New scrutiny coming for mutual fund fees

By GRANT CAMERON

Debate over Canada's mutual fund fees has been re-ignited with the recent announcement by the Canadian Securities Administrators (CSA) that research contracts have been awarded to help determine if new regulatory action is needed.

Industry officials maintain the current structure, while not perfect, is working well and allows small and first-time investors, in particular, access to affordable advice. However, investor advocates argue that Canada's mutual fund fees are too high and are urging regulators to scrap embedded commissions, arguing that the fee structure is complicated and confusing.

The umbrella group for provincial securities regulators selected Douglas Cumming, a professor and Ontario research chair at the Schulich School of Business, York University, to review data on whether sales and trailing commissions influence sales of mutual funds.

The Brondesbury Group, meanwhile, will look at whether the use of fee-based versus commission-based compensation changes the nature of advice and investment outcomes.

The research reports are a follow-up to a discussion paper published by the CSA that identified a number of potential investor protection issues arising from Canada's current mutual fund fee structure, and subsequent public roundtable and discussion forums in 2013.

One area being examined is the trailing fees that are paid to dealer firms for the ongoing services and investment provided after a mutual fund purchase. Trailing fees are generally embedded in the management fee charged by the mutual fund.

Marian Passmore, chief operating officer and director of policy at FAIR Canada, a national organization representing investors, says the mutual fund fee structure in Canada needs to be reformed and embedded commissions should be banned as they encourage investment recommendations that provide higher compensation to the advisor.

"We think that embedded commissions lead to ineffective price competition, high mutual fund fees, and a conflicted renumeration structure where the incentives of the advisor and the consumer are not aligned," she says. "There's a bunch of systemic and structural issues that are created by that type of payment structure that need addressing."

Passmore says banning embedded commissions would create more competition among mutual fund vendors and lower the fees paid by purchasers, thus improving returns.

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Often, says Passmore, investors aren't aware of the trailing commissions that they're paying, so it's essential that consumers be able to agree to such fees in advance and also understand what services an advisor will be providing them in exchange.

FAIR Canada, meanwhile, is also urging the CSA to impose a statutory duty on dealers and advisors to act in the best interests of their clients, as it would increase protection for consumers and enhance the level of professionalism and trust in the financial services industry.

PASSMORE

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"A best-interest standard is necessary and feasible," says Passmore. "People think there's a best-interest standard but they're mistaken as to the level of duty owed to them."

Sandra Kegie, executive director of the Federation of Mutual Fund Dealers (FMFD) which represents dealer firms with more than $114 billion of assets under administration, says it would be naïve for anyone to believe that the system is perfect, as individuals will always try to take advantage of an opportunity, but for the most part advisors are honourable.

"The industry generally believes that 99.9 per cent of the advisors out there respect the industry and respect the clients that they have, and generally act in the best interests of their clients, and if there's a choice between two like funds with like performance they (advisors) will recommend the fund that is best for the client."

She says the issue of trailing commissions is important to the investment industry because trailers were brought in years ago by regulators as a means to stave off churning, which is excessive trading of a client's account in order to increase a broker's commissions.

"Now they're saying we may have rectified churning but we've created another problem. We've created an unintended consequence where advisors recommend funds that maybe have a larger trailer for them, and they're saying it might not be the wisest decision or recommendation for the client."

Kegie says the FMFD wants regulators to look beyond the pros and cons of eliminating bundled fees and instead consider what the investor is getting in terms of ongoing advice and service.

She notes that when consumers buy a product they are paying for the hidden costs of manufacturing and distribution, and investments like mutual funds are no different in that clients are paying for the cost of paperwork, time, regulation and disclosure requirements.

Kegie doesn't buy the argument that Canada's mutual fund fees are too high, and maintains that studies that have been done have not provided accurate comparisons between countries.

For example, she notes, they have not taken into account that Canada is the only jurisdiction without a national regulator, which could add to the cost for investors because a mutual fund that wants to sell across the country has to file a prospectus and pay fees to every jurisdiction in the country.

Jon Cockerline, director of research at the Investment Funds Institute of Canada (IFIC) which represents organizations, fund managers, distributors and industry service organizations, says the current structure and system is serving the market and investors very well and recent research has shown there is a danger that investor costs could rise if the market moves away from embedded fees.

"There are consequences of that and we're seeing some consequences emerging already in other countries where trailing fees have been prohibited."

The IFIC has noted that recent research into U.S. fees conducted by Strategic Insight (New York) indicated that investor costs have risen as that market has evolved away from embedded fees. Similarly, the IFIC says that early reports from the U.K. indicate the prohibition of embedded fees has created a system where investors aren't getting any advice.

The IFIC has warned that Canada should be wary of adopting such approaches without understanding the consequences for investors.

Cockerline says a portion of the trailing commissions cover a host of regulatory and supervisory functions and there's more to it than meets the eye.

"It's not only a payment to the advisor, it's a payment to the distributor for all of the services that entails, including the cost of compliance on all of the regulations. There is an advice component to it as well."

Cockerline says he isn't buying the argument that mutual fund fees in Canada are out of hand, as comprehensive research conducted by Investor Economics (Canada) and Strategic Insight shows the fees paid by advised investors in Canada are very close to those paid by advised investors in the U.S. when tax differences are taken into account.

The report, called *Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios, A Canada – U.S. Perspective*, indicates that on a tax-adjusted basis, the cost in Canada is 2.02 per cent of invested assets, compared to the level of two per cent in the U.S.