likely to be smaller than those fostered by embedded compensation, but we do not have adequate

evidence to assert that conclusion based solely on the research related to investment returns. There is certainly bias created by different compensation schemes, but we also lack evidence on the comparative impact of the bias on after-fee returns to the investor. Comparisons of demographically and financially matched groups of investors using advisors with different compensation schemes are desirable. Long-term studies that compare successive approaches would also be helpful, for example, using groups of people who are advised via commission, then fee-based, then commission (or the reverse) provide controls similar to those used in medical research.

Additional research on the flow of funds under different compensation regimes may also provide evidence that is more conclusive.

Evidence from US funds will be discussed in Chapter 4. Ideally, evidence from the parallel study being conducted in the Canadian funds market will help address the issue of "what sells" in Canada under different compensation schemes.

⁴ US Securities and Exchange Commission, "Study on Investment Advisers and Broker-Dealers", January 2011.

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3. Impact of Compensation – Flow of Funds

Highlights

There are three major conclusions about advisor compensation and the flow of money into mutual funds that we can draw from the research literature.

1. Compensation influences the flow of money into mutual funds.
2. Different types of compensation have different influences.
3. Advisors push investors into riskier funds.

There is clear evidence that embedded compensation influences fund flows. While less often researched, there is also strong evidence that affiliation between a fund manager and its distributor influences fund flows, regardless of the type of compensation. For firms with proprietary products, such as banks, there are also other monetary and non-monetary compensation influences available between the firm and the advisor. Revenue sharing, a form of compensation between a fund manager and a distributor, also affects the flow of money into mutual funds.

Research on investment performance and on fund flows shows that advisors influence investors to take on riskier investments. Higher commissions for riskier investments may account for some of the preference, as may a desire to maximize return for clients.

In short, there is ample evidence that commission-based compensation influences fund flows. What is more difficult to assess is the nature and relative impact of other types of compensation.

3.1 Background

There is more than ample academic research that addresses the impact of compensation on fund flows. While most of the research focuses on commission-based compensation, there are also studies that look at fund flows for self-managed clients. In a few studies, the groups are compared.

As in Chapter 2, most research focuses on US mutual funds, and especially US equity funds. The typical research report relies on aggregated data about mutual funds drawn from a few publicly available sources including Morningstar, The Center for Research on Securities Pricing (CRSP) and N-SAR filings. Regression analysis (e.g., ordinary least squares, multi-level regression, probit, etc.) at the level of the mutual fund is the most common method of analysis. Studies are more likely to focus on the impact of marketing and distribution as a cost to the fund rather than focusing on the nature of compensation to the advisor.

There are a few studies that focus on individual level findings drawing on varied samples including: employees enrolled in the Oregon University System; employees in the US Department of Labor pension plan; a sample of more than 1 million Canadian clients of independent financial advisors; and more. There are also two mystery shopping studies that provide strong evidence, one from the European Union and the other from the US. The US study was explicitly designed to test advisor motives, and as a result, it forms conclusions that are directly inferred from their findings.

3.2 Findings

We have grouped our findings under a series of headings that highlight the conclusions drawn by researchers. For some conclusions we will also cite related studies with a different view, but these studies mainly serve to suggest greater complexity rather than contradicting the main findings.

There are three major conclusions about compensation and the flow of money into mutual funds that we can draw from the research literature.

- 1. Compensation influences the flow of money into mutual funds.**
- 2. Different types of compensation have different influences.**
- 3. Advisors push investors into riskier funds.**

Compensation Influences Fund Flows

There is ample evidence that compensation influences the flow of money into mutual funds. Before looking at that evidence, let us look at a study that provides a baseline for comparison.

Most studies of aggregated mutual fund data have relied upon net fund flows (i.e., Net flow=Inflows-Outflows). Using individual data on 78,000 discount broker clients from 1991-1996 and separating inflows and outflows, Ivković and Weisbenner (2009) found that fund inflows were mainly related to relative performance of the funds with better funds getting more flow. Outflows were related to absolute fund performance in the previous year. While this study

shows fund flows are related to performance, it does so without considering brokered funds, so it is not strictly relevant to our findings, since advised clients are different than self-directed. Nonetheless, it is relevant in that it sets a baseline for investor behaviour. In the absence of broker advice, investors focus on performance. And as this and other studies also show, investors avoid funds with high costs. Thus deviations from this behaviour can be attributed at least in part to broker advice. We can tie that advice to compensation.

The influence of compensation is not a new issue. In 1958, the Wharton Report commissioned by the Securities and Exchange Commission concluded, *“there is a significant positive correlation between the size of the sales charge and the rate of inflow of new money into individual funds”*⁵. While the reliance on certain types of commission has changed, trailer fees today rather than sales charges, the underlying principle has not changed in 57 years.

There is a history of studies showing that both front-end loads and 12b-1 fees stimulate fund growth. As we saw in the preceding chapter, they do so at the expense of investment performance. While there is earlier work on the topic, it is subsumed into later research, thus we first cite Walsh (2004) in our review, who used aggregated data from 1997-2002. Walsh concluded that 12b-1 plans are successful in growing fund assets with no real benefit to the shareholders of the fund. Using a similar approach, researchers found more specifically that the presence of 12b-1 fees is associated with faster growth for both equity and fixed income funds (Downen & Mann, 2007). The influence of incentives was broadened in a subsequent study that took a very refined look at funds with 19

⁵ Friend, Irwin, F. E. Brown, Edward S. Herman, Douglas Vickers, 1962, A Study of Mutual Funds, U.S. Government Printing Office, Washington D.C.

different investment objectives. It observed that load funds with higher loads and 12b-1 fees tend to receive higher flows (Zhao, 2008). A 2010 study confirmed these general findings, but found that they only applied to independent financial advisors. Captive advisors behaved differently (Christoffersen, Evans & Musto, 2010) bringing the benefit of recapturing outflows from their fund family and the cost of cannibalizing inflows.

Several other studies confirm the influence of loads and 12b-1 fees. In a well-executed study using aggregate data for the US market, the authors confirm that money flows more readily into brokered funds with larger front end loads and 12b-1 fees (Bergstresser, Chalmers & Tufano, 2009). More recently, researchers again confirmed that there is a positive relationship between market share and fees charged directly for marketing and distribution (advisor and firm compensation), as well as between market share and loads. In this case, however, they found that the influence of loads was limited to smaller funds (Khorana & Servaes, 2012).

Even a survey of financial advisors suggested the influence of compensation, although it took a different approach and focused on the choice of share classes selected for mutual funds. Reviewing the survey evidence, the authors felt there was evidence suggesting that advisors recommended fund share classes that generated more commission (loads and 12b-1s) without being visibly related to benefits for the client (Jones, Lesseig & Smythe, 2005).

With the exception of Jones et al (2005), all of the preceding studies relied upon aggregated data, much of it from a small set of US sources (e.g., Morningstar, Center for Research in Security Prices, N-SAR filings, etc.). There is little surprise that they reached similar conclusions. The authors conclude that investors are guided into these funds by advisors, but in fact they do not provide direct

evidence. Their conclusions are based on supposition and a lack of alternative explanations.

A few studies provide better substantiation. One study used individual level data from employees in the Oregon University System. Despite the limitations this sample might impose, researchers found **that a 50bp increase in broker fees led to a 17% increase in allocation to the higher remunerating investment**. In general, they found that broker clients in their system invested more in funds with higher remuneration to the broker and less in funds not benefitting the broker (Chalmers & Reuter, 2012). This study is particularly important because they were able to compare investments by broker clients with the investments made by other employees who opted to self-manage their accounts.

Another study pointing to the influence of embedded compensation comes from the mortgage brokerage industry. Analyzing a balanced sample of over 3000 mortgage loans, the incidence of yield spread premiums (embedded compensation) was quite high. Because most mortgage loans probably should not have a yield spread premium, the study demonstrated that brokers took advantage of side payments when it was possible (Jackson & Berry, 2007) which measurably influenced product choices.

The most direct evidence comes from a mystery shopping study that used four tightly controlled scenarios and had trained auditors meet with financial advisors. The scenarios were explicitly constructed to pit broker interest against client interest. Researchers found that advisors often recommended switching to active management from a perfectly balanced low-cost and indexed portfolio, even though this would lower returns. In some other cases, advisors pushed clients toward funds with higher expected costs with little change in portfolio diversification and thus reduced

the expected returns on their portfolios. The authors concluded, **“Advisors have no problem discouraging clients from investing more in their current strategies if this is not in the interest of generating fees for the advisor.”** (Mullainathan, Noeth & Schoar, 2012).

Different Types of Compensation Have Different Influences

Advisors employed by firms that manufacture and distribute funds (captive advisors) often behave differently, even when compensated by salary. **Captive advisors are more likely to recommend in-house products.**

Bank customers in Spain are more vulnerable to marketing or advice from their bank. They are more likely to invest in bank-managed mutual funds than to shop for better quality or cheaper funds (Gil-Bazo & Martinez, 2004). More recently, an extensive mystery shopping study in the EU (1200 mystery shops) found that EU banks tend to propose their own investment products for more than 80% of their recommendations, rather than recommending products from a third-party (Synovate, 2011).

In the US, Jones et al (2005) found that advisors employed by firms with proprietary funds tend to sell a higher proportion of their most profitable fund classes.

Among captive advisors in the US, researchers found a more positive result. When investors want to redeem money from a lower performing fund, they encourage them to buy another fund in the same family. Whether directly motivated by compensation or not, it is clear that captive advisors are more likely to move

investors from low performing funds to better performing funds in the same captive family (Christoffersen, Evans & Musto, 2010).

For unaffiliated advisors, there appears to be a benefit to asset-based fees. A positive view emerges from a non-academic study produced for the US mutual fund industry. It concludes that a shift to an asset allocation-based portfolio of funds wrapped with fee-for-advice creates a more balanced and prudent investment strategy, eliminating some harmful opportunistic transactions that investors might choose to make (Strategic Insight, 2013). While the conclusion is logical, we did observe that many of the other conclusions in this report run contrary to the research literature. Given the industry audience for the report, we are concerned that its level of objectivity is not as strong as for academic research.

A recent study focusing on 401k plan advisors for the US Department of Labor, casts the investment suggestions of advisors in a different light. While this is a specialized circumstance, it is worth noting that the study confirms the influence of advisors. For 401k advisors, however, the influence is different. Researchers found that client 401k plans have similar holdings to their advisor’s plans. Well above chance levels, they tend to hold identical funds, identical fund families and identical categories of mutual funds (Dvorak, 2013). The influence here is more benign and not seemingly related to compensation. Advisors choose what they honestly believe to be best choices as evidenced by their personal stake, and then share their choices with clients.

Compensation influences affecting the advisor that are hidden, including 12b-1 (trailer fees in Canada), can be as powerful as those that are visible. With CRM2, eventually all of the advisor’s compensation will be visible in Canada. Nonetheless, the firm itself is also capable of influencing the advisor based on their own

internal incentives, such as more rapid promotion for sales of desired products or bonuses for selling proprietary products.

There is more to compensation than money paid to the advisor's firm, which is disclosed in fund reporting. There can also be hidden compensation to the firm. In this regard, it is important to mention revenue sharing. Revenue sharing agreements are agreements between a fund manufacturer and a distributor, whereby the distributor is compensated for a range of administrative and shareholder support services. There can be substantial differences in revenue sharing compensation between fund manufacturers.

At one time, in the U.S. market, revenue sharing led to preferred lists of mutual fund companies who effectively paid the distributor for "shelf space". The distributor encouraged advisors to sell just the "preferred" mutual fund families (Hillman, 2004). While preferred lists are now discredited in the US, Haslem (2014) discusses the many ways that regulations can be skirted to effectively create incentives to sell more of one family of funds rather than another fund family. Describing many methods identified by other academics, Haslem concludes, "...the world of regulation and practice of revenue sharing lacks clarity, consistency, proper redress and investor transparency". In our view, any discussion of the influence of compensation should include the influence of revenue sharing or its functional equivalents. While revenue sharing is prohibited in Canada, there may be ways to circumvent the restrictions. For example, an integrated firm can limit their product offerings to proprietary products, but then engage a specific manufacturer to sub-advise all or some of the portfolio on their behalf.

Advisors Push Investors into Riskier Funds

If we look at the influence of compensation on the flow of money into mutual funds, we must consider risk-related advice. As we saw in Chapter 2, many of the key findings focus on risk-related returns and allude to the fact that advisors encourage risk.

A recent Canadian study drawing on the records of over 1 million clients of independent financial advisors concludes that advisors influence client savings behaviour yielding more risky asset holdings. Unfortunately this study does not tie the amount of risk to the form of compensation received by the advisor, but nonetheless it highlights the role of the advisor in encouraging riskier investment (Foerster, Linnainmaa, Melzer & Provitero, 2014).

Comparing commission-based brokers to self-managed clients in another study, **researchers found that the portfolios of broker advised clients have greater systemic market risk**, more exposure to smaller firms, more high market-to-book value firms and more firms with a larger momentum factor. All of these create greater risk (Bergstresser, Chalmers & Tufano, 2009).

A European Union mystery shopping study we alluded to earlier (Synovate, 2011) found that 57% of product recommendations were broadly unsuitable, and for over 80% of these products, the relatively high level of investment risk was the basis for judging the product unsuitable. In this finding, the EU work confirms the findings of US research largely based on aggregated data.

The question that is unanswered is why advisors recommend higher risk products. In Canada, higher commissions for riskier

investments⁶ may account for some of the preference. More broadly, there may be a desire to maximize return for clients.

A study from the Swiss mutual funds industry may shed some light on this. In Switzerland, they found that investors expect fund managers to deliver an overall annual return of around 3% over the S&P index net of fees (Hu, Malevergne & Sornette, 2009). In Canada, we know that half of investors expect a 6-8% return and another 10% expect more than that (The Brondesbury Group, 2012). These are high expectations.

We speculate that advisors recommend riskier investments in the hope of getting better returns for their clients. They are motivated by a belief that clients will ultimately base advisor retention decisions on the amount of money they make. This is consistent with investor behaviour for exiting mutual funds, but we have no direct proof that it applies to dropping advisors. Our firm has heard comments to this effect in interviews with advisors, but this issue was not central to those advisor studies. Since we did not systematically collect the information, this does not constitute empirically supported findings. And indeed, the CSA report on Mutual Fund Fees does show that in Canada advisors are better compensated for selling riskier funds.

So why do we mention risk at all here? We mention risk because it is highlighted in chapter 2 in the discussion of investment performance. There are strong indications that advisors push clients into riskier investment. The question that we cannot answer from existing research is whether their motive is solely personal compensation or simply fostering quicker growth in client investable

assets. By asking the question, we move closer to an answer about motivation.

3.3 Discussion of Findings

Our discussion of findings is in two parts. The first part is a discussion of technical issues. The second part discusses the meaning of the findings in the context of the objectives of this research.

3.3.1 Technical Issues

The majority of studies on impact are based on regression analysis of aggregated data relating to US equity funds. The technical issues associated with this approach are discussed in section 2.3.1. As we noted in the preceding chapter, despite technical limitations the most important findings hold up across a range of studies and methods. This indicates that the findings are robust and cannot be dismissed because of technical issues.

Having said that, we point out that studies comparing the impact of different forms of compensation on individual investors provide evidence that confirms findings based on aggregated data [Chalmers & Reuter, 2012; Ivkovich & Weisbenner, 2008; Jackson & Berry, 2007]. Mystery shopper studies further support these conclusions [Mullainathan, Noeth & Schoar, 2012; Synovate, 2011].

⁶ CSA Discussion Paper 81-407 (Mutual Fund Fees), December 2012, p.11251.

3.3.2 Discussion: Compensation and Fund Flows

It is incontrovertible that compensation affects fund flows. In our view, **the literature on compensation and fund flow provides sufficient evidence to conclude that embedded commissions influence broker advice, and at times, that advice serves the interest of the broker and the product provider rather than the client.** The indirect research methods of analyzing aggregated data are confirmed by more direct individual level analysis and mystery shopping studies. While studies may differ in their conclusions about which types of funds are influenced more than others, they are uniform in concluding there is influence.

The literature also leads us to conclude that **when a fund company and a distributor share ownership, their affiliation leads to bias in the advice of the advisor regardless of the form of compensation.** The affiliation between fund and distributor affects advisor advice to investors. While there are fewer studies focusing on this issue, their result is clear. While we cannot prove that the same conclusions apply to “captive advisors” in Canada (i.e., advisors working in vertically integrated financial service firms like banks, credit unions, insurance firms etc.), with some care and deliberation to understand the true underlying compensation structure, this is testable. In fact, in some firms in Canada the sale of funds is limited to proprietary products, taking much of the product selection decision away from the front line advisory staff.

Revenue sharing is a form of hidden compensation, which is “embedded” in the relationship between a fund company and a distributor. Based on the notion that a distribution company can incentivize its advisors in a variety of ways, we suspect that it also influences advisor decisions. Unfortunately, carrying out research on hidden agreements is difficult. Most of the evidence on the

impact of revenue sharing in the U.S. market comes from court cases, many of which are documented in some detail in Haslem (2014). Haslem makes it clear that both the courts and the SEC treat revenue sharing as a serious concern.

In a very real sense, the research on compensation and fund flows leads to a conclusion similar to Chapter 2. While there is no doubt that commissions can engender biased advice, there is ample evidence that other types of compensation can lead to biased advice as well.

It is likely that someone going into a bank branch for advice has a reasonable expectation of “brand bias” in the advice they get, as can be seen in both academic research [Christoffersen et al, 2013; Gil-Bazo & Martinez, 2004] and an EU compliance study [Synovate, 2011]. Ultimately, the perception of the typical Canadian consumer is that the convenience of dealing with their own bank (reduced search cost) outweighs the expected monetary benefits of “shopping”, especially for small investors.

In summary, we remain conservative in our conclusions. Without evidence on the comparative impact of commission based, fee-based, salary based and hourly based compensation, we cannot be certain that any one method will clear all issues of advisor bias in recommendations to clients.

Regardless, the research clearly shows that commissions materially impact flows. All other things being equal, the removal of those commissions should lead to a material change in product selection. Affiliation moderates this impact. To the extent that fee-based compensation yields a net benefit to the investor, affiliation is likely to moderate that benefit.

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4. Advisor Compensation in the US

Unlike preceding chapters, this chapter does not summarize academic research literature. Instead we analyze information from a set of US databases on mutual fund advisors compiled by Cerulli Associates and their Research Partners. Cerulli is a well-respected firm and is viewed as the leading provider of information about US investment product distribution. Cerulli Associates describe their firm as “specializing in worldwide asset management and distribution analytics”.

To be clear on attribution, The Brondesbury Group created the graphics in this chapter. The data used are drawn from the Cerulli Lodestar Intermediary platform and its underlying database. The selection of variables, their depiction, and their interpretation comes from The Brondesbury Group.

Our overall conclusion from the Cerulli data is that **differences in the products and services received by investors reflect advisor sources of revenue (fees, commission) and registration category.** Sorting out the impact of different forms of compensation is complicated by a link between method of compensation and the investable wealth of the advisor’s clients. **The proportion of fee-based compensation an advisor gets increases as the investable wealth of their clients’ increases.** In addition, underlying licensure shapes the focus of advice, as well as its legal limits.

Notwithstanding these limitations, there are several useful findings within this chapter that have implications for the Canadian market. They confirm earlier findings and provide us with additional understanding of their meaning.

4.1 Background

All of the findings in this chapter are based on 2014 research provided by Cerulli Associates & Research Partners. The research is solely based on US advisors for calendar years up to 2013. The solely US base is comparable to most of the research studies on fund flow and investment performance, so this research is relevant to our understanding of the research literature.

In terms of Cerulli’s methodology, it is best to simply quote their own description of their methodology.

“Cerulli collects intermediary data throughout the year. Cerulli’s advisor surveys run quarterly, and include nearly 2,000 individual advisor surveys conducted through Cerulli’s proprietary survey engine. Data is incorporated into the Intermediary subscription as soon as it is processed by Cerulli analysts. Cerulli’s wholesaler surveys are run annually. A number of these surveys are conducted in partnerships with industry organizations, such as the Investment Management Consultants’ Association, the College for Financial Planning, Morningstar, Sequoia System, the Financial Planning Association, and Bill Good Marketing.

Cerulli’s annual sizing of the advisor marketplace provides assets under management and advisor headcounts by channel for retail advisors. Cerulli defines retail advisors as those advisors in the business of offering financial advice to retail clients and who seek to manage an entire asset allocation strategy for their clients. Cerulli’s definition of retail advisors excludes registered personnel such as wholesalers and home-office staff who are not addressable for asset managers and broker/dealers, but who are commonly included in other attempts at sizing the advisor marketplace.

The SEC and FINRA regulatory filings serve as a starting point from which Cerulli analysts individually remove broker/dealer and RIA firms not engaged in financial advising for retail clients.” (Cerulli Intermediary Overview - Methodology, October 2014)

While the information in this chapter is based on the Cerulli data, we have taken the liberty of using different terminology a few times to ensure consistency with the research literature.

Compared to other chapters, this chapter mainly presents evidence in the form of graphics. This is accompanied by a relatively small amount of commentary.

4.2 Findings

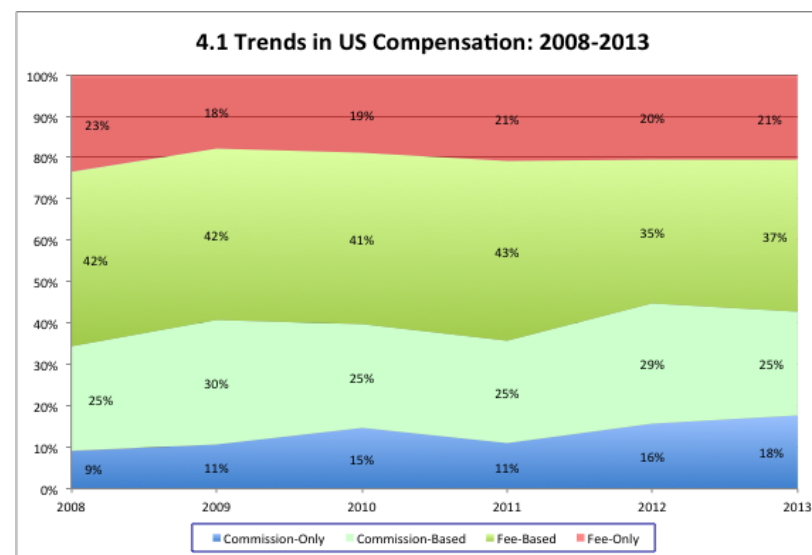
There are four major findings worth noting here.

1. Revenue is seldom derived purely from fee or commission.
2. Advisor compensation is correlated with both advisor experience and client wealth.
3. Compensation and licensure have clear impacts on product recommendations.
4. Services and time usage are linked to revenue sources.

It is also worth noting that Cerulli distinguishes how a firm generates its revenues (e.g., fee, commission, etc.) from how an advisor is compensated (e.g., salary, asset-based fees, etc.). While the two variables are commonly aligned, it is useful to remember that they don't have to be aligned. For example, a firm can earn revenue through commissions or fees, while paying its advisors a salary.

Revenue is seldom derived purely from fee or commission

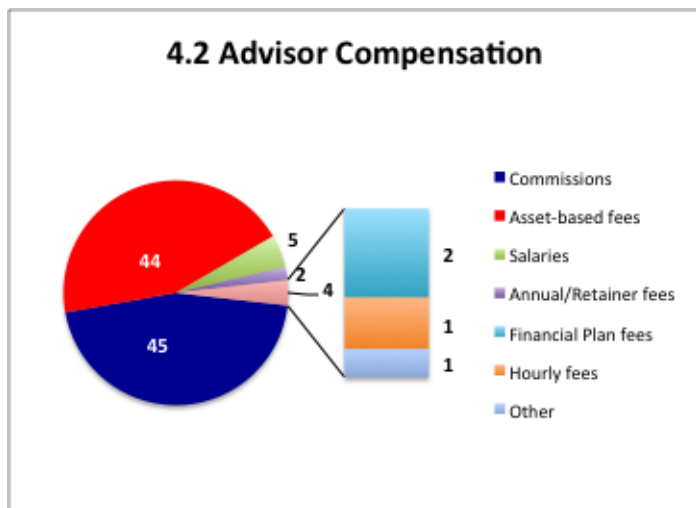
As we can see in Exhibit 4.1, **fewer than 40% of retail advisors are Fee-only or Commission-only** (18% Commission-only and 21% Fee-only). Commission-only advisors doubled from 2008 to 2013, while Commission-based held steady. Fee-only and Fee-based advisors both declined since 2008. **The proportion of advisors mainly generating revenue by fees dropped from 66% to 57% from 2008-2013**, suggesting two things: US investors do not show a marked preference for using fee based compensation; and potentially, commissions are needed to meet revenue targets.



Neither the Fee-only nor the Commission-only groups are “pure”. The designation “only” signifies that at least 90% of their total revenue comes from one source, either fee or commission. Commission-based advisors get at least 50% of revenue from

commission but no more than 89%. A comparable definition applies to Fee-based advisors. From these definitions, we can see that differences in motivation between Commission-based and Fee-based advisors will be negligible at the margins of these groups.

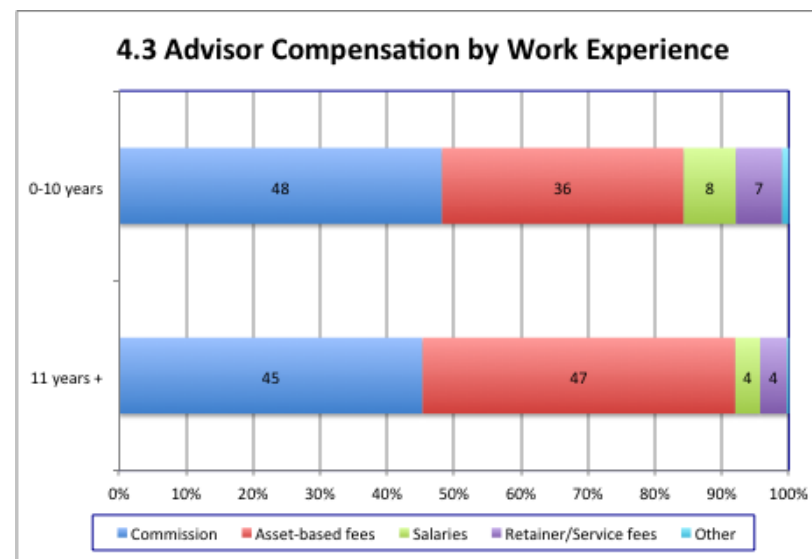
Not everyone generating revenue from fees is compensated in the same way by their firm. In the total advisor population, most are compensated based on Asset-based fees⁷ (44%). The others are compensated through salary (5%) or through retainer/service fees (6%). The means of revenue generation and compensation are not always identical. This means that knowing how the client pays for services is not a perfect guide to how the advisor is motivated, albeit given the alignment; it is a very good guide.



⁷ While 12b-1 fees are technically fees tied to assets they are categorized by Cerulli as Commissions and are not included in the ABF category.

Advisor compensation is correlated with both advisor experience and client wealth

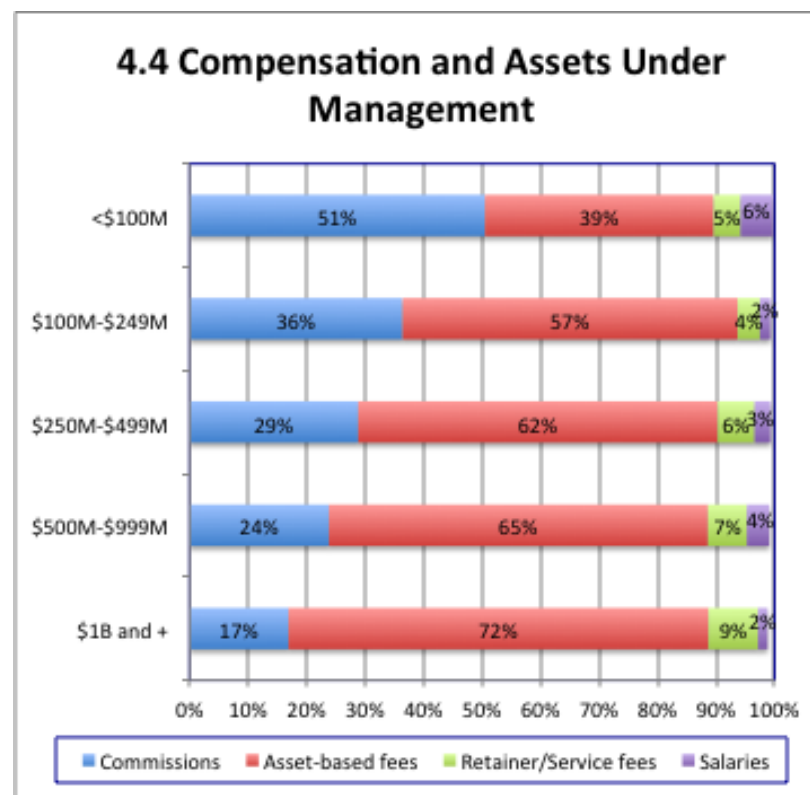
Client wealth and advisor experience are related to methods of revenue generation and advisor compensation. Over time, an advisor who remains in business builds their number of clients, the investable assets of their clients, and their assets under management (AUM). Thus client wealth and advisor experience are strongly related with both parties increasingly knowledgeable⁸.



⁸ Relation between investing experience and knowledge is demonstrated in two studies by The Brondesbury Group: Investor Education Fund, “Benchmarking Investor Knowledge”, 2012; Ontario Securities Commission, “Performance Reporting and Cost Disclosure”, 2010

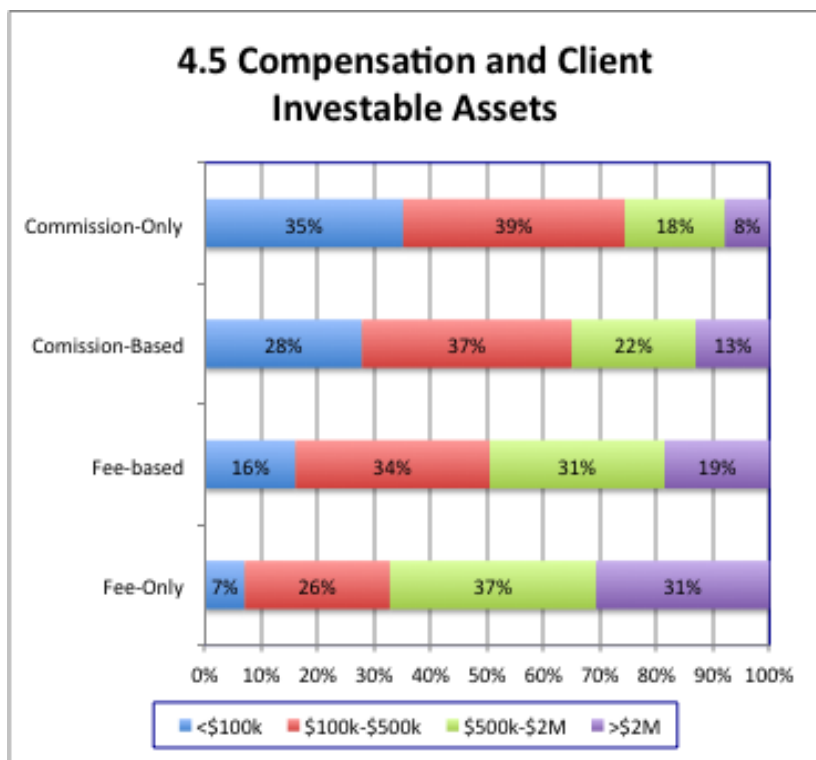
More advisor experience signifies more compensation through asset-based fees (ABF). Just over one-third (36%) of those with less than 10 years' experience are compensated by ABF. This climbs to just under half (47%) for those with more experience. Changes away from commissions, retainer/service fees and salary contribute equally to the total shift. It is unclear whether the firm, the advisor or the client initiates this shift. This is certainly a topic that merits future research, because there is a real possibility that the shift is in accord with the compensation scheme yielding the greatest revenue.

More assets under management signify more compensation through ABF. Among US advisors with less than \$100M AUM, 4 out of 10 (39%) are compensated by ABF. The proportion compensated by ABF increases steadily from 57% to 72% above \$100M AUM. Research is needed to demonstrate why this shift occurs, and more particularly, to understand how this shift relates to revenue and advisor compensation. The key questions here are “who initiates this shift in compensation” and “why”.



At the client level, the proportion of client payments in the form of fees increases along with the amount of investable assets. Using \$500k in investable assets as a cutoff, the proportion of client assets above that mark for each compensation category is: 26% for Commission-only; 35% for Commission-based; 50% for Fee-based; and 68% for Fee-only. For an equally stark comparison, we note that among Commission-only advisors some 35% of clients have less than \$100k in investable assets; while among Fee-only advisors the proportion is only 7%. **While we expect that the dividing line for investable assets is lower in Canada, the principle is likely to be**

the same. Smaller investors are more likely to pay commission and larger investors are more likely to pay asset-based fees. It is unclear whether this trending is equally beneficial to client and advisor, or whether one party benefits more than another.



Compensation and licensure have clear impacts on product recommendations

An assessment of product allocation (i.e., what products advisors get for their clients) and compensation suggests that compensation

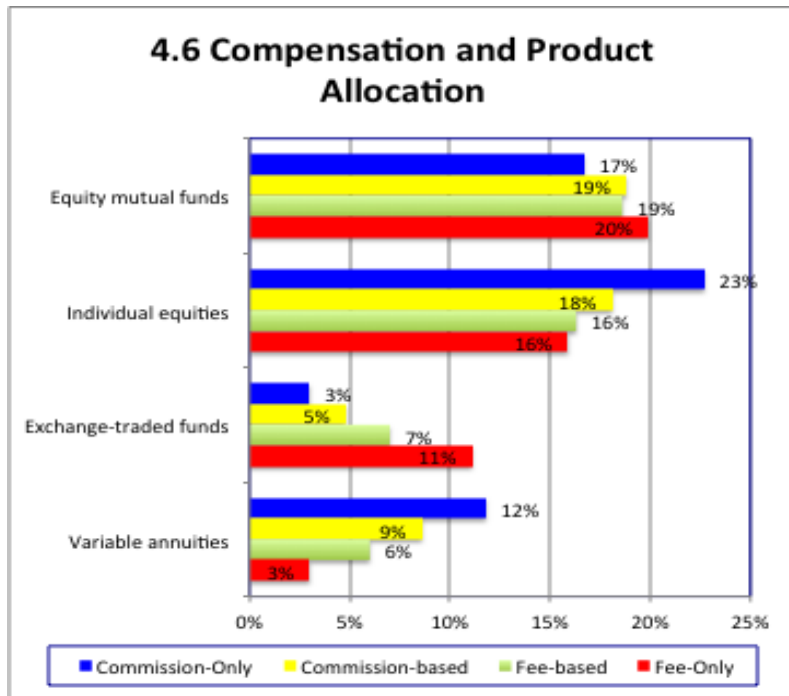
has an impact on product recommendations. For a moment, let us focus on two products that are only sold by advisors with a securities license, namely individual equities and ETFs. Let us assume that all four forms of compensation are solely applied to advisors with Series 7 licensure (general securities). Among this group, Commission-only advisors sell Individual equities more than others; while ETFs are sold more by Fee-only advisors. We can't compare to mutual funds, since that includes advisors who only have Series 6 licensure (limited-investment securities)⁹, as well as those with Series 7.

As we see it, Commission-based advisors are more likely to promote the purchase of individual securities because selling several securities will generate more commission than selling a single ETF. Conversely, advisors compensated by fees want to minimize transactions, so they recommend ETFs as a “buy and hold” alternative that results in fewer costs incurred against their fees. In both cases net revenue is maximized for the advisor but the incentives operate in opposite ways.

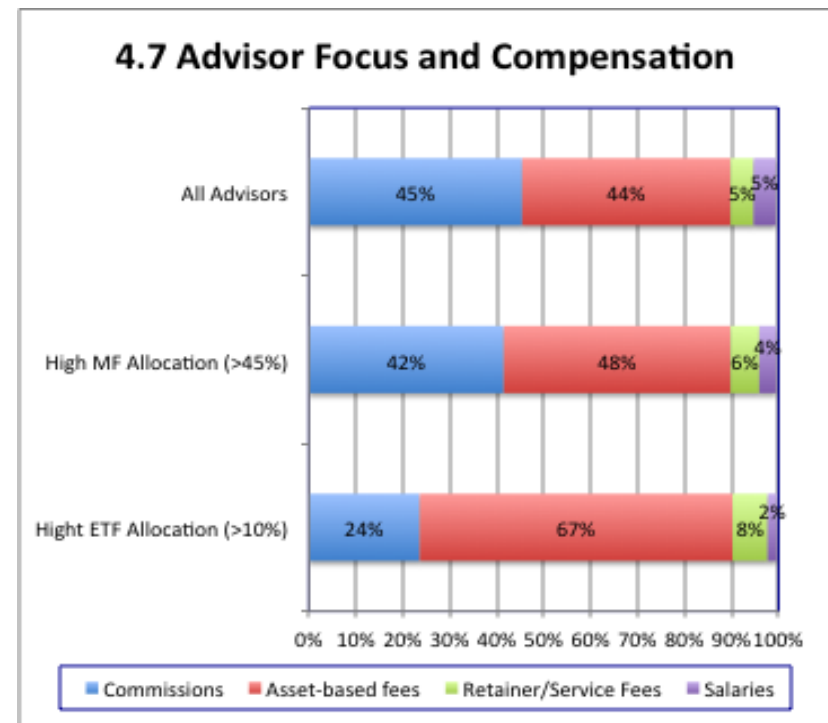
Having said that, the sale of ETFs vs. mutual funds is not just a compensation issue. Despite lower cost and typically higher net return, there are at least three other reasons for lower ETF sales.

- Many financial advisors are not allowed to sell ETFs.
- Some clients and advisors view “stock-picking” as the focus of their relationship.
- Advisors may not be willing to expend the time and effort to get clients comfortable with a new product.

⁹ See Mark Cussen, “Breaking Down Financial Securities Licenses”, Investopedia, 2015. http://www.investopedia.com/articles/financialcareers/07/securities_licenes.asp



The sale of ETFs reflects the linkage between client wealth and the use of fees as part of revenue. ETFs are unarguably a less known product than mutual funds or individual equities, and by virtue of that fact alone can be considered more “sophisticated”. Three-quarters of advisors with high ETF allocations are compensated by fees versus only half among advisors overall. This likely demonstrates the difference in influence of compensation rather than licensure regimes, as well as the sophistication of clients.

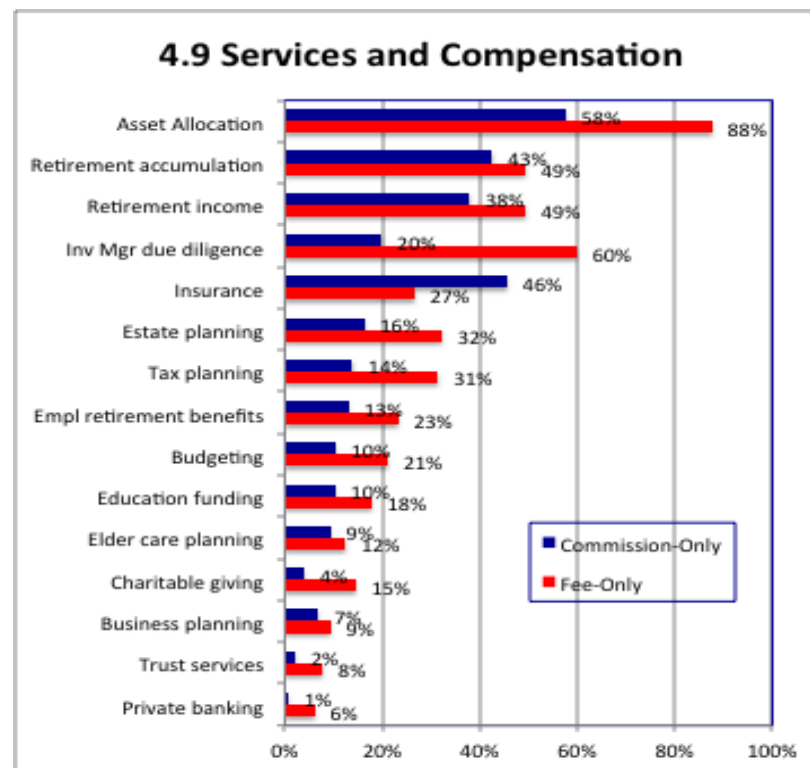
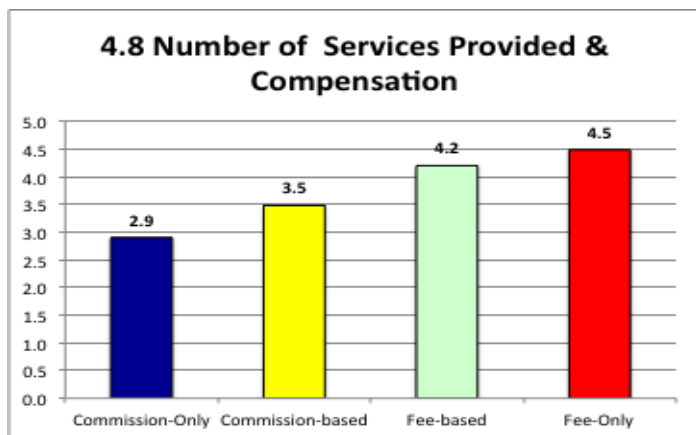


The relation between licensure, products and compensation makes it difficult to sort out the impact of compensation on product recommendations. Advisors who sell life insurance are a good illustration, since they typically generate revenue from commission. These advisors do not recommend insurance products over other products because they differentially generate commission, but rather because insurance is the core of their advisory relationship with their client, who sought out an insurance-focused advisor (*see ‘Variable Annuities’ in Exhibit 4.6 as an example product*). A similar argument can be made for clients who deal with advisors selling individual securities, in that the sale of these instruments is at the core of their advisory relationship.

Services and time usage are linked to revenue

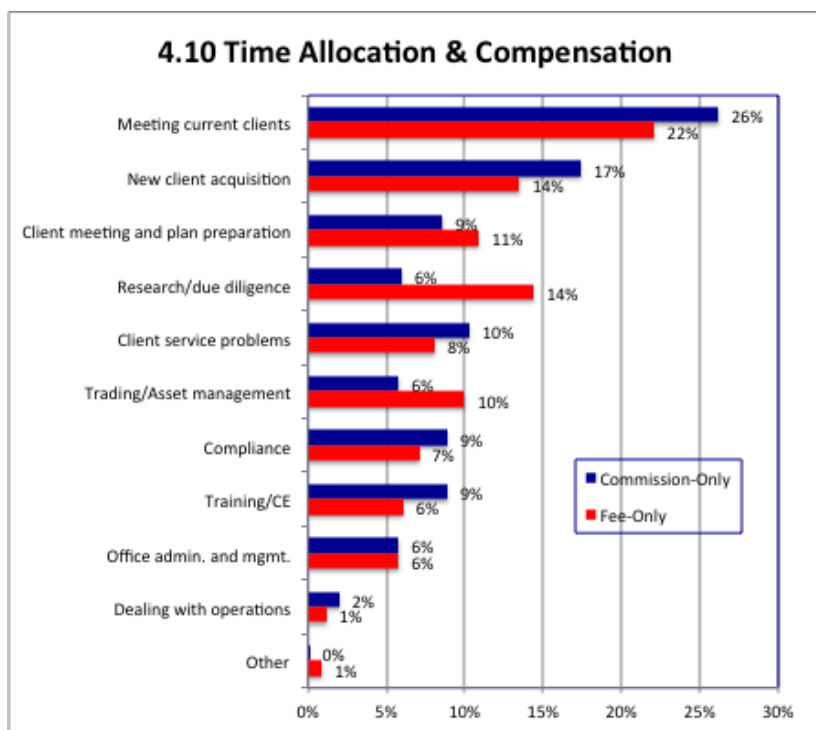
Fee-only advisors provide more services than Commission-only providers. The number of services provided (out of 15 possible) increases as the proportion of fees in the advisor’s revenue increases. This means that the number of services also increases with client investable assets, as one would expect.

With one exception, life insurance, every other service is provided more by Fee-only advisors. But it is critical to remember that the proportion of compensation based on fees increases with client investable assets, so **it is likely that more services reflects greater needs generated by more wealth and complexity.** It is also worth remembering that with typical US fees, the \$6000-\$7500 typically generated by a \$500k account can pay for more advisor time than a smaller account which can practically yield no more than \$2000 in revenue.



Commission-only and Fee-only advisors spend a comparable portion of their time meeting with existing clients, but advisors with more mixed fee and commission compensation spend a bit more time than either group. Where Fee-only advisors really differ is in the time they spend on “higher level services” like research/due diligence and trading/asset management. They spend twice as much time on higher level services as Commission-only advisors. This likely reflects the greater wealth and complexity of their clients and a higher proportion of Portfolio Manager relationships.

4.10 Time Allocation & Compensation



4.3 Discussion

As previous chapters have suggested, there are a number of issues that need clarification to draw firm conclusions about the impact of compensation. **The biggest question emerging from this chapter is whether the investor, the advisor or the firm chooses the compensation arrangement.** Two related questions come to mind based on the research literature and our prior experience in financial services research:

- Do larger and more sophisticated investors demand fee-based arrangements or is that just what they are offered; and
- Do smaller investors demand commission-based arrangements because they focus on the value of transacting and don't really appreciate the value of advice (Weinstein & Bottrell, 2011) or do they have no choice?

Let us focus on the two main methods of revenue generation, commission and fee-based arrangements (FB). In the purely optional approach, all clients would be offered a choice between paying commission, FB or some combination thereof. Economic rationality suggests that investors assess what is more economically beneficial for them and then choose that option. Research discussed in the next chapter will show that people are not very good at that. As well, other payment attributes may be important to the investor, such as certainty of amount, link to performance or payment timing.

In the mandatory approach, the firm would have some criteria like size of account and proportion in packaged products, and then apply a decision rule to the criteria to identify the best structure. The firm then tells the investor how they will pay for services, and unless the investor strongly objects, they will be subject to the firm's policies. On the assumption that the firm aims to maximize

its long-term profits, we would assume that the method of payment is optimal for the firm in terms of both profit and client retention. In essence, the optional approach is based on an economically rational investor while the mandatory approach is based on an economically rational firm.

But what does this have to do with embedded compensation? The answer is simple in that it supposes FB are better for the firm for larger accounts, while commission is better for the firm for smaller accounts. The discussion around embedded compensation focuses on biased product choices with “bias” the operative word. While we know that commission has its biases, we also know that FB likely creates some biases. These biases are not as well established as those for commission; but a few are strongly suspected (e.g., reverse churning, more sale of proprietary products). They require further study.

We know far less about the biases of FB nor how its impact compares to commission, but we do know that commission creates considerable bias. Nonetheless, we may need to broaden our understanding of product biases to include a bias against recommending products that incur unnecessary expenses for the firm. “Reverse churning” is an obvious bias of this kind, but we suspect there are also differential costs for different investment products, especially since hidden revenue sharing agreements or informal quid pro quo practices (e.g., referrals, use of the Financial Institution for “unrelated” business services) may affect net revenue to a firm.

All this goes to say that **we need to know a lot more about the impact of FB compensation compared to commission, particularly in relation to amount of investable assets.**

A second question that emerges from this chapter is “Despite the risks of bias from embedded compensation, why do commissions continue to thrive?” The research does not provide definitive answers to this, yet the role of commissions in the US market suggests that “pay as you go” has a good deal of consumer appeal. It is also likely a profitable model for firms for small clients. In addition, what research does tell us is that when some of the commissions are hidden, then people will not be sensitive to them [Barber et al, 2005; Mazzoli & Nicolini, 2010]. In short, the popularity of commission-based advisors may be partly due to the seemingly small amount of compensation they get from an investor compared to the reality of their compensation. In both the US and Canadian markets [Weinstein, 2012], we know that investors are not aware of all the costs.

The final question is “Why do most advisors have a mix of methods of revenue generation?” Is the mix within client or do they have some Fee-only clients and some Commission-only clients? Is it evolutionary or by design? If they have separate groups of clients, how can they clearly separate their recommendations to the two sets of clients to support a bias that generates more revenue? The data we have do not inform this discussion at all. If clients are segmented by wealth into fee-only and commission-only to form the mixed compensation of most advisors, it speaks to segmenting clients based on knowledge and sophistication. This is a possibility certainly mentioned in academic research, which views such a practice as geared to taking advantage of the less sophisticated investor. Alternatively, if most clients have a mix of fees and commission within client, it suggests that the combination has a broad appeal that meets the needs of both advisors and investors. We have no research data that bears on this issue.

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5. Investor Behaviour and Compensation

Highlights

When looking at research on the impact of compensation, we have concluded that understanding investor behaviour is critical for understanding the impacts. Advisor compensation affects a number of key investor decisions that affect outcomes, including but not limited to investor:

- Selection of an advisor (including self-directed);
- Requests for advice, information or products;
- Response to advice; and
- Investment choice.

In this context, there are two important conclusions we can draw from the research.

1. Investors cannot easily assess what form of compensation is most beneficial for them.
2. Behavioral biases of investors are not easy to overcome. Behavioral biases affect advisor behaviour (just as advisors affect investor behaviour), investor choices of investment, and ultimately, investor outcomes.

With very few exceptions, the research literature does not focus on the impact of different types of compensation at the investor level of impact. Studies on compensation are more often macro-level and focused on the impact of commission, or alternatively, they may focus on the value of advice. The result is that it is difficult to draw defensible conclusions. Despite this limitation, there are valuable things to be learned that may shape future research, even if they can't resolve the question of compensation impact today.

5.1 Background

There is an extensive literature on investor decision-making and the behavioral biases that affect decision-making. The research is clear that behavioral biases prevent investors from achieving optimal returns.

It is worth identifying some of these biases.

- **Disposition effect:** Selling winners too early and holding on to losing investments too long (e.g., I will hold it until it comes back);
- **Narrow framing:** Choosing individual investments without regard to the composition of the entire portfolio;
- **Home market bias:** Preference for buying investments coming from the domestic market even when achieving optimal performance requires broader diversification by market;
- **Return chasing (Recency bias):** Buying the investment that did well in the most recent time period, regardless of its long-term success or its prospects for the future;
- **Short-term thinking:** Over-reaction to short-term events which leads to buying investments at their peak and selling them at their lowest value; and
- **Cost-Value fallacy:** If it costs more to buy it is better, which is sometimes applied to fund purchase fees. Logic driven by the belief that “you get what you pay for”.

There are a number of studies that compare behavioral biases for clients of commission-based advisors to self-directed clients. These studies suggest that behavioral bias affects both self-directed clients and commission-based clients [Chalmers & Reuter, 2012; Hackethal et al, 2011]. They don't address clients of advisors with fee-based compensation.

Unlike most of the studies mentioned in earlier chapters, these studies focus on individual investor impact more than on aggregated findings. They bear on our earlier concerns that aggregated data can easily hide what happens to individuals. Several of these studies look at the entire portfolio of an individual's investments rather than some simplistic comparison of an aggregate of investors (e.g., load versus no-load) where one group is more likely to be using commission-based advisors based on share class.

Some of the individual level studies cited deal with sizeable samples of investors: 30,000 US discount brokerage clients; 8,000 European retail investors; 3,400 US mutual fund buyers; and more. Two of the studies report on samples of advisors.

There is more diversity of method in the work cited in this chapter than in preceding chapters. In addition to analysis of available datasets, there are: surveys; laboratory experiments; Internet-based experiments; analysis of website visits; opinion leader research; and mystery shopping studies in both the US and the EU. A few of the samples are exceptionally literate, including Harvard and Oregon University System employees, but those findings are balanced by other studies from the general population.

Despite the diversity of work, we still do not have the kind of tightly linked studies of impact for investors using different compensation methods. While this limits the conclusions we can draw, in combination with other work it leads us closer to understanding the impact of compensation and its limits. Time is a precious commodity to most advisors. There is only so much time an advisor can afford to spend to overcome the behavioral biases of investors, regardless of how they are compensated.

5.2 Findings

Our approach is to look for consistent findings and focus on them. We have grouped our findings under a series of headings that highlight the conclusions drawn by the researchers in those studies.

There are five major conclusions about compensation and investor behaviour that we can draw from the research literature. The first two conclusions focus on investors' ability to understand and identify optimal compensation.

1. Investors cannot assess compensation.
2. Compensation schemes available to investors differ by wealth.

The other three conclusions deal with investor biases and the limits to overcoming them.

3. Investor behaviour biases lead to sub-optimal returns and these biases can be confused with compensation impacts.
4. Compensation affects the efforts made by the advisor to overcome investment biases.
5. Investors don't always take advice and compensation affects whether they do or not.

5.2.1 Assessing Compensation

Investors Cannot Assess Compensation

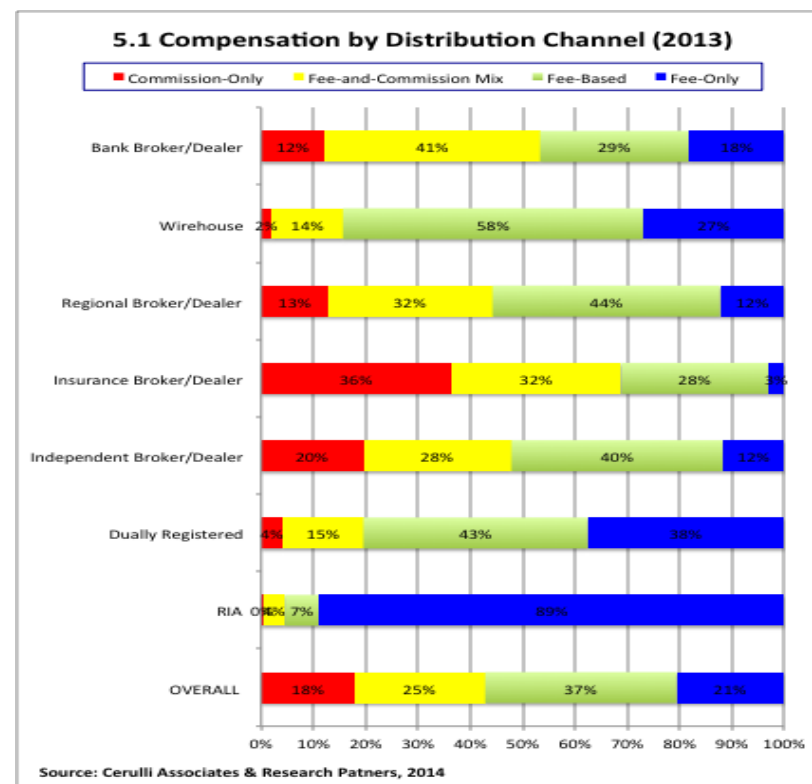
Research demonstrates conclusively that **most investors are unable to understand and assess different forms of compensation**. They cannot assess which of commission, percentage of assets under management, services fees or other compensation arrangements are best for them. They cannot make the economic assessment nor can they assess the implications of compensation arrangements for creating potential conflicts of interest in the advice that advisors give them. Disclosure does not help them identify the best advisor for them based on compensation.

The sheer variety of possible forms of compensation makes comparison difficult, both for investors and for researchers seeking to understand the impact of different forms of compensation in the market. Using disclosure data from 7,043 Registered Investment Advisors¹⁰ (RIA) in the US, researchers concluded that there are an almost bewildering number of forms of compensation that can be combined in different ways (Dean & Finke, 2012). In this study they found compensation that included combinations of commission, a percentage of assets under management, hourly charges, fixed fees, subscription fees, performance-based compensation and other methods.

¹⁰ Cerulli defines RIAs as “An independent financial advisory firm that operates under its own SEC ADV filing. RIA firms may include multiple advisors or just one, and contract for trade clearing through service agents ... or custodial banks.” A ‘wirehouse’ is one of “the four national full-service broker/dealers. Their financial advisors are tied employees of the firm, have large investment banking and institutional presence, and have a large metropolitan presence. Dually registered independently maintain RIA and Broker/dealer relationships.

To illustrate the range and complexity of compensation schemes, we present Exhibit 5.1 based on Cerulli Associates & Research

Partners Lodestar Intermediary database (2014), which is the most comprehensive source of data on advisor compensation in the US. What the chart illustrates, is that only 4 out of 10 advisors are either purely fee-based or purely commission-based, and in the distribution channels with the most assets, the proportions are sometimes lower.



The reality of advisor/firm compensation is often that it consists of different parts with some more visible than others, even when we think it should be simple. An assessment of fee structures in the US and Italy showed that **opaque pricing policies are frequently applied to advisory services** provided by tied agents (banks, investment companies and advisory companies) that combine advisory services with other activities such as the placement of products and services. Mazzoli & Nicolini (2010) concluded that the different combinations of fees and commissions determine a wide range of pricing structures that may lead to confusion among investors who wish to buy financial advisory services.

There are different forms of hidden compensation. In Canada, for example, we know that only one-third of mutual fund investors are aware of trailer fees on mutual funds (Weinstein, 2012), making this a hidden fee for many. Some would argue that there are other hidden forms of compensation for a firm including trading activity through the firm and client-related administrative services. A recent US study (Haslem, 2014) highlights revenue-sharing as a hidden source of compensation paid by fund managers to distribution firms that has the potential to affect commission-based, fee-based and self-directed investors. Revenue-sharing agreements often include differential fees for services provided by dealers including networking fees, account maintenance fees, sub-transfer agency fees and other programs. In earlier years, revenue sharing agreements encouraged some firms to maintain “preferred lists” of mutual fund companies that advisors were encouraged to sell (Hillman, 2004). Even though revenue sharing is a form of compensation that only directly benefits the firm and not the advisor (and it is banned in Canada), we note that firms have the potential to incentivize their own staff to sell some funds more than others (e.g., proprietary or related products) via their internal compensation arrangements.

All of the foregoing goes to say that comparing forms of compensation is difficult and often not comprehensive or accurate. But the difficulty in comparing forms of compensation is most often noted when investors are asked to assess compensation related to mutual funds.

More than ten years ago, researchers found that **most investors are not financially sophisticated enough to understand the impact of expenses on investment returns**. In a comprehensive literature review, academic researchers concluded that the complexity of calculations and the difficulty of choosing the right underlying assumptions made it difficult for investors to choose the compensation scheme most advantageous to them, as manifested in the choice among share classes (Livingston & O’Neal, 1998). As one of the authors observed in later work, fund-related expenses pose a particular challenge because they vary in both magnitude and timing (O’Neal, 2003).

Another early study concluded that investors (including discount brokerage clients) cannot assess fee trade-offs on mutual funds, especially when some fees are hidden (Barber, Odean & Zheng, 2002). The authors commented that for hidden fees, out of sight is out of mind. As Van Campenhout (2007) observed, investors do not have a clear-cut assessment of mutual fund fee structures. A biased understanding of their meaning and implications blurs the perception of fees.

More recent work continues to support the earlier conclusion that investors are unable to assess fees. A study of 5,000 mutual funds in four major EU markets concluded that clients cannot evaluate the cost of the distribution service, so they are unable to judge whether this cost is consistent with the quality of the service they get. It is

also difficult for them to assess the net benefit of moving to a cheaper distribution channel (Navone & Nocera, 2014).

In a commission-based environment, disclosure does not help investors identify either the best advisor or the best share class based on compensation. In an experiment involving Harvard employees, a more literate than average sample, researchers found that investors show confusion regarding loads and don't take them sufficiently into account. Simple disclosure doesn't change decisions or create price pressure. In fact, results showed that disclosure of compensation did not affect choices very much, even among this far more literate than average set of Harvard employees (Beshears, Choi, Laibson & Madrian, 2009). In the real world, it is more likely that the advisor will propose the share class and it will be advantageous to them [Jones et al, 2005].

In a recent survey we conducted (Weinstein, 2012) on behalf of the Investor Education Fund, we found that even when different forms of commission are explained to retail investors, half could not form an opinion about whether the commission structure posed a potential conflict of interest. Among the half that did form a point of view, three-quarters felt the advisor would look out for their best interest. Based on this belief, investors have little reason to look for alternative forms of compensation.

In an Internet-based survey and experiment, however, researchers found that when subjects in an experiment were explicitly told that fees matter, the instruction had the effect of changing how they searched, what they believed, and which funds they invested in. Based on this and other findings, the authors concluded that when fees are easier to find, distill, and compare (i.e. when they are more salient) that investors will be more likely to take them into account

(Wilkinson-Ryan & Tess, 2012). This implies that fee-based compensation can potentially create real understanding.

Nonetheless, there is a difference between an experiment and the real world. In the experiment, investors had a choice between ten mutual funds in four asset classes, all having comparable information provided in a neat form with 30 years of simulated returns. In the real world, the investor is confronted with thousands of mutual funds, performance and fund expense information spread over different time horizons, and a far more bewildering range of variables and choices. In a real world situation, people deal with the mountain of information by finding ways to pare the information down to a size they can actually think about. This is often the role of the advisor, but some investors do this themselves.

Financial literacy may affect ability to assess compensation. An experiment looking at choice of fees suggests that lower financial literacy affects ability to assess fees and to select mutual funds advantageously. The same logic can be applied to selection of advisors (Dominitz, Hung & Yoong, 2008). There is some evidence suggesting that the less financially literate choose commission-based advisors (Zhao, 2008), but at least in the US market, research suggests that the less financially literate (who assumedly have less assets) are not offered the same choices as those with more assets.

Most of the research focuses on commission-based compensation. It is likely that a simple "percentage of assets under management" fee directly charged to the investor's account will be easier to understand eventually. What can still be missed are other fees like platform and administrative fees, which can cause confusion. As well, even if fee-based compensation become the model for all

future transactions, confusion is likely to continue as “grandfathered” commission-based accounts continue to exist.

Compensation Schemes Available Vary by Wealth

A further complication for advisor selection is the limits of what is available to the investor. **At least in the US, the form of advisor compensation that a firm offers a client is often a function of how much money the client is willing to place with the firm.** Different firms will have different favoured compensation arrangements and different thresholds, but there is unquestionably a relationship between existing wealth and type of advisor compensation arrangements available. Someone with \$1 million has all the choice they want. Someone with \$25k has fewer options.

A recent study by Dean & Finke (2012) focuses on wealth and compensation. Dean & Finke find that wealthier clients are more likely to have fee-based compensation including performance-based fees. Commission compensation is most common among advisors who provide financial planning services, have more employees, and cater to lower-wealth clients. They also found that more than half of broker-dealers who are primarily compensated via commissions had no account minimums and were willing to assist investors with small sums. This suggests that the commissions from the current transaction(s) are sufficient compensation for their services. Dean & Finke suggest that evidence on client size and form of compensation suggests that commission is the most viable method of compensation for smaller accounts. They speculate that without commission, many small accounts would not be serviced. Despite their speculation from the data, the evidence they present is not controlled enough to posit that as a firm conclusion, but it is certainly suggested by the evolution of the US market. As Chapter 6 (International Regulation of Compensation) will show, evidence

following regulatory changes in the UK and Australia is mixed about the shortfall of advice for small accounts. Both advisor and investor behaviours have changed and changes suggest new service models (including the use of automated advice) are developing to meet the need.

Our analysis of the Cerulli Associates & Research Partners Lodestar Intermediary Database (2014) supports the assertions of Dean & Finke. Our analysis found that the median investable assets of investor clients increased as the proportion of fee-based compensation increased. Median investable assets were:

- \$250k for Commission-only advisors (>90% commission);
- \$340k for Commission-Fee mix (51-90% commission);
- \$500k for Fee-based advisors (50-90% fees); and
- \$1.2M for Fee-only advisors (>90% fees).

Only 7% of fee-only and 16% of fee-based clients had investable assets less than \$100,000. By comparison, investors with less than \$100k are 35% of the commission-only advisor base and 28% of advisors with a commission-fee mix. We assume that this reflects the options they were offered more than it represents an inability to choose among the full range of options, because in the latter case, responses would be closer to random and more comparable to one another. The orderly stepped pattern shows this is far from random.

In the preceding pages, we commented that it is difficult for an investor to compare alternatives available to them. Nonetheless, there is research (Mazzoli & Nicolini, 2010) that shows that the likelihood of an investor getting an offer with transparent pricing (i.e., advisory costs separated from investment product prices) is higher if:

1. The advisor is an “Independent Financial Advisor”;

2. Not also involved in a distribution process of investment products; and
3. The advisor has received a certification of quality from independent authorities.

We have no evidence about whether clarity in compensation follows this pattern in Canada, but it is clear that most advisors in Canada do not meet all three of the conditions.

5.2.2 Investor Biases

Investor Behaviour Biases Lead to Sub-optimal Returns

Investor behavioral biases, the very core of behavioral finance, point to another challenge. **Behavioral biases of investors are not easy to overcome and they are a key factor in sub-optimal returns on investment. This poses a real limitation of the conclusions we can draw from the research literature, when we look solely at clients of commission-based advisors.** If there is no comparison between different forms of compensation, one can easily be misled into believing that sub-optimal behaviour is the result of the advisor's recommendations and not, **at least in part**, the behaviour and attitudes of the investor.

Among discount broker clients, for example, investors with strong behavioral biases (disposition effect, narrow framing, overconfidence) tend to gravitate towards individual stocks and avoid low expense index funds. It is not advisor compensation that results in poor returns but rather their own choices. When this group does invest in mutual funds, they tend to select high expense funds, trade funds frequently, avoid index funds, and time their buys and sells poorly, thereby damaging their portfolio's

performance. They also exhibit stronger trend-chasing behavior (Bailey, Kumar & Ng, 2011). Other research suggests that behaviour is more rational, but it was based on 1991-1996 data (Ivkovich & Weisbenner, 2008) – a time when stock markets were steadily improving after the massive downturn of 1987. There is no recent confirmation of these findings.

Investors tend to select funds at the worst possible times (e.g., buy at peak, sell at bottom). This tendency is most clear for the funds with the best risk-adjusted performance. **Buying the wrong funds cost investors 6 basis points per month, but selling at the wrong time reduced fund investor returns by 15 basis points** (Friesen & Sapp, 2007).

It is also clear that investors irrationally expect to “beat the market”. Investors expect the fund managers to deliver an overall annual excess-return of around 3% over the S&P 500, net of fees, irrespective of the investment style and of the risk level of the funds (Hu, Malevergne & Sornette, 2009).

A small survey and an Internet-based experiment highlighted investor biases. Investors preferred funds with strong past performance, paid some attention to load, and grossly discounted fees (Wilkinson-Ryan & Tess, 2012). Investors have a predisposition to chase last period's risk-adjusted returns when selecting funds, especially if the fund is marketed as distinctive in some way (Li, 2003).

Many investors affirmatively believe that higher fees in particular lead to better performance. Investors who focus their attention on outperforming the market may either ignore fees in favour of past performance, or may read a fund's fees as a good sign for future returns (Wilkinson-Ryan & Tess, 2012). This confirms earlier

research which found a belief that higher expenses meant better managerial talent and likely performance, but this study also found that “old money” is more likely to leave when expenses rise (Ivkovich & Weisbenner, 2008).

Other earlier research confirms the tendency to prefer more expensive funds but points to the earlier finding that investors cannot assess the implication of different fee structures for different funds. We don’t know what today’s numbers would be, but a decade ago researchers found that 84% wrongly believe that funds with higher expenses earn higher returns, even though the opposite is true (Barber, Odean & Zheng, 2002).

As we posited earlier in this chapter, the complexity of investor choices is the root of the problem. Experimental research shows that investors are often uncomfortable with the investment process, and instead of understanding the concepts, they seek shortcuts, heuristics, and opportunities to delegate that relieve them of the burden of understanding the complexity. They don’t understand the concept of diversification nor do they understand the magnitude of fee impact (Fisch & Wilkinson-Ryan, 2014). Disclosure of costs and compensation is unlikely to have an impact on their understanding or their investment choices.

Referring again to the experiments conducted with Harvard employees, researchers found that a Summary Prospectus reduces the amount of time spent on the investment decision without adversely affecting portfolio quality, but a Summary Prospectus does not change, let alone improve, portfolio choices (Beshears, Choi, Laibson & Madrian, 2009). If disclosed information has little impact with this relatively literate group, it is unlikely to have an impact with the general population.

One thing that advisors claim to do that their clients sometimes neglect is to place greater emphasis on objective information. In a survey of financial advisors in the US, advisors claim to put more emphasis on objective information sources than clients do on their own. They say they place greater emphasis on fund objectives, risk, investment style, manager tenure and reputation, while judging performance relative to funds with comparable style. They indicate that they tap information that clients either fail to consider or are unable to access (Jones, Lesseig & Smythe, 2005). What they do with this information is the question we address next.

Incentives Affect Efforts to Overcome Investor Biases

Advisors are aware of behavioral biases and make choices about how they will address those biases. The impact of compensation on those choices is not that simple. There is evidence to suggest that advisors play to the behavioral biases of their clients. This can be motivated not just by increased commission, but also by a desire to retain the client. In other studies we have done, we have often heard this sentiment expressed by senior executives managing investment advisors. It would be very useful to formally research how advisors deal with unrealistic client expectations and what affects their response.

Self-directed clients provide a contrast to commission-based in that one group receives advice and the other does not. Several studies show broker clients to be less behaviorally biased than self-directed investors, but the results depend on the behavioral bias, the sample, and the methods of analysis used. It is unclear whether the same results would be found comparing self-directed and fee-based clients.

The most comprehensive look is a study done in the Oregon University System (OUS), which used individual level data rather than aggregated to look at behavioral biases. With all participants working for the university system, this is likely a more literate sample than the general population. The study in the OUS focused on retirement savings and gave investors a choice of using high advice brokers (commission) or self-directed investment. Broker clients were more diversified in their investments, initially showing more chasing of returns, and were no different in home bias than direct clients (Chalmers & Reuter, 2012). In addition, commission-based investors bought more funds than self-directed investors, and they allocated a larger fraction of their retirement contributions to index funds. Broker clients were also less likely to invest solely in the default investment options for new participants, and less likely to change their allocation to domestic equity during the financial crisis. Chalmers & Reuter (2012, p.3) also found that “in exchange for paying broker fees, broker clients receive advice on how to construct well-diversified portfolios.” While this finding certainly applies to the OUS study, we found the asset allocations of all groups in this study reflected above average numeracy that may have influenced all results. Regardless, the results do point to both positive impacts for working with commission-based brokers instead of self-directed investing. There is no comparison to brokers compensated by means other than commission.

Another study relying on aggregated data showed broker clients (which may not be purely commission-based) demonstrating less home market bias than the direct channel, but other biases were comparable to the direct channel including return-chasing (Bergstresser, Chalmers & Tufano, 2009). The two studies certainly differ in their conclusions about biases.

A mystery shopping study done in the US showed that **commission-based advisors did not often discourage return chasing**, suggesting that the reason was that return chasing is a good commission generator. The study noted that commission-based advisors did not substantively recommend international investment, even though the portfolio was faulty due to home market bias. More critically, commission-based advisors recommended switching to active management from a perfectly balanced low-cost and indexed portfolio, even though this would lower returns (Mullainathan, Noeth & Schoar, 2012). The results are compelling as evidence of bias created by commission-based compensation, but the study would be far stronger for our purpose of comparing compensation regimes if the authors had replicated their four mystery shopping scenarios with fee-based advisors.

Assuming compensation practices are comparable in the EU, a recent mystery shopping study suggests the potential for biased recommendation simply based on advisor affiliation rather than compensation. An EU study of 1200 mystery shops in 27 member states showed that banks tend to propose their own investment products (80% of their recommendations), rather than products from third-party financial entities. As we noted earlier, even without commissions, there are other ways to incentivize employees, potentially including: recognition, end-of-year performance awards, promotions or just a good performance appraisal. As is well established in Organizational Psychology, money is not the only incentive that gets people to perform¹¹. Status, recognition, competitiveness, and a sense of responsibility are among the many other factors that motivate performance.

¹¹ For a summary of the research, see http://en.wikipedia.org/wiki/Work_motivation#Other_factors_affecting_motivation

There are two issues related to behavioral biases that must be mentioned here. The first is the question of who is responsible for overcoming the behavioral biases of individual investors. While helping clients to do so may be something that a top-notch advisor will choose to do, we are not aware of any rule or principle that points to de-biasing as an advisor or a firm responsibility, regardless of compensation scheme unless a failure to do so impacts 'investment suitability' in some way. We are not saying that an advisor should capitalize on behavioral biases to increase their personal compensation, but rather we are saying that there are practical limitations to their ability to de-bias.

This takes us to the other point we want to discuss, namely the practicalities of client retention. This is an area where academic research is lacking. We believe our own experience interviewing senior executives who manage advisors has a bearing on this question. Drawing on interviews we have done in the past, we suggest that trying to overcome a behavioral bias may result in the client just going to another firm or advisor who will do what they want. This is certainly an issue meriting formal research.

Similarly, looking at something like home market bias, an advisor can't really compel their client to invest outside Canada. Investing patterns show that investors are most comfortable investing within Canada and show little propensity to actively invest outside North America. If an advisor advocating foreign investment meets with a lot of resistance from their client, they are not going to argue with the client but rather just encourage them to make some shift of assets over time. The same is true for other behavioral biases in our view, especially return chasing.

When the client reads a financial columnist lauding the performance of a particular fund, it may be hard to dissuade them

not to buy that fund and it might even make them suspicious of the advisor's motives. An article by a financial columnist that discusses top performing funds is a powerful force, as research on Investor Decision-Making has shown [Weinstein, 2012; Weinstein, Bottrell & Al-Saffar, 2010], although it does not necessarily outweigh the opinion of the advisor.

As the foregoing evidence suggests, disclosure and rational discussion may not be enough to overcome behavioral biases. This is especially the case since many investors have no interest in this type of discussion. With 40% of Canadians failing a general investment knowledge test and many demonstrating unrealistic expectations for investment returns (CSA Investor Index, 2012), it is clear that many investors don't wish to spend a significant amount of time on financial matters. Without a real comparison of investment decisions for investors of comparable sophistication using advisors with different compensation, we suspect that much of what we see as impact of compensation is just investors failing to make rational decisions. This is all testable, but to our knowledge, no one has rigorously done so.

Investors Don't Always Take Advice

Several other studies point out that the offering of advice is by no means a guarantee it will be taken. Furthermore, the willingness to take advice is shaped in part by its perceived cost. While we will present these findings, our recent study of advisor relationships and investment decision-making in Canada indicate that Canadian investors with an advisor will take their advice (The Brondesbury Group, 2012) most (but not all) of the time.

Some 5 out of 6 Canadian investors with advisors (88%) say they rely on the advice of their advisor to decide what mutual fund to buy. Typically, they are asked to select from a small set of choices presented by their advisor. Their understanding of the advisor's compensation is limited (The Brondesbury Group, 2012). US numbers are comparable. Some 87% of mutual fund investors who use advisors either delegate all decisions to the advisor or choose from among a set of funds they recommend (Zhao, 2008).

A series of three experiments found that participants relied more heavily on advice when it cost money than when it was free. Cost of advice affected the degree to which participants used advice but did not affect the value gained by following advice. Participants weighed their personal opinions less than others when advice cost money. When advice was free, they instead weighed their personal opinions more than others (Gino, 2008).

When free advice was offered for the first time to hundreds of thousands of active self-directed retail investors in Europe, only 5% of clients sought out the advice. Few took the advice, despite the fact that the advice could be proved to be financially sound. The advice was not tied to compensation at all. The research also found that the people who most needed the advice were the least likely to obtain it (Bhattacharya, Hackethal, Kaesler, Loos & Meyer, 2012). Bear in mind that this is an unusual sample, in that all of the participants had initially opted to direct their own investments.

Taken together, these studies indicate that clients must see themselves as paying for the advice, if advisors want them to take it. What is lacking is a comparison of acceptance of commission-based and fee-based advice, which by inference would tell us what investors believe they are paying for in the two compensation models. The wording of the questions in such a comparison would

be critical for ensuring that no response biases were introduced by the questions.

5.3 Discussion of Findings

Our discussion of findings is in two parts. The first part is a discussion of technical issues. The second part discusses the meaning of the findings in the context of the objectives of this research.

5.3.1 Technical Issues

As we cited earlier, there are a wide variety of methods used to investigate investors' behavioral biases. Experimental approaches, sometimes in combination with a survey, are particularly prominent (Beshears, Choi, Laibson & Madrian, 2009; Dominitz, Hung & Yoong, 2008; Fisch & Wilkinson-Ryan, 2014; Gino, 2008; Wilkinson-Ryan & Tess, 2012).

The key issues for experiments are the sample they use and the simplification they often employ to make an experiment possible. It is important to understand that experimental design requires the researcher to control the situation quite tightly, so that any findings can be attributed to a small range of intended possibilities. This simplification makes experimental results seductively appealing, but at the same time reflects their weakness of over-simplifying the complexity of the real world.

In terms of sample, we would typically conclude that the generalizability of the Beshears et al (2009) study is limited by its use of Harvard employees, which in our view do not constitute a general investor population sample. But since education should indicate respondents who are more capable of using information, their sample actually enhances the credibility of their findings that information on compensation is not used effectively.

Experiments using undergraduates or graduate student are common and such samples cannot be considered a good cross-section of the investor population. Recognizing this, two studies (Fisch & Wilkinson-Ryan, 2014; Wilkinson-Ryan & Tess, 2012) added a second sample drawn from a broader online survey panel to enhance the credibility of their conclusions. A third survey (Gino, 2008) recruited people through ads to supplement their student population. Dominitz et al (2008) used a broad-based Internet survey panel for their sample, thereby enhancing the generalizability of their conclusions. In fact, the use of the Internet for experiments was prominent. Based on the profile of internet users and investors, we do not view this as a limiting factor in the credibility of these studies.

In addition to experiments, findings on behavioral biases are also based on two mystery shopping studies, one done in the US and the other in the EU. The EU study actually focused on advisor compliance with EU guidelines but touched on issues germane to this chapter. With 1,200 mystery shops in 27 countries it is quite compelling. The US mystery shopping study (Mullainathan, Noeth & Schoar, 2012) is much smaller but it is an exceptionally well-designed study. It uses four well-designed investor scenarios and trained auditors who meet with advisors and get advice. The scenarios reflect biases that are likely to either enhance the revenue opportunities of advisors (e.g. return-chasing) or run counter to their interests (e.g., low-fee index funds). Advice can be assessed cleanly in terms of whose interests are best served by the advice.

Several studies cited in this chapter rely on analysis of individual accounts and they are particularly useful for assessing individual level impacts. Barber et al (2002) gives us a good view of the impact of behavioral biases using a massive sample of discount brokerage clients. Bailey et al (2011) provide a particularly compelling analysis

of individual investors using several behavioral proxies and control variables. Bhattacharya et al (2012) provides us with a complementary analysis, comparing those getting advice to those who don't, even if compensation differences are not involved. Chalmers & Reuter (2010) and Hackethal et al (2009) are especially valuable because they allow us to compare self-directed and advised (with commissions) accounts and to assess the potential consequences of compensation. Unfortunately, there are no studies that allow us to compare the impact of commission-based versus fee-based advisors.

Most of the remaining studies cited in this chapter use aggregated data and regression analysis to form conclusions. These studies tend to focus on narrow mutual fund buying decisions, especially load versus no load. Other aggregate analyses (Zhao, 2008) link findings to research on individuals to extend their conclusions.

As we stated earlier, the variety of methods here is unusually broad. Conclusions confirmed by multiple methods are generally deemed to be more robust than those reached by a single method.

5.3.2 Discussion: Individual level Impact of compensation

The kinds of comparisons that are ideal for assessing impact are simply not available. Nonetheless, there are some questions raised by the research on investor behaviour that merit our attention.

Much of the research we review in this study is binary, comparing load fund and no load fund buyers, advised versus not advised clients, or broker clients versus non-broker clients. The categories used do not correspond perfectly to compensation. For example, some buyers of no load funds may have fee-based advisors and

others may be self-directed. Some advised clients in the studies we reviewed did not pay for the service so compensation was not at issue. Broker clients are seldom paying in a manner that is purely commission. Comparisons get a bit murky.

Despite these limitations, there are a number of related questions that require further investigation.

1. To what extent are deficits in investor outcomes due to their own behavioral biases rather than the advice they get?
2. Does the advice of fee-based versus commission-based advisors differ so much that it makes more of a difference to outcomes than behavioral biases?
3. Given that wealthier and more experienced clients can get fee-based advice from more experienced advisors while newer and less experienced clients can typically just get commission-based advice, how much of the difference in outcomes is due to client and/or advisor capabilities?
4. To what extent are advisors obligated to de-bias their clients?
5. Can disclosure of compensation change the kind of advisor people choose?
6. Can disclosure of compensation mitigate any impacts of type of compensation on investor outcomes?

Questions 1 and 2 deal with the impact of behavioral biases. We don't believe these questions can be answered with available evidence. In fact, comparisons of self-directed versus advised clients suggest that behavioral biases weaken investor outcomes. Unfortunately, without comparing advised clients using fee-based versus commission-based advisors, we cannot generate accurate answers for these two questions.

Client capabilities affect decision-making and thus affect outcomes. Wealthier clients tend to be older, better educated and have worked in higher-paying jobs. In general, they have more experience with investments and more knowledge of investment products. Yet to get to this point, they needed to be younger and less experienced investors first. **The underlying question is really whether younger less experienced clients would do as well as older investors if they had fee-based advisors. Our opinion is that it is unlikely they would do as well as older investors due to their own lack of knowledge and the comparative inexperience of their advisors.**

The bigger question is whether investors with commission-based advisors would do better with a fee-based advisor than they do now. For the majority of investors, it is likely that they would. For the smaller investor, the answer may well depend on whether a fee-based advisor can afford to spend time with them, or alternatively, whether they are willing to pay explicitly for advice.

Findings certainly indicate that commission-based advisors sometimes give biased advice that enhances their own revenue. Concerns about reverse churning and focus on proprietary (or related) products among fee-based advisors, suggest advisors with other forms of compensation can give biased advice too. How else could someone justify the finding that EU bank advisors recommend in-house products some 80% of the time? We are not saying that happens here, but rather just pointing out that every form of compensation is likely to have some form of bias associated with it. As we commented earlier, firms are quite capable of incentivizing their advisors to sell what is in the best interest of the firm.

In reviewing research reports, we noted that several researchers asked whether there was evidence that advisors de-biased their

clients. The conclusion was that any de-biasing was minimal, and in one study at least (Mullainathan, Noeth & Schoar, 2012), there was even solid evidence of “biasing” an unbiased portfolio when it was to the advisor’s advantage. Foerster et al (2014) certainly suggested that advisors have influence, making their clients’ portfolio look like their advisor’s portfolio. Regardless of these findings, the answer to whether advisors are obligated to de-bias clients (other than when a failure to do so leads to suitability issues) can only be a matter of policy. On a practical level, however, we can say that **an obligation to de-bias clients would be time-consuming and costly.**

Questions 5 and 6 both deal with the impact of disclosure. The impact of cost disclosure with CRM2 should provide us with answers to both of these questions, given that disclosure of compensation will be clearly stated in dollar terms. Even so, people still may not grasp the implications of the information they receive about compensation, especially with regards to conflict of interest. Canadians mostly continue to believe that their advisor will put their clients’ interests first.

This implies that if there are clear evidence-based differences in the outcomes resulting from distinctly different forms of compensation, that it would be better to act on this information than to leave it to investors to assess implications. That kind of evidence is certainly available for commission-based compensation, but not yet available for fee-based compensation.

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6. International Regulation of Compensation

Highlights

Throughout Europe and in other jurisdictions, regulators in recent years have made efforts to limit the role of commissions in the sale of retail financial products. Regulations are typically not evenly applied across all financial products, that is to say, that there are few jurisdictions that have addressed all insurance, investment, mortgage and all other commission-driven products.

Regulations have run the gamut from outright ban of commissions for all sales of financial products (Netherlands) to bans of new commissions for specific product classes (EU) to elimination of specific types of commissions like front-end loads on mutual fund sales (India). Much of the time, changes in compensation are accompanied by strengthened rules on disclosure of charges. And with a greater emphasis on advice, regulation may also address the level of knowledge (proficiency) the advisor requires to advise capably.

Regardless of the mechanism used to effect change, regulators talk about ensuring financial advice primarily benefits the investor. They aim to bring clarity to the advisor-client relationship by creating clear divides between product “manufacturer” and advisor. Payment from client direct to advisor is thought to ensure that the advisor is perceived as being clearly on the “investor’s side”, both from the client and the advisor perspective.

Many regulators have found the evidence on product bias induced by commissions is strong enough to justify putting restrictions on

commission, even if the consequences of a fee-based regime are not known in advance. And indeed, there is a great deal of opinion regarding the impact of moving to a fee-based regime, albeit few facts. Most of the regulatory changes are quite new, so there is little independent research on its impact as yet. Nonetheless, with the backing of academic literature, the research on impact leads to five major conclusions.

1. Embedded compensation does lead to biased product advice;
2. Removing commission lowers product cost and also leads to purchase of more low cost products. Nonetheless, advisory fees rise in the absence of commission. It is too early to tell whether increases in advisory fees will offset net improvement in the overall return to the investor.
3. Commissions are only one form of inducement that influences sales.
4. Investors will tend to remain confused about charges regardless of compensation regime. Regulations will likely affect only new sales so old charges will continue. As well, there may be administrative charges. The clarity of disclosure is the issue.
5. Segments with lower income and lower wealth may be challenged to get personal advice, but there is no evidence that this is a change from the pre-regulation situation.

6.1 Background

Three regulatory initiatives are the focus of most opinion and activity regarding compensation:

- MiFID 2 (Markets in Financial Instruments Directive 2) in the EU;
- RDR (Retail Distribution Review) in the UK; and
- FoFA (Future of Financial Advice) in Australia.

The EU (MiFID2) initiative sets a baseline of regulations for the sale of financial products in the EU. Countries can impose stricter rules if they wish. MiFID2 regulates the sale and distribution of investment products and structured bank products, but to date it has not substantively addressed life insurance products. MiFID2 will be implemented at the end of 2016 through early 2017.

MiFID2 bans the receipt and retention of new commissions by Independent Financial Advisors (IFA) and discretionary portfolio managers. It does not ban commissions for tied/restricted advisors like those working in a bank or directly working for a life insurer, but it does mandate that these companies incentivize their advisors in a manner designed to ensure that the advisor is motivated to provide advice that puts the client's best interest first.

6.1.1 EU Regulation¹² Pertaining to Compensation

EU	<p>MiFID2 covers sale and distribution of investment products and structured bank products, but not life insurance products.</p> <ul style="list-style-type: none"> • Bans receipt/retention of commissions by IFA and discretionary PM
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¹² Source: BlackRock Viewpoint, May 2014. "The Changing Face of European Distribution"

	<ul style="list-style-type: none"> • Tied/restricted advisors (bank or insurer-based advisors) can retain commission but must be appropriately incentivized. • No ban on commissions to execution-only platforms that do not offer advice. • Countries can impose stricter rules, if desired. <p>Implementation end 2016/early 2017</p> <p>Further efforts to effect change in insurance have only led to requirements for greater disclosure.</p>
UK	RDR implemented end 2012 with added requirement in April 2014. Bans commissions between product providers and fund distributors on <u>new</u> business and forces advisors into fee-based models to replace revenue streams.
Netherlands	Ban on commission for income insurances, unit-linked insurance, annuities, and non-life insurance effective January 2013. Inducement ban for investment services effective January 2014. Transition for transactions in financial instruments and open-end funds. Part of a decade-long series of increasingly tough legislation to foster consumer-oriented advisory services.
Sweden	Assessing impact of RDR, consultations planned.
Denmark	May act ahead of MiFID
Belgium	Following MiFID
Germany	Prior to MiFID focused on transparency of cost of advice, whether via commission or fee. Must

	disclose incentives from product providers or other intermediaries. New rules must make it clear to investor about how they are paying. Fee-based advisors must be able to demonstrate adequate knowledge to advise. Regime came into effect on August 2014. Other changes likely to be tied to MiFID2.
France	No moves likely until MIFID2. Regulator expresses concerns about churning in move from commission to fee-based advice.
Italy	Possible will move to a dual system of fee-based and commission-based advisors. Other moves unlikely in advance of MiFID2

MiFID2 is expected to affect the culture and behavior of advisors and their firms. Anticipating significant change from MiFID2, many EU countries are unlikely to act on new initiatives in advance of MiFID2 (see Exhibit 6.1). The two most striking exceptions to this are the UK and the Netherlands.

The Dutch regulation has been effected through a series of increasingly tough regulations over the past decade but ultimately it will ban all inducements from product providers including (but not limited to) commission. As van der Linden (2014) comments, the strength of the Dutch approach is a very “clear line between the adviser and the manufacturer” that makes it easier for Dutch consumers to know that the advisor is working in their best interest.

The UK Retail Distribution Review (RDR) bans commissions between product providers and fund distributors on new business. It forces advisors into fee-based business to replace their existing commission-based revenue stream. Among other things, it also raises education requirements for advisors and mandates greater

disclosure regarding charges. The logic behind the RDR and the implementation of the RDR are better researched than any other initiative, as we will see later in this chapter.

Leaving the EU (see Exhibit 6.2), we find that Australia’s Future of Financial Advice (FoFA) legislation is the most sweeping regulation pertaining to compensation outside the EU. It places restrictions on percentage-based fees and a ban on receiving commission for new advice. Retail investors must opt-in to the fee-based charges every two years.

India placed a ban on mutual fund entry loads and capped exit loads in 2009. Commissions are paid directly from the investor to the advisor creating a clear divide that puts the advisor squarely on the side of the investor.

6.1.2 Non-EU Regulation Pertaining to Compensation¹

Australia	Future of Financial Advice (FoFA) came into force in July 2013. Restrictions on percentage-based fees and a ban on receiving commission for <u>new</u> advice. Retail investors must opt-in to ongoing adviser charges every two years. In November 2014 some provisions of the FoFA legislation were disallowed, but they are not central to the overall thrust regarding commission.
India	Banned entry loads on mutual funds since August 2009 and capped exit loads. Disclosure on charges are required. Upfront commission to distributors will be paid by the investor directly based on services provided.
Singapore	In 2012, MAS launched the FAIR initiative.

	Focus on bank incentive models rather than outright ban. Includes a balanced scorecard in the remuneration framework.
Switzerland	New fund law devised with parts coming into effect gradually. It will be fully implemented by March 2015. Fund law fully revised. Distribution regime tighter but classification of investors doesn't match EU rules. New laws likely to mirror MiFID 2 are being drafted.
USA	Co-existence of commission-paying and fee-based advice. No immediate change expected.

Singapore looked at the possibility of a commission ban and concluded that it was not ready to pursue that direction. It has instead proposed a quality-focused basis for remuneration in the form of a balanced scorecard.

The USA has opted for co-existence of commission-based and fee-based compensation with clear disclosure. No other immediate change is expected. As we saw in chapter 4, the current approach has not led to a decline in commission-driven advice.

6.2 Findings

Most articles about these new regulations are opinion pieces, typically predicting their impact. The predictions are often easily anticipated by looking at the self-interest of the author. Academic opinion pieces have predicted impacts from a theoretical base (Gorter, 2013), as well as by synthesizing the opinion of senior industry executives and UK-based financial advisors gathered in in-depth interviews (Clare, Thomas, Walgama & Makris, 2013).

Impact of RDR

BlackRock is the world's largest asset manager and definitely has a stake in what happens, but nonetheless, their comments about the RDR initiative focused on strengthening the effectiveness of regulation.

- Confusion about charges is likely to continue since the commission-ban only applies to new transactions. There remains a continued stream of trailers, platform fees, cash rebates and unit rebates.
- Continuation of commissions for "wrapped life" and pension business is likely to confuse.
- Differences in regulation of life and investment products doing similar things may lead to 'regulatory arbitrage' as advisors move clients into insurance-wrapped investments. For a commission-ban to be effective it must be applied to every type of advisor or commission-based advisors may simply switch to products that do pay commission.
- To ensure no additional incentives from product manufacturers, administrative platforms must not be bundled and must be paid separately for the services they perform.

Sorenson (2013) writing in Global Risk Insights discusses the potential negative side effects of RDR, but suggests that these can be remedied by fine tuning legislation. Some potential side effects are "dumbed-down" funds, less access to advice for low and low-middle households, and a consolidation in the industry.

The most extensive evidence about any compensation-related legislation in recent years comes from the RDR Post-Implementation Review (PIR) just released in December 2014 (Europe Economics). This is a balanced empirical review using data available in the public domain plus data from studies commissioned by the FCA. These

studies include: online interviews with over 4000 investors (Burns and Clarke, 2014); a qualitative study on understanding of charges (Thrift, Burns and Craig, 2013); modeling of supply and demand for financial advice (Towers Watson, 2014); and responses from the FCA Practitioner Panel.

With respect to how RDR affects retail investors, PIR notes that the impacts of RDR are yet to be fully realized but some impacts can be identified. **The PIR concludes that RDR has lessened product bias. It also notes that advisers are earning more now and there is no evidence as yet that total costs to investors are lower.**

The PIR concludes that the ban on third-party commission has reduced product bias. There was a decline in the sale of products that had higher pre-RDR commissions and a definite increase in the sale of those that paid low or no commission pre-RDR.

Looking at cost, the same evidence shows that **there is increased access to lower cost products**, but the report does not find evidence of overall lowering of investor cost. Charges for retail investment products have been falling post-RDR, but at same time there is evidence that cost of advice has increased. It is also difficult to compare platform and product costs pre- and post-RDR, much less how they interact with adviser payments for each investment product.

Evidence suggests that non-commission costs are rising in the post-RDR environment. **The evidence currently available implies adviser charges have increased post-RDR, at least for some consumers. There are also increases in some platform and product costs. It is likely that only wealthy clients are paying less now.**

On average, RDR has not led to a reduction in adviser remuneration, but evidence is difficult to interpret because of legacy payments and lack of comprehensive database. One database finds the proportion of advisers with higher income has increased steadily since RDR (Pp.64-65). **The FCA Practitioner Panel finds higher ongoing advice charges post-RDR.** The report comments on unexpectedly low levels of price competition among advisers. The report also notes that RDR demands evidence of ongoing advice to justify fees and speculates that fees for more holistic advice may have spurred higher costs.

One of the concerns expressed about fee-based regimes, especially those with higher qualification requirements for advisors, is that they will drive existing advisors out of the business and limit public access to advice among the less wealthy. There is mixed evidence on this. There is evidence of increased segmentation of client books and a focus on wealthier consumers, but little evidence so far that consumers see themselves as being 'abandoned' by advisors.

Towers Watson (2014) in a very well-done modeling of demand for advice and supply concludes that there is ample availability of advisors. They comment that there is "Little evidence that availability of advice has reduced significantly. The majority of advisors are still willing and able to take on more clients."

Having said that there are enough advisors overall, they concede that it is likely the segments with fewer assets and lower income are under-served. The three segments they specifically mention are based on a comprehensive segmentation of client segments commissioned by the FCA. The characteristics of these segments are extracted from the Towers Watson report.

- **Living for now** (14%): Low income, younger, male. Keep on top of bills, but less organized and prone to risk taking. Rely on friends & family for advice.
- **Striving & supporting** (8%): Low income, mainly female with dependents. Risk averse. Fall behind in bills. Busy & pressured. Loyal to FI.
- **Starting out** (9%): Young, more than half from ethnic minorities. High level education & qualifications but incomes still low and many still studying. Struggle to make ends meet. Strong support networks. Confident & optimistic about the future.

Whether these segments have less access to advice than pre-RDR is never addressed, but it is a question that is worth asking.

Regardless of the total availability of advice, not everyone wants to pay fees and not everyone wants advice. There is increasingly more “do-it-yourself” (DIY) investment through direct-to-consumer (D2C) platforms. For those who need simplified advice, there is an expectation that technology will eventually meet their needs.

As part of the evidence on availability of advice, the PIR report cites an online survey of over 4,000 investors with investable assets in excess of £5000 (Burns and Clarke, 2014). Quoting from survey results, the relevant findings are:

- Consumers will use different channels depending on their circumstances, amount available to invest and complexity of requirement at that point of time.
- Non-advised are more likely to invest a modest amount than advised.
- As investment level grows and/or complexity of product increases (i.e. starting pension/retirement plan), non-advised are increasingly likely to seek out regulated advice.

- Willingness to pay for advice varies with the amount invested. While only 17% say they would seek advice for an investment of £5,000, this climbs to 84% for £100,000.
- The move to charging for advice has not deterred consumers from seeking advice. There is little evidence from research to suggest that cost is major deterrent to seeking advice.

Much as BlackRock Investment predicted in 2012, **there remains confusion about charges and advice services.** The same NMG (Burns and Clarke, 2014) online survey of investors found both advised and non-advised investors were a bit confused about charges. Three out of 10 advised investors (29%) said the organization they purchased through received commission. Some 2 out of 10 (20%) thought that neither fee nor commission was involved in their purchase. Non-advised clients also fail to understand charges. Two-thirds of non-advised investors (66%) who bought an RDR investment product did not believe they had paid fee or commission. As another survey found, advice from commission-based advisors is often perceived as free¹³.

An earlier NMG qualitative study (Thrift, Burns and Craig, 2013) anticipated this finding. **Just as many academic studies demonstrated, people don’t readily understand charges and how to figure out what applies to them.** They have difficulty understanding costs stated as percentages because they make errors with decimals. They have difficulty with hourly fees because they are not sure how long it will take to help them. They also find it difficult to select the costs that apply to them from a menu of fixed fees. Finally, timing is an issue, because they may not know when they will pay for services (initial or ongoing charges).

¹³ “The Changing Face of European Distribution”, BlackRock Investment: ViewPoint, May 2014.

While not part of the Post-Implementation Review commissioned by the FCA, it is worth mentioning the findings of a small (n=100) UK advisor survey conducted by BlackRock Investment. They found that advisors were quite positive about RDR saying it will lead to better FA technical knowledge; more servicing to foster retention; and greater focus on articulating value to core client groups. Some 4 out of 10 advisors are looking at segmenting their clients. Overall, **45% of these advisors believe RDR will raise consumer confidence.**

Impact in Other Jurisdictions

All of this regulation is quite recent and evidence of impact is more notable for its absence. It takes time to see impact. Nonetheless, there are some uncorroborated sources that are worth noting.

Allen & Overy (2011), a law firm specializing in regulatory law, refer to a Dutch Ministry of Finance review in 2010, which assessed the impact of legislation to that date. The Ministry assessment showed that consumers still did not know what charges to expect or their cost. At that point, the Ministry also found links between advisors and manufacturers were quite strong. They concluded that their legislation had not achieved the cultural shifts they aimed for, which would clearly put the advisor on the side of their client. There also remained uneven inducements for some products that could distort advice.

The result of the 2010 review was additional legislation to remedy those issues including efforts to stem product displacement, standardize disclosure and remove inducements from manufacturers. It remains too soon to assess the more recent legislation.

For an alternative view, we cite an article by van der Linden (2014). Van der Linden works for a major global reinsurer and in that role he can be seen as “above the fray” of retail distribution.

Van der Linden (2014) describes a decade long progression toward the banning of all financial product commissions (or any other inducement including a lunch) in the Netherlands including protection products. Early efforts included caps on the ratio of front-end versus trailing commissions; a cap on investment charges at 2.5% with retrospective repayment for excesses; and a cap on duration of trailing commissions.

Van der Linden reports that there are far fewer advice companies in the Netherlands than 10 years ago (4,000 versus 11,000) but does not talk about number of advisors or access to advice, so we don’t know if this is a drop in availability or industry consolidation.

The major business driver for the insurance market in the Netherlands is that life insurance is mandatory in order to get a mortgage -- and 60% of households are home buyers. This means that 60% of adults must pay a fee for insurance advisory service whether they want to or not. He asserts that companies are adapting to the new regime as it is phased in, but speculates that it will take a decade to see all of the effects of legislation.

Turning to regions outside Europe, we note that India banned loads on mutual funds in 2009. Payments for product purchase were made direct from investor to advisor. The academic report looking at impact commented that the commission ban on loads in the Indian market did not damage growth in funds with previously high fees, but the overall impact of the legislation was muddied by a global downturn that lessened investment in all funds (Anagol, Marisetty, Sane and Venugopal, 2013).

We have not found any empirical evidence on the Australian legislation, and of course, it is just being implemented. Anthony James of PwC (Australia) speaking at a 2014 Advocis Panel in Canada stated that the commission ban in Australia has led banks to push more in-house products [Industry Super Australia, 2014]. He speculates, likely based on an actuarial report [RiceWarner, 2013], that those who don't want to pay for full-service advice will seek scaled advice, perhaps through technology platforms like robo-advisor. Both of these claims are in accord with preliminary findings from the UK and EU.

Mis-selling

Ahlswede (2012) at Deutsche Bank (DB) research asserts that the key issue in retail advice is mis-selling, which is the result of bad advice rather than commission. Ahlswede contends that bad advice is driven by inaccurate assessment of investor risk, investor priorities and product features. While it is unquestionable that these are causes of mis-selling, the DB view is naïve in assuming that mis-selling cannot be due to ignoring information because acting on the information lessens the advisor's commission earnings.

Nonetheless, mis-selling is an issue that has grabbed the attention of regulators. The European Securities and Markets Authority (ESMA) commissioned a mystery shopping study involving 1200 "shops" in 27 countries, which in part looked at mis-selling (Synovate, 2011) prior to the pending MiFID2 legislation. The study found mis-selling a significant problem, especially mis-selling based on incorrect match between client and product risk. As we reported in chapter 3, the study found 57% of product recommendations to

be unsuitable with 80% of these due to higher than justified investment risks.

In light of our earlier comments, we note that packaged products with higher risk (e.g., equity funds) do pay higher commissions than low risk products (e.g., money market funds), so that commission may be the issue rather than incorrect assessment.

The FSA (now the FCA) in the UK (January 2013) looked at risks to customers driven by a broad range of financial incentives in some 22 authorized firms. They concluded that "most incentive schemes were likely to drive people to mis-sell and these risks were not being properly managed". They noted that bonus schemes were common and firms did not do well at managing mis-selling risks or even recognizing that their incentive schemes may promote mis-selling. The report commented on inadequate governance and oversight on design. It concluded that the likelihood of mis-selling went up when incentives made up a high proportion of remuneration for sales staff.

In terms of placing clients into higher risk products than their risk profile suggests is warranted, we speculated in an earlier chapter that this may be an advisor strategy to help deal with a mismatch between risk profile and investment objectives. In a 2014 InvestorPulse Survey commissioned by BlackRock Investments, they found that investors have consistently unrealistic beliefs about the income their retirement savings will generate, typically underestimating what they will need by 50% or more. The report comments that inconsistencies between risk profile and attainment of objectives are likely to be at odds over the long-term. This may explain some of what is seen as mis-selling, but as the authors conclude, it really "speaks to the need for advice, even among those not seeking it."

Whether mis-selling practices are primarily driven by compensation or by poor advisor judgment, both are likely involved. Regulators are addressing the issue of mis-selling by strengthening knowledge requirements for advisors and by attempting to create new compensation regimes. Their aim is to push the advisor to focus on assessing investor needs without that assessment being potentially influenced by their compensation for that advice.

6.3 Discussion of Findings

The impact analyses and the earlier academic work focus attention on a number of issues. The first, the dominant question for this study, is whether embedded compensation introduces product selection bias on the part of advisors. The answer from the academic research was that embedded compensation did influence advice. The evidence from the Post-Implementation Review of RDR confirms that the removal of commission has resulted in more low cost products being sold. In short, **embedded compensation does lead to biased advice**. That is clear from both academic research and research on regulatory impact. Given the volume of evidence, faults with a few studies cannot be enough to overcome the weight of evidence.

In academic research, much of the disadvantage engendered by biased advice is that the return on a recommended investment is greatly diminished by commission costs. When commissions are removed from the equation then return to the investor should be higher. As we pointed out earlier, however, the return to the investor in a fee-based regime can only be reckoned after all fees have been charged against the investment return. **The research on regulatory impact suggests that while product cost is lower and**

advisors recommend more low cost products, the cost of advice and other fees (e.g., administration, platform) is likely to rise. It is not yet clear whether the total return to the investor will be improved by the shift in compensation regime. Nonetheless, there may be other benefits from unbiased product selection, but as yet such benefits are not documented.

Earlier work has also shown **that commissions are only one form of inducement that influences advice**. Bonuses, potential for promotion, and other forms of recognition can also differentially motivate selection of one product over another (FSA, 2013). As well, when payments are made to a firm for administrative services, differences in the amounts paid by different fund managers can influence the firm's preferences. The FSA (2013) report entitled "Risks to Customers from Financial Incentives" makes it clear that these are important issues to address along with commission.

We also note that some of the regulation banning commission, most notably in Australia (ISA, 2013), exempts banks from commission bans on their own products. This allows banks to focus their sales efforts on their own products. In our view, and we admit this is speculative, most investors getting advice from the branch of a major Canadian bank would buy their securities where they buy their other financial products, without being aware of commission underpinning the sale. Those wanting third-party products could use other advisors or other sources to buy.

With all of the discussion of fees and other charges, it is clear that **investors still remain confused about charges regardless of the compensation regime**. Regulations will likely affect only new sales so old charges will continue. As well, there may be administrative and platform charges. Disclosure of total costs in dollars can help somewhat, since dollar values are easier for people to understand

and eliminate the need to coordinate a variety of percentage-based charges. Even so, clarity of the nature of charges may remain elusive. Other than pushing for greater simplification and transparency, it is difficult to think of what else can be done beyond the cost disclosure requirements coming into force next year.

Availability of advice in the face of changes in compensation and knowledge requirements is still an open issue. **Evidence suggests an initial decline in numbers of advisors leading up to RDR followed by a recovery in numbers to meet need^{14,15}. Looking at the UK work and who is under-served⁴, we comment that in several brokerage studies we have done, we have not encountered investment advisors focusing on low income-low wealth groups**, unless the advisor was at least equally interested in lending products. Regardless of compensation regime, it is clear that everyone who needs advice will not seek it out (Bhattacharya, Hackethal, Kaesler, Loos & Meyer, 2012).

In commentary within the RDR Post-Implementation Review, the authors comment that the move to DIY investing and more reliance upon technology to support decision-making may simply be part of a broader societal trend towards the use of technology. In studies we have done on information-seeking behavior in recent years¹⁶, it is clear that the Internet is the dominant source for getting financial information for all but the oldest age groups.

¹⁴ NMG. "The Financial Adviser Market In Numbers." Association of Professional Financial Advisers, 2014.

¹⁵ Europe Economics, "RDR Post-Implementation Review", 2014.

¹⁶ Weinstein, Edwin, L. Bottrell & D. Al-Saffar, "Learning and Key Events" *Investor Education Fund*, 2009, 2010.

Regulatory arbitrage is a topic that is only briefly addressed in the impact studies. This is to say, **that if an advisor can by-pass new regulations by changing their product mix, they may choose to do so¹⁷. In this regard, it is important to realize that many independent financial advisors (IFA) in Canada are licensed to sell both mutual funds and a roughly comparable packaged product created by insurance companies.** Given a choice, we suspect that many of the IFAs will opt to sell the commission-based insurance products as well as securities, just as we commonly see in the US market (see chapter 4). Alternatively, they may offer clients a choice of buying a full range of products if they are willing to pay fees or a restricted range for those who are not willing to pay fees. Given that many investors perceive advice given with commission-based products as free, it is an attractive alternative for some.

Last but not least, the impact literature discusses risks of mis-selling. Research commissioned by The Investor Education Fund looked at product ownership in relation to propensity for risk¹⁸. Findings indicate that risk-based mis-selling is much less of an issue in Canada than it is in the EU. The research also suggests that some of those exceeding their risk profile are doing so in an effort to bolster retirement income in a low interest rate environment. While the incidence of risk-based mis-selling is lower in Canada, the potential for incentive-induced mis-selling is just as real as elsewhere.

As a close to this discussion, we note that none of the regulation or impact studies look at the responsibility of the individual investor for their own well-being. The philosophical underpinning of the regulation is that investors need help because this is too complex to

¹⁷ Industry Super Australia. "Commissions by Another Name.", 2014.

¹⁸ E. Weinstein, "Investor Risk, Behaviour & Beliefs". *Investor Education Fund*, 2013.

figure out on their own. While we don't dispute that assertion, we contend that a discussion of individual responsibility is merited. To use an analogy, seatbelts are mandated to help save lives in the event of an auto accident, but it is the driver's responsibility to handle their vehicle in a manner that makes an accident less likely. Perhaps there is a parallel in financial services regulation.

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7. Summary and Conclusions

7.1 Summary and Conclusions

The over-riding objective of this study was to determine the extent, if any, to which the use of fee-based versus commission-based compensation impacts investor outcomes.

In order to address this objective, the study aimed to:

1. Identify whether the evidence on the impact of compensation is conclusive enough to serve as a basis for policy formation;
2. Assess the weight of the evidence and formulate conclusions about its meaning, potentially including the conclusion that there is insufficient evidence to form a balanced conclusion; and
3. Identify gaps in the research that would improve policy formulation regarding compensation practices.

1. Identify whether the evidence on the impact of compensation is conclusive enough to serve as a basis for policy formation

Evidence on the impact of compensation is conclusive enough to justify the development of new compensation policies. All forms of compensation affect advice and outcomes. There is conclusive evidence that commission-based compensation creates problems that must be addressed. Fee-based compensation is likely a better alternative, but there is not enough evidence to state with certainty that it will lead to better long-term outcomes for investors.

Evidence from academic research is sufficient to form several clear conclusions about investor impacts. In terms of investment returns from mutual funds, research demonstrates that funds that pay commission underperform. Distribution costs raise expenses and

lower fund investment returns. Returns are lower than funds that don't pay commission whether looking at raw, risk-adjusted or after-fee returns.

Research shows that advisor recommendations are sometimes biased in favour of alternatives that generate more commission for the advisor. On a more "macro" level, compensation influences the flow of money into mutual funds. Higher embedded commissions stimulate sales. One study even demonstrated a linear relationship between increases in commission and increases in fund flows. Other types of compensation and non-monetary influences (e.g., limiting products to related parties) can also stimulate sales including revenue sharing and administrative fees between funds and firms.

Looking at the US market, there is evidence that fee-based clients get a broader range of services and products from their advisor. The proportion of fee-based clients increases steadily as client investable assets increase. The pattern of usage implies that fees lead to more client-focused service. Based on the analysis of segments in the UK¹⁹, however, it is more likely that people with complex needs are more willing to pay for holistic advice. Wealthier clients are likely to buy a broader range of products, as well as having more complex needs that merit more service. And of course, their accounts are large enough to generate fees that pay for more service.

Where regulation has been changed to ban or limit commission, there is evidence that this change impacted investor outcomes. Research on regulatory impact demonstrates that in the absence of embedded compensation, advisors recommend lower cost products. But while removing commission lowers product cost,

¹⁹ Europe Economics, "RDR Post-Implementation Review", 2014.

advisory fees rise as a means of paying for the cost of service. There may also be new or increased administrative fees, higher costs on margin accounts and lower payments on cash balances. Based on available evidence about fee increases, it is not yet clear whether moving from commission to fees will result in a net improvement in the overall return to the investor, although it is likely that lower cost products will outperform those bought under a commission-based regime, given the negative impact of expenses on investment returns.

2. Assess the weight of the evidence and formulate conclusions about its meaning

Based on the research cited, we can formulate some high level conclusions that are backed by substantial evidence. In addition to compensation, we identify some related issues that affect investor outcomes.

- All forms of compensation affect advice and outcomes, but some types have more desirable or less pernicious effects than others. Commission has the best-documented negative impact including embedded commissions like trailer fees. The impact of fee-based compensation has not been sufficiently studied yet.
- Investors are easily confused about charges. To the extent that legacy commission-based compensation persists alongside asset-based fees, confusion is likely to continue. New fees and charges (e.g., administration, paper-based reporting, etc.) can deepen the confusion.

- Investor behavioral biases are unlikely to be overcome as a result of changing compensation schemes alone; although it is possible they can be moderated. Investor biases are substantial, persistent, and have a marked impact on their investment outcomes. While advisors can certainly influence client behavior, advisor attempts to overcome behavioral biases run the risk of alienating and losing the client.
- Investor outcomes cannot be judged solely by economic returns. Peace of mind can be derived from having a plan or from discussing a decision regardless of compensation regime. For wealthy investors, the opportunity cost of their time must be considered, although it appears from the evidence that fee-based service addresses the opportunity cost more effectively.
- People with less wealth and less income will find it harder to get advisory service than others. This is likely not related to compensation regime so much as it is related to the comparatively limited opportunity for advisor and firm.
- Mis-selling of investments based on improper match between risk propensity and the risk of the investment will not be eradicated by a change of compensation regime, but it will likely be diminished.

Having discussed the impact of compensation already, let us turn our attention to the challenge of getting investors to make informed decisions about compensation. Research evidence suggests that investors are easily confused about charges. Evidence suggests that investors cannot identify the compensation arrangement that is most favourable to their own interests. With percentage-based compensation, investors frequently make errors regarding the decimal place. With hourly rates they have little idea of the total

cost of serving their needs. With a menu of potential charges, investors do not have a real understanding of the services delivered; nor do they understand which charges they should reasonably incur. To complicate matters further, retail investors often believe that they don't pay for advice, but instead they just pay for executing the transaction with advice offered as a way to get the transaction. And finally, they may be able to buy products that appear substantively similar from different advisors under different compensation regimes.

Investor behavioral biases affect selection of an advisor, response to advice and investment choice. Biases have a negative impact on investor returns that is likely linked to advisor compensation, but the exact linkage is unknown.

In the selection of an advisor, the “cost-value fallacy” plays a role. Thus most investors are likely to think that if it costs more, it must be better. Certainly this has played a role in fund purchases too, much to the detriment of the investor.

While we know that most investors with advisors take the advice of the advisor, the advisor is guided by client preference in the selection of investments they offer. An advisor must accept the client's wishes when clients want to ‘take profit’ early by selling a winner early or hold on to a losing investment until it ‘comes back’. The cost of this bias is documented and substantial. It is also difficult to dissuade return chasing and short-term thinking, which often push clients to buy riskier investments than they should, especially when riskier investments often provide better compensation. Working against ‘home market bias’ also means pushing clients outside their comfort zone. As well, while professionals look at the entire portfolio, retail investors tend to make ‘one-at-a-time’ choices about investments.

All of these biases have a cost, and potentially, a good advisor can reduce the negative impact of these biases. There is conflicting evidence about whether commission-based or fee-based advisors are more motivated to reduce behavioral biases. For the commission-based advisor, there are direct earnings from transactions to consider, as well as product embedded compensation such as trailer fees and 12b-1 fees. For both commission-based and fee-based advisors, there is the potential of losing the client if they push too hard against their biases. This is a particular problem when investment objectives are aggressive but risk appetite is low. Telling the client the full truth, “You can't achieve your objectives without taking more risk”, is a strategy that advisors believe can lead to their dismissal.

An early study of compensation (Capon, Fitzsimons & Prince, 1996) pointed out that studies may miss important attributes when judging the impact of compensation. As well as considering both anticipated return and risk in their purchase decisions, investors positively value other attributes. Another study showed that investors value “peace of mind” (Chalmers & Reuter, 2010). Tracking individual data over several years, one study found that wealthy were less inclined to manage their own money with ‘opportunity cost’ the suggested cause (Hackethal, Haliassos & Tullio, 2009). While non-financial outcomes are likely to be very important, we do not know whether commission-based or fee-based advisors better provide the added value.

People with less wealth and less income will find it harder to get advice for two reasons. First, it is difficult to generate sufficient income to cover costs, solely from sales of investments to this group. Second, in a fee-paying regime, there is evidence that they are less willing to pay fees to cover their cost of service. From a

business point of view, these segments can be profitable if the advisor can also sell them protection or credit products. In addition, young advisors just starting to build a book of business may be willing to take on these clients with the aim of growing their business over time. With commission focusing an advisor's thoughts on today's transaction while asset-based fees focus attention on assets under management (AUM), we would surmise that asset-based fees (or an equivalent with no up-front compensation) are a better method for achieving advisor comfort with foregoing a sale today to improve long-term prospects for the client.

As we saw in the preceding chapter, mis-selling is a polite way of saying that sometimes advisors give seemingly bad advice. The heart of the mis-selling issue is the extent to which this is done through ignorance versus intention. To the extent that the problem is knowledge-based, regulatory efforts to raise knowledge standards will help remediate the problem. To the extent that the problem is intentional and for the personal gain of the advisor, the strategy of regulators is to remove the potential for gain through mis-selling. Evidence suggests that a reduction in commission-based sales will reduce mis-selling, but given the problems of behavioral biases and mismatches between the client's investment objectives and risk profile, a change in the compensation regime alone is unlikely to eradicate the problem entirely. In addition, we believe that risk has a wide variety of meanings to investors, many of which are not captured by current risk assessment tools. A poor or inappropriate definition of risk may mean that judgments of risk-based selling are over-stated, or alternatively, it may show why it is likely to happen.

3. Identify gaps in the research that would improve policy formulation regarding compensation practices

There are a number of important questions that existing research does not answer which bear on the impact of compensation. We focus on four areas of research below.

The ideal study for any number of these would involve comparison of individual clients and advisors over time spans of a few years, with a sample that included clients served through different compensation regimes. The regimes to be compared should include: commission, fee-based, salary, and transaction fee (discount broker). To be effective, any study would also need to consider the income, wealth and sophistication of the client. It should also consider the licensure and experience of the advisor.

With this general approach as a background, the major research questions that would improve policy formulation on compensation include the following.

- **Investment returns after all costs:** Considering all sources of cost including administrative fees, below market interest paid on free account balances and other relatively subtle costs, how do investment returns differ by compensation regime?
- **Product advice:** How does product advice differ by compensation regime considering cost, risk, and effect on remediating biases in the investor's portfolio? To what extent is there evidence of mis-selling in the product advice?
- **De-biasing investors:** How does compensation relate to the behavioral bias in an investor's portfolio over time? Is there evidence that some compensation regimes are more likely to de-bias investors? When evidence of de-biasing is absent, what factors deter the advisor and the investor from acting?

- **Intangible benefits:** What do investors want in addition to money? Do they want peace of mind, time for more economically valuable pursuits, time for more pleasurable pursuits, or just the sense that someone else is looking after their needs? How well do different forms of compensation deliver on these intangibles? And if we wanted to get very technical, we could look at the subjective expected utility of these outcomes compared to more money.

In the absence of time or sample, mystery shopping methods have proved useful for investigating some of these issues. A mystery shopping study that posed the same scenarios to advisors paid by salary versus fees versus commission would be particularly valuable. It could certainly address product advice, de-biasing investors and perhaps intangible benefits. With sufficient information and a follow-up on advice 1-2 years later, such a study could also assess investment returns after all costs.

There are two other areas of research that require different methods: the link between compensation method and wealth; and an assessment of potential impact of non-commission compensation schemes.

The link between compensation method and wealth is unclear. Why are fee-based compensation methods more likely as investable wealth increases? Is this driven by client demand, client complexity, profitability to the firm, or other factors? There are no perfect methods for this but any investigation would probably begin with qualitative work. A study focusing on investors who have experienced a shift in compensation regime would be a good starting point, particularly comparing those who had a shift while doing business with the same financial institution and those who changed financial institution to get a different compensation

regime. Interviews with advisors who are paid by both means would probably prove helpful, and as a follow-up, potentially interviews with those who set the policy for what clients should be offered.

The other critical issue for policy is the impact of compensation schemes other than commission. Even where advisors get a salary, there are often bonuses, promotion opportunities or special recognition for selling more in general or more of a particular type of product. Between 2010 and 2011, the FSA in the UK visited some 20+ firms and took a close look at their incentives (FSA, “Risks to customers from financial incentives”, January 2013). Their aim was anticipating how these incentives could inadvertently promote mis-selling, and as well, they aimed to understand what governance processes were in place to guard against such incentives. A study comparable to the one done by the FSA would help create policy in the customer’s best interest, especially in financial institutions where asset-based fees and salary currently dominate compensation for advisors.

7.2 Impact of Banning Commissions

This section briefly summarizes some common impacts of limiting or banning commission. Bearing in mind that there are a variety of different approaches to limiting commission, it is impossible to say with any certainty what will happen in Canada, since the approach likely to be taken here is not yet known. Nonetheless, by being aware of potential outcomes, it is possible to shape policy to anticipate or limit those outcomes deemed less desirable.

Academic research consists of gathering evidence, weighing it, and rendering opinions about its meaning. Following this approach, the

outcomes selected here are conclusions based on the review of the research in this report, coupled with a grasp of Industrial & Organizational Psychology.

This list of impacts is not meant to be exhaustive. It is simply a list of the impacts we are capable of anticipating.

Product Impact

- More sales of lower cost products including lower cost mutual funds and ETFs.
- Reduced sale of third-party products on the part of large distributors with their own sales force.
- Continued or increased sale of commission-based investments manufactured by life insurers by advisors who are dually licensed to sell both insurance products and packaged securities.

Investor Outcomes

- Less biased product selection from advisors.
- Higher explicitly stated cost for full service advice.
- More use of non-advised or simplified advice (robo-advisor) channels by lower income and lower wealth investors.
- Heightened confusion about charges as regimes shift due to carry-over of commission based incentives (trailers) on previous sales combined with the new fee-based compensation regime, potentially accompanied by administrative and platform fees.

Access to Service

- Increased rate of retirement among older advisors, especially those with below median assets under management.
- Increase in entry of younger advisors drawing from people who did not want to work for commission.

- A short-term shortage of advisors for some segments that rebounds to meet demand within 2-3 years.
- More segmentation of clients with fees and services geared to the needs and value of each segment.
- Increased use of technology-assisted brokerage services among younger investors, either as an alternative to advice or as a way to lower advisory costs.
- For the cost-conscious older investor, shift of stable assets to execution-only platforms to lower their asset-based fees.
- Some consolidation of advisory firms.

Costs and Compensation

- Increased focus on bonuses and other incentives in the compensation schemes of investment firms.
- Manufacturers and distributors will find new ways to work together for mutual benefit, which are not clearly prohibited by legislation pertaining to revenue sharing (NI 81-105).
- A mix of commission-based and fee-based business for advisors operating under both insurance, securities and traditional banking regulation.
- By virtue of the size and comparative wealth of the Canadian market, fee-based compensation in Canada will likely be much higher than in the US.

Undoubtedly there are other impacts, but our ability to anticipate impacts is limited to these domains.

Glossary

A. US Mutual Fund Definitions

Definitions in this Glossary are quoted from Cerulli Associates. With most of the research describing the US market, these US definitions are important for understanding.

Compensation Types

Asset-based fees: Client pays a fixed percent of the total invested assets on a given schedule (e.g., pay 1% annually based on quarterly 0.25% valuations). This fee structure can only be used as an IAR/RIA [Investment Advisor Rep / Registered Investment Advisor].

Commissions: This is traditional brokerage business conducted under a Broker/Dealer umbrella.

Salaries: The advisor receives a fixed salary. This is most common for junior advisors or service advisors who are not responsible for generating new clients, but they generally hold Errors & O insurance and provide advice to clients.

Fees for financial plans: The advisor charges a set fee to build or modify a financial plan. This fee structure can only be used as an IAR/RIA.

Annual or retainer fees: This is a fixed annual fee that is typically billed throughout the year. It usually covers the cost of financial planning and wealth management services. This fee structure can only be used as an IAR/RIA.

Hourly fees: The client pays an agreed upon hourly fee. This is typically used for targeted, modular planning engagements. This fee structure can only be used as an IAR/RIA.

Other: This includes other less common arrangements, such as billing clients based on a percent of their net worth.

Revenue Source

Commission-Only: The advisor is primarily compensated on commission, which accounts for 90% or greater of their total revenue.

Fee-and-Commission Mix: The advisor is compensated with a mix of fees and commissions, with 50%-89% of revenue from commissions and 10% to 50% fee revenue.

Fee-Based: The majority of the advisor's compensation (50% to 90%) is sourced from fee revenue.

Fee-Only: More than 90% of compensation is derived from fee revenue.

Distribution Channels

Bank Broker/Dealers: Retail brokerage arms of banks, excluding trust departments, or third-party broker/dealers that provide brokerage services to banks on a contract basis. Advisors are tied to or direct employees of the firm. Examples: J.P. Morgan Chase, Citizen Bank, PNC Brokerage, Primevest.

Wirehouse Broker/Dealers: The four national full-service broker/dealers (Bank of America Merrill Lynch, Morgan Stanley Wealth Management, Wells Fargo Advisors, and UBS). Their financial advisors are tied employees of the firm, have large investment banking and institutional presence, and have a large metropolitan presence.

Regional Broker/Dealers: Full-service broker/dealer firms with a strong concentration of offices in one region of the nation. Their financial advisors are tied employees of the firm. Examples: RBC Dain Rauscher, Robert W. Baird, Morgan Keegan.

Insurance Broker/Dealers: Full-service brokerages that are part of an insurance company, ranging from employees/career agents of the B/D to statutory employees to independent contractors who are fully licensed to sell all types of financial products, not just insurance products, and can sell nonproprietary products. Examples: NYLife Securities, Lincoln Financial Advisors, Mass Mutual Investors Services, Inc.

Independent Broker/Dealers: Broker/dealer firms that may be of any size, but most are small (fewer than 1,000 advisors). Advisors are affiliated independent contractors (rather than direct employees). Advisors assume most of the cost of running their practices (e.g., office space rental, employee salaries, computers) in return for a higher payout. Examples: LPL Financial Services, Cetera Financial Group, and Commonwealth Financial.

Dually Registered: Advisors who maintain both an independent RIA, registered through the SEC, that is separate and distinct from their B/D relationship, which is typically held through an independent broker/dealer. These advisors have access to both fee and commission revenue sources.

Registered Investment Advisor (RIA): An independent financial advisory firm that operates under its own SEC ADV filing. RIA firms may include multiple advisors or just one, and contract for trade clearing through service agents such as Charles Schwab or Fidelity, or custodial banks.

B. Additional Terms Used

Embedded compensation: A type of compensation that is linked to a specific product and typically not readily visible to the investor. Because different funds pay different amounts to an advisor, this compensation can be viewed as an incentive for sales. For mutual funds sold through advisors, trailing commissions are the most common form of embedded compensation. While trailing commissions may be disclosed, disclosure alone may not make it clear that they can act as incentives.

Hidden compensation: This type of compensation is not disclosed and never known to the investor. Often it is not readily seen as differential compensation. It can take the form of compensation to a firm or an advisor. At the firm level, it can include revenue sharing agreements, differential payment for administrative services, or other incentives to encourage a distribution firm to send more business to a fund manager. At the level of the individual advisor, it is more typically non-commission incentives such as opportunities for advancement, special recognition for sales of preferred products/vendors, or other incentives.