Regulatory changes are afoot in several countries

Protecting investors

BY JAMES LANGTON

Financial services industry watchdogs around the world are fortifying the ramparts erected to protect investors. They are moving to outlaw certain long-standing industry practices and impose new duties on financial services firms, but Canada has yet to follow suit.

The securities regulators that watch over the major capital markets in the English-speaking world — the U.S., Britain and Australia — are all seeking to strengthen investor protection at a fundamental level. They are doing this in two basic ways: by making new rules about how financial services firms can charge clients for their services, and by imposing a legal obligation on those firms to put their clients' interests ahead of their own (commonly known as a "fiduciary duty").

At the heart of these moves is a desire to ensure that retail investors are getting a fair shake from the financial services industry. In particular, regulators are concerned that certain types of compensation structures create incentives for financial services firms and their front-line personnel (salespeople, brokers, financial advisors and financial planners) that aren't necessarily in their clients' best interests; and that there is a disconnection between the service investors seek from the industry — namely, financial advice — and how they pay for it.

These arrangements entail what economists call a "principal/agent problem," which occurs when one person (the principal) hires another, more knowledgeable person (an agent) to work on his or her behalf — putting the agent in a position to exploit superior knowledge for his or her own gain, possibly at the expense of the client.

This means that when investors seek the service of a broker or advisor, they are vulnerable to that broker acting at least partly in self-interest rather than solely on behalf of the investor.

Compensation arrangements are particularly important in determining whether a principal/agent problem arises because they can drive a wedge between the interests of an investor and a financial advisor.

For example, when advisors are paid a commission per trade, there may be an incentive for advisors to generate trading activity on behalf of their clients in order to bolster their own revenue. Paying an advisor a fee based on assets under management is generally perceived as a fairer method, as it puts investors and advisors in the same position — the advisor's revenue increases only if the client's portfolio increases.

Also, some financial products, such as mutual funds, are built around complicated fee structures that can create other conflicts. In Canada, some mutual funds can be sold with a deferred sales charge (DSC), which means that investors don't pay upfront sales commissions but will face a charge if they cash out before a given time period elapses. Most mutual funds also pay an ongoing commission, known as a "trailer fee," to the advisor who sells units in the fund to compensate the advisor for continued service on an investor's account.

Trailer fees can also create a conflict by influencing asset-allocation advice or investment recommendations. And although these fees are supposed to be for ongoing service, they are paid whether the investor receives any ongoing service or not.

Traditionally, regulators have stayed out of the business of regulating sales commissions and fees charged by the investment industry. Instead, they have required that the charges be disclosed, and then leave it up to investors to determine whether they are getting value from their advisors.

However, the U.S., Britain and Australia have seen their share of "misselling" scandals in recent years, and the global financial crisis also had helped highlight the damage that can

be caused by poor incentives. In this light, disclosure alone is no longer seen as being good enough to protect retail investors.

Said Lord Adair Turner, chairman of Britain's Financial Services Authority (FSA), in a recent speech: "In many retail financial markets, the imbalances of knowledge and power between consumers and providers are so profound, and the potential for perverse incentives so great, that even highly competitive markets and extensive information disclosure are insufficient to protect consumer interests."

Regulators in some countries are beginning to intervene more directly with financial services industry practices. The FSA is preparing to outlaw embedded commissions (such as trailer fees) by the end of 2012. Instead, independent advisors will be required to negotiate sales charges with clients up front.

Australia is going even further. It has introduced a ban on what it terms "conflicted remuneration structures," including commissions on retail investment products. Although financial services firms will still be permitted to charge their clients fees based on the assets they administer, these fees can only be levied on unleveraged assets. Australia is also introducing a new policy to have clients pay directly for advice. These changes are to take effect in July 2012.

The U.S. Securities and Exchange Commission is considering more modest changes, although the underlying intent is similar: to reduce the influence of embedded commissions paid from a financial product manufacturer to a distributor (such as a broker or advisor), and encourage that compensation be agreed upon directly between the investor and the dealer or advisor that's selling the product.

By regulating some of the compensation structures that can create conflicts of interest, regulators hope to defuse the principal/agent problem.

A couple of regulators are also fighting the problem by requiring advisors to put their clients' interests ahead of their own. Australia, for one, is imposing this fiduciary obligation on advisors.

And, as part of the financial services industry regulatory reform crafted by the U.S. Congress in response to the global financial crisis, the SEC also is considering whether to impose fiduciary obligations on brokers there.

In Canada, regulators have been comparatively quiet. So far, there are no similar efforts afoot to interfere with compensation arrangements within the financial services industry or to impose fiduciary obligations on advisors.

By regulating compensation structures, regulators hope to defuse the principal/agent issue

It's not that the same problems don't exist in Canada. Regulators here have been aware of the inherent conflicts in certain compensation structures for some time now. The country's largest provincial securities regulator, the Ontario Securities Commission, has worried about the conflicts created by embedded compensation in mutual funds, and had contemplated outlawing it. However, that proposal was abandoned before it got very far.

Canada also has seen its share of mis-selling scandals. Most recently, in the period just prior to the global financial crisis, some retail investors in Canada were sold asset-backed commercial paper as a safe, higher-yielding alternative to ordinary money market products — only to find their assets frozen when the crisis hit; it was revealed soon afterward that these products weren't nearly as safe as advertised. Moreover, many advisors didn't understand what they were selling.

Yet, there doesn't appear to be much of an appetite for similar regulatory action here. For one thing, provincial securities regulators are currently preoccupied with the latest effort to create a national securities regulator.

Nevertheless, investor advocates are lobbying for regulators to impose a fiduciary duty on advisors in Canada. Currently, advisors are required to ensure that any investment they recommend is "suitable" for their client. This is a weaker standard than a fiduciary duty because an investment can be suitable but not in an investor's best interest.

The Canadian Foundation for Advancement of Investor Rights (a.k.a. FAIR Canada) argues that suitability is not enough, because investment advice that is considered suitable may nevertheless prove costly for an investor, and investors may not understand that their advisors aren't necessarily acting in their best interests.

"Many clients appear to assume mistakenly that their advisors must provide them with advice that is in their best interest — and that is not the case in Canada," says Ilana Singer, deputy director, FAIR Canada. "There is an imbalance and knowledge gap [between] what clients often think they are getting from their advisors and the reality."

For now, however, it's up to investors in Canada to understand how their advisors are getting paid, what they are getting for their money and to decide whether that advice is in their best interests. •