BALANCING ACT:

ENHANCING REGULATION WITHOUT COMPROMISING FINANCIAL ACCESS IN CANADA

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PRIMERICA®

Executive Summary

Canadian regulators have a unique opportunity to fully understand the potential impacts of financial services regulation changes, similar to those undertaken in other nations in recent years.

The proposals under consideration in Canada aim to increase transparency, enhance credentialing of financial advisors and financial planners, reduce risk, and ultimately increase investor and consumer outcomes for Canadian households. Since the 2008 global financial crisis, regulators in other countries have enacted similar measures, providing Canadian policymakers with the ability to use those nations as case studies and avoid unintended consequences when enacting their own policies.

Mutual funds and segregated funds have long been considered reliable vehicles to build confidence in retirement security; they are also popular and accessible to the entire market. However, lack of financial advice is a major deterrent to accessing financial investments for a significant portion of Canadians. Moreover, Canadian households underinvest in investment assets, keeping a third of their investable financial assets in cash and deposits rather than in wealth-generating assets. Recent survey findings also point to Canadians utilizing advisors for more than just investment advice but rather for guidance on a multitude of financial needs, such as helping with building long term financial goals, extending the value Canadians receive from their financial advisors.[1]

Since 2013, the Financial Conduct Authority (FCA), the primary financial regulator in the UK has made significant changes to rules governing financial advisors and advisor compensation. While the country has succeeded in improving credentials and expertise among financial advisors, it has come at the cost of higher overall fees charged to investors, a significant increase in the minimum portfolio size needed for clients to get advice, and millions of smaller and potential investors losing access to financial advice[2].

Current deliberations in Canada on advisor commissions for mutual funds and segregated funds, like the regulations implemented in the UK, risk limiting access to financial advice, and worse, deterring wealth creation for millions of Canadians, especially those who have limited financial means. Coupled with the growing cost of regulatory compliance, restrictions to compensation will further incentivize advisors[3] to focus on the wealth market and abandon the mass market.

There is a strong correlation between having an advisor and having healthy financial habits and achieving financial success. Those who don't have an advisor are less likely to save, take advantage of tax beneficial vehicles, and to invest.[4]

[1] Brondesbury-Golfdale Research, 2022, "Mutual Fund and Segregated Fund Owners in Canada."

[2] The challenges due to lack of financial advice for the mass market in the UK has been in the spotlight in recent years. In the UK, a report by the Financial Conduct Authority (FCA) found that many financial advisors had stopped providing advice to their clients since 2012, potentially leaving millions of people without access to financial guidance. https://www.fca.org.uk/publication/corporate/evaluation-of-the-impact-of-the-rdr-and-famr.pdf

[3] The term "advisor" has been used in the Paper generically to describe licensed individuals who provide financial services and financial advice; the term "adviser" has been used in the description of the UK reforms and experience consistent with their use of the term, as well as in the titles of referenced studies where the authors had used that term

[4] CANADA FINANCIAL SECURITY MONITOR NOVEMBER 2022, Report is available here

Introduction

Advising clients on financial investments involves considerable initial effort and cost for the advisor and their firm. There is cost and time training, licensing, and onboarding advisors, along with ongoing client servicing in a complex regulatory environment. The level of work required is even higher for new clients as advisors must establish a relationship and gain an understanding of the client's needs. Advisors need to be adequately compensated upfront for these efforts and their costs. There are many models for compensation effectively used in Canada and across the globe.

The challenge for consumers is understanding the value of financial advice in their investment journey, knowing how to find a qualified and trustworthy advisor, and ascertaining the true cost versus the value of the services they are receiving. The challenge for regulators is to ensure that advisors have adequate qualifications and training and are incented to act in their clients' interest. Regulators must also ensure that financial products are not predatory and that capital markets work efficiently and promote financial inclusion.

Since the 2008 global financial crisis, regulators and lawmakers around the world have endeavored to mitigate information asymmetries[5] and moral hazard[6] risks for investors wherever possible. Predatory practices have been curbed or banned, information requirements enhanced, and fiduciary or duty of care style responsibilities have been introduced. Some countries have focused on licensing requirements for financial advisors and planners and their duties to serve clients, while others have focused on the regulation of financial products or a combination of the two approaches.

Canada is examining its regulatory structure with the benefit of hindsight and in the unique position to develop policy based on the experience of other countries. This could minimize unintended consequences of regulatory reform. Recent regulations in Canada have banned certain compensation models and proposed regulations seek to eliminate others. Because similar regulatory actions have already been taken in the UK, the impact of Canada's proposals can be examined both in theory and in effect.

There is a strong correlation between having an advisor and having healthy financial habits. Those who don't have an advisor are less likely to save, take advantage of tax-beneficial vehicles, and invest their savings.

5 Where one party to a transaction has more information than the other and can use it to their advantage against the other party.
6 A lack of incentive to guard against risk where one is protected from its consequences, e.g. by insurance.

Financial Asset & Advisory Regulation in Canada

Canada has a federal constitutional system based on an explicit division of powers in the Constitution Act of, 1982.[7] Under the Constitution, the Government of Canada has jurisdiction over certain matters, such as banking regulation, while others fall within the jurisdiction of the provinces and territories, such as regulation of securities brokering. Regulation of insurance companies is generally split between federal and provincial/territorial jurisdictions.

In recent years the Canadian government attempted to form a national regulatory agency to oversee securities regulations, but courts blocked the move due to a lack of constitutional authority. While efforts toward a formal structure failed, Canada enjoys coordinated rule development across provinces and territories through several cooperative regulatory bodies: the Canadian Council of Insurance Regulators (CCIR), the Canadian Insurance Services Regulatory Organizations (CISRO), and the Canadian Securities Administrators (CSA). They propose rules, seek comments on proposals, and formulate policy recommendations for adoption by provincial/territorial regulators.

Several key provisions have come from the CSA regarding investment services. Among them are:

Conflict of Interest Rules: Registered firms and advisors are required to address material conflicts in the client's best interest and inform clients how those conflicts are being addressed. The information must be made in a timely fashion and using clear and understandable language.

Know Your Product (KYP) Suitability Obligation: Firms and investment advisors must take reasonable steps to understand the securities that they sell or recommend to clients, including consideration of the product features, structure, risks, costs, and the range of alternatives.

Know Your Client (KYC) Suitability Obligation: Firms and investment advisors must document crucial information about the client's personal and financial circumstances, the client's investment objectives, risk tolerance, time horizon, and their financial ability to withstand losses (risk capacity). The results must then be to reviewed with the client. These changes are intended to result in suitable investment recommendations. Advisors must also take reasonable measures to update the KYC information regularly and any time there is a material change in the client's circumstances or financial situation.

Initial Account Disclosure: Firms and investment advisors must provide information about potentially significant terms and conditions of the account opened. These include any restrictions, investing costs (including compounding effects), and any limitations relating to the products and services offered (e.g., if clients will only be offered proprietary products that cannot be transferred in kind to another Dealer).

The CCIR and CISRO have proposed similar regulations for segregated funds, an annuity contract issued by an insurance company where the investor's premiums are invested in funds managed by the life insurance company but segregated from the rest of the company's assets. The value of the

[7] Constitution Act, 1982, being Schedule B to the Canada Act 1982 (UK), 1982, c 11.

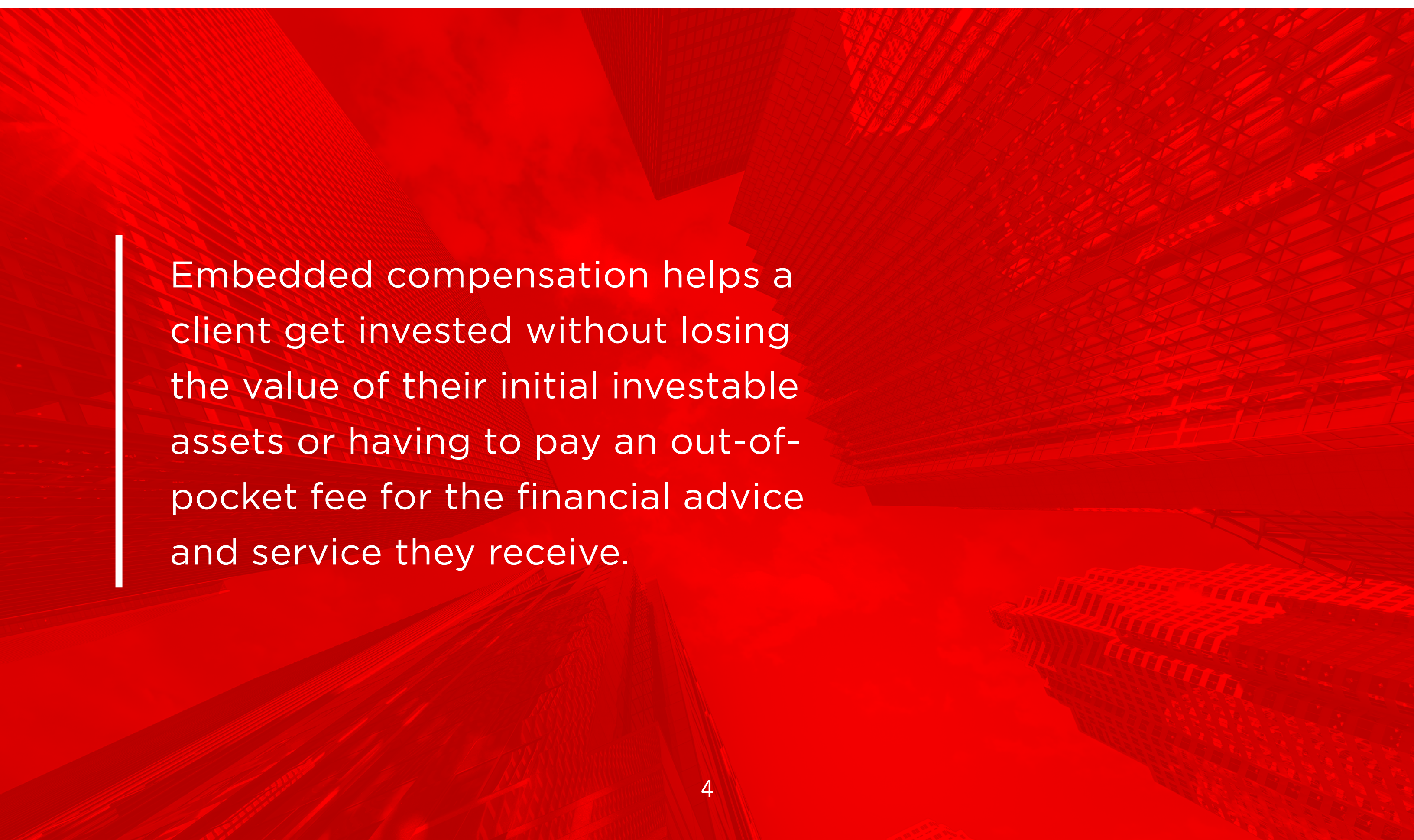
plan will vary over time based on the value of those investments, but the investor is guaranteed to receive at least 75% of what they have paid into the plan on death or sale, even if the investments have dropped in value. Investors also have additional life insurance benefits such as estate protection. Companies that offer segregated funds may offer other additional benefits. Investors may shift the composition of their investment across different assets offered by their segregated fund issuer without incurring additional expenses.

The following are changes specific to segregated funds:

Banning Deferred Sales Charges on Segregated Funds – Regulators recommended issuers cease using DSCs in new sales from June 2022 until full phase-out by June 2023.

Proposed Changes to Compensation on Segregated Funds – Proposals range from additional disclosures on funds fees to prospective investors to banning all embedded fees and chargebacks on advisors.

These changes are intended to increase fairness and transparency for segregated fund investors and level the playing field across different investment types for Canadian investors. While many of these changes are supported by industry, banning all embedded compensation is controversial and viewed as a barrier to serving Canadians with modest incomes. Embedded compensation helps a client get invested without losing the value of their initial investable assets or having to pay an out-of-pocket fee for the financial advice and service they receive. The CCIR has asked for comments on these issues and below the impact of financial regulation is explored for Canada and the UK.

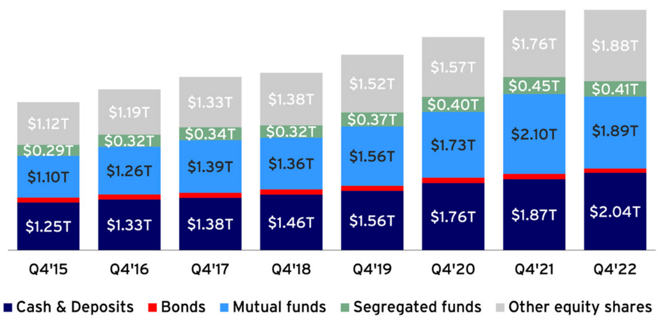


Embedded compensation helps a client get invested without losing the value of their initial investable assets or having to pay an out-of-pocket fee for the financial advice and service they receive.

Canadian Household Investments Today

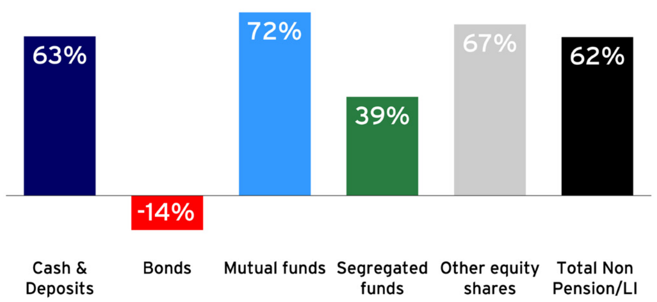
Canadian households have accumulated $6.3T in financial assets not tied to pensions or life insurance policies (Exhibit 1). The largest single asset class is cash and deposits, worth $2.0T. Mutual funds and non-mutual fund equity shares are about equal at $1.9T each, with segregated funds accounting for 0.4T and bonds and other fixed income securities accounting for the remaining $0.1T.[8]

Exhibit 1: Total Non-Pension, Non-Life Insurance Financial Assets Held by Canadian Households



Source: Statistics Canada (National Balance Sheet Accounts Table: 36-10-0580-01) Canadian Life and Health Insurance Association (Canadian Life and Health Insurance Facts, 2022 Edition). Note 2022 Segregated Funds holdings are estimated by the author.

Exhibit 2: Total Growth in Non-Pension, Non-Life Insurance Financial Assets Held by Canadian Households 2015–2022



Source: Statistics Canada (National Balance Sheet Accounts Table: 36-10-0580-01) Canadian Life and Health Insurance Association (Canadian Life and Health Insurance Facts, 2022 Edition). Note 2022 Segregated Funds holdings are estimated by the author.

Growth in financial asset holdings comes from both added investments or savings and growth in the underlying asset values. Over the 2015-2022 period, financial assets excluding pensions and life insurance grew 62% (Exhibit 2). Due to global central bank monetary tightening in 2022, bond holdings lost value and the market value of bonds fell enough to record a loss over the period.

Over the past seven years, Canadian households socked away nearly $800 billion in savings in the form of currency or other deposits, holding a third of their investable assets in cash at the end of 2022. During this period, inflation reduced the value of cash holdings and bank interest rates on deposits were running less than 1%.[9]

Consider that if instead of growing cash balances as they did from 2015-2022 at an annualized rate of 7.2%, Canadian households had grown cash balances by just 3% per year and invested the remainder in a diversified portfolio? A rough estimate for this time period puts a balanced portfolio at an average annual return of 4-8%, taking into account positive and negative returns in any given year (including 2022 when the S&P/TSX 300 index lost 9%). With an average return of 5% per year, at the end of the period aggregate holdings in financial assets would have been $120 billion higher (net of the $72 billion cash converted to investment). In a fund generating 7% per year, aggregate holdings would have been $173 billion higher.

[8] Statistics Canada (National Balance Sheet Accounts Table: 36-10-0580-01).

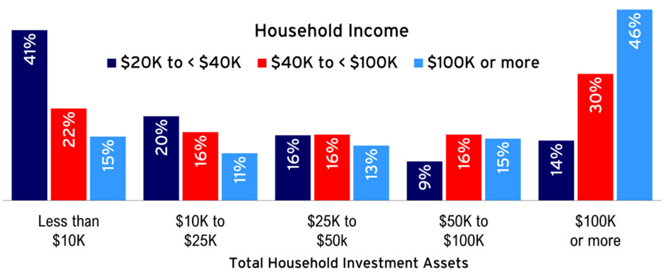
[9] https://www.bankofcanada.ca/rates/interest-rates/money-market-yields/ calculated on the daily Overnight Money Market Financing Rate.

The cost of not investing in financial instruments that generate increasing wealth over time is enormous for households. As defined benefit pensions give way to defined contributions and inflation eats at cash value, the burden on households to take on preparation for retirement is growing heavier. According to a BMO Financial Group survey, only 44% of Canadians feel they have enough savings for retirement, a decline of 10% since 2020, and Respondents cited needing $1.6 million on average to retire comfortably, up 12% from a year earlier.[10] 63% of those surveyed claim they have a tax free savings account (TFSA), but most of these accounts (56%) hold uninvested cash, and only about half of Canadians (49%) know that TFSAs can hold investments as well as cash. This means a large portion of investable funds are sitting on the sidelines.[11]

Primerica commissioned a survey in late 2022 of over 3,000 Canadian households regarding their investments in mutual funds and segregated funds and whether they made those or past investments with the help of an advisor.[12] This research solely focused on adult Canadians who currently or previously have owned mutual funds and/or segregated funds, across all income levels.

The survey found strong correlation between annual income and total investments in mutual funds, exchange traded funds (ETFs), and segregated funds. Among lower middle-income investor households, earning between $20,000 and $40,000 annually, 41% cited having total investments of less than $10,000 (Exhibit 3). However, among investor households earning at least $100,000, 15% stated that they too had total investments of less than $10,000. At the other end of the assets scale, 46% of high earning investors have investments totaling at least $100,000 while only 14% of lower middle-income investor households claimed portfolios of this size. Importantly, a substantial portion of investment funds are held by modest-income Canadians.

Exhibit 3: Total Investment Funds (Mutual Fund, ETFs, and Segregated Funds) Held by Household Income in Canada



Source: Brondesbury-Golfdale Research, 2022.

The cost of not investing in financial instruments that generate increasing wealth over time is enormous for households.

[10] BMO Financial Group's Retirement Study (2022). Available at https://newsroom.bmo.com/2022-02-14-BMO-Annual-Retirement-Study-Average-Amount-Canadians-Believe-They-Need-to-Retire-Increases-by-12-Per-Cent,-But-Fewer-Than-Half-are-Confident-They-Will-Have-Enough-to-Achieve-It

[11] BMO Financial Group's Retirement Study (2022). Available at https://newsroom.bmo.com/2022-01-11-BMO-Savings-Study-Cash-is-King-in-TFSAs,-as-Many-Canadians-Miss-Out-on-Higher-Returns-from-Longer-Term-Investments

[12] Ibid. Footnote 1.

How do Canadians Benefit from Advice?

Advisors can help to increase average returns on investments, the so-called "alpha factor" of investing, decrease volatility, the "beta factor" of investing, and be there to lend support and guidance through thick and thin, the "gamma factor." If we simply consider the alpha factor, it can be hard to justify the expense of an advisor beyond the occasionally complicated situation because few fund managers can outperform comparative indexes over sustained periods. However, if we take a holistic approach to measuring advisor value on household wealth, the results are overwhelmingly in favor of retaining services for any investor, regardless of wealth.

Three companion academic studies by CIRANO researchers examined the value of advice through robust statistical analyses on survey panels that were put in the field in 2010, 2014, and 2018.[13] Their research was unique on several fronts and collectively determined the following:

Over the long term, those with advisors have larger gains than otherwise similar non-advised Canadians. Over 15 years, the advised group had 2.7 times the level of assets of the non-advised group.

The most statistically significant difference in the gains comes from greater savings discipline and a larger allocation into non-cash investments among advised households. This is the gamma factor of investing at work. Similarly, another study from 2013 finds that the support and savings discipline of the gamma factor alone amounts to 159 basis points (1.6%) on an annualized return basis.[14] This finding is especially important for investors starting with small investment portfolios.

Investors seek advisors, rather than being solicited by advisors. This result was reaffirmed in a study of mutual fund and segregated fund investors in 2022.[15] This finding is key because it contradicts a primary basis for stronger regulations for financial advisors: that it is advisors seeking clients that lead to advising and, worse, to conflicts of interest in the provision of advice to the detriment of investors.

Matching respondents in the 2014 survey with those in 2010 and again in the 2018 survey with those in the 2014 sample, the researchers were able to determine the impact of gaining or terminating an advisor on asset accumulation. Over each four-year period, they estimated the difference in financial assets of having an advisor initially but terminating the relationship resulted in a portfolio that was at least $90,000 lower than those of households that were advised in both periods.

In the most recent study, they demonstrated that it was not simply having more assets initially that led to the newly advised having more at the end of the observation period. Households that did not have an advisor in 2014 but had one in 2018 had $116K in financial assets initially which gained $81K in value by 2018. For investors that didn't have an advisor in either year, they gained $43K on an initial investment of $134K.

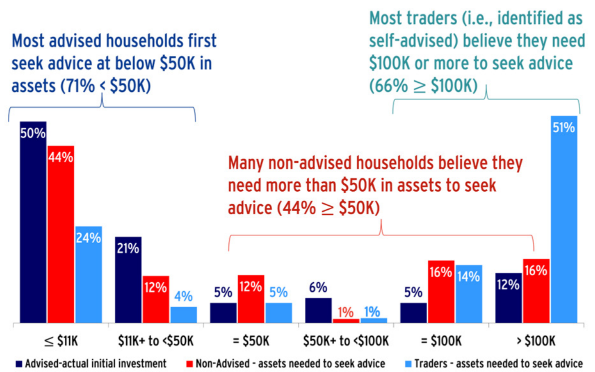
[13] Montmarquette, C. and Viennot-Briot, N. 2015. "The Value of Financial Advice," Annals of Economics and Finance, 16(1), 69-94; Montmarquette, C. and Viennot-Briot, N. 2016. "The Gamma Factor and the Value of Financial Advice." CIRANO Working Paper 2016s-35; and Montmarquette, C. and Prud'Homme, A. 2020. "More on the Value of Financial Advisors" CIRANO Project Report 2020RP˜-04.

[14] Blanchett, D. and Kaplan, P. 2013. "Alpha, Beta and Now … Gamma," The Journal of Retirement, I(2), 29-45.

[15] Ibid. Footnote 1.

One impediment to seeking financial advice is uncertainty about the amount of investable funds necessary to retain an advisor. The Montmarquette and Viennot-Briot (2015) study of Canadian households found that most investors who identified as self-advised believed they needed at least $100,000 to seek out an advisor and 44% of non-advised, non-investor households believed they needed at least $50,000 to seek an advisor.[16] Yet most (71%) advised investor households first sought advice with less than $50,000 as shown in Exhibit 4. In their subsequent study, Montmarquette and Viennot-Briot (2016) found 32% of survey respondents would not seek advice at any level of assets.

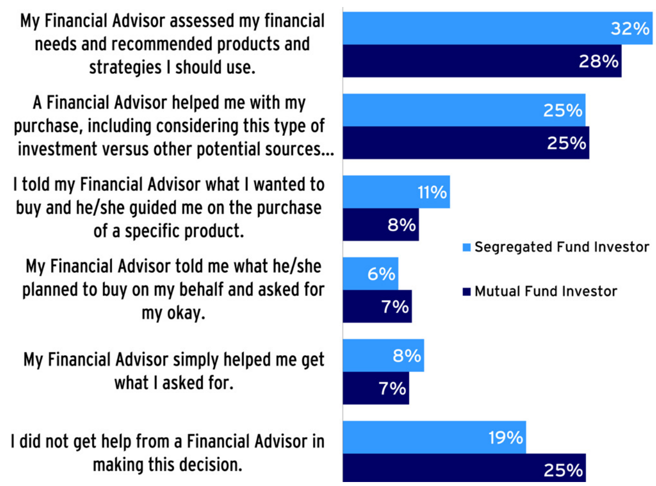
Exhibit 4: Distribution of the Value of Assets that would prompt a Canadian Household to Seek Financial Advice



Source: Montmarquette, C. and Viennot-Briot, N. 2015. "The Value of Financial Advice," Annals of Economics and Finance, 16(1), 69-94. Figure 1.

Claims that Canadian investors are steered into products without adequate consideration of their financial situation and goals run counter to the actual experience of investors in mutual funds and segregated funds. When surveyed about the advice they received prior to their purchase decision, 74% of segregated fund investors and 68% of mutual fund investors received help from a financial advisor. (Exhibit 5) Of these, just 6% of segregated fund investors and 7% of mutual fund investors indicated that "My Financial Advisor told me what he/she planned to buy on my behalf and asked for my okay."[17]

Exhibit 5: Advisor role in Mutual Fund and Segregated Fund Purchase Decision



Source: Brondesbury-Golfdale Research, 2022. Question was "For the Segregated Fund/Mutual Fund that you have purchased, which of the following best describes the role a Financial Advisor played in making the decision to invest. By 'Financial Advisor', we mean any person working in financial services that was involved in helping you choose or buy a product."

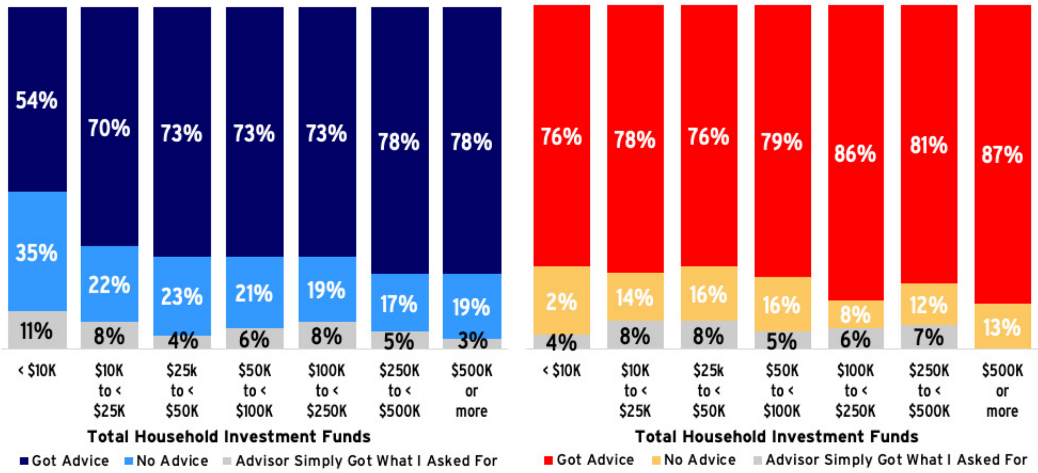
Getting advice to the most financially vulnerable is a key concern. When potential investors have a small portfolio of investable assets advisors are less incented to provide services. When examining mutual fund investors that did not get advice from a financial advisor with those that got at least some advice by the amount invested, those with smaller investments received less advice (Exhibit 6).[18] However, the advice gap by asset size was smaller and the overall share of those receiving advice was higher among those that purchased their mutual fund through a life insurance or mutual fund agent. For those that invested $10,000 or less with an agent, 76% received advice versus 54% of all mutual fund investors in the survey.

[16] Similar results were found in the subsequent study by Montmarquette, C. and Prud'Homme, A. 2020. "More on the Value of Financial Advisors" CIRANO Project Report 2020RP-04 for the 2018 survey.

[17] Ibid. Footnote 1.

[18] Ibid.

Exhibit 6: Advisory Help for Canadian Mutual Fund Holders by Amount of Invested Assets for all Investors and those that Purchased from an Life Insurance or Mutual Fund Agent



Source: Brondesbury-Golfdale Research, 2022.

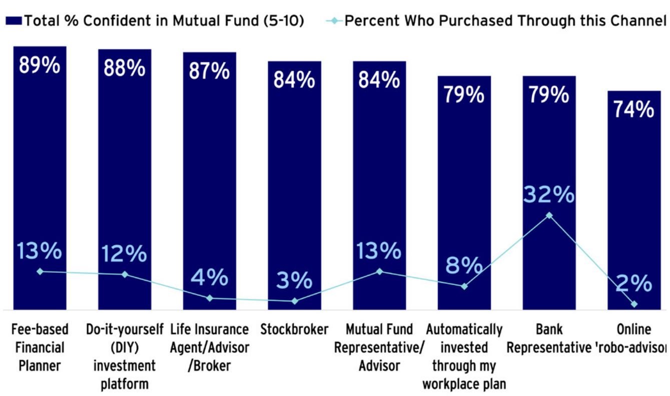
Willingness of Canadians to Pay an Upfront Fee for Financial Advisory Services

The Brondesbury-Golfdale Research 2022 survey explored investor confidence regarding their investments in mutual funds and segregated funds, their satisfaction with any advice they may have received in deciding on what investments to make, and what price a respondent would be willing to pay if they had to explicitly compensate their advisor upfront for investment advice given on future investments.[19]

Among current or past investors in mutual funds shown in Exhibit 7, those expressing the least confidence that the investment would help them reach their financial goals purchased their fund through a bank representative or from an online 'robo-advisor'. Interestingly, these represent both the most popular form of purchase and the least popular form of purchase, respectively. Those who paid upfront for advice, took a DIY approach, or purchased with the help of various types of advisors (agents or stockbrokers) all had mid- to high-80s percent confidence in the product they purchased.

When the same question was asked of segregated fund owners, which is a more complex product with more limited means of purchase, a similar pattern was evident with the notable exception that those who could afford

Exhibit 7: Confidence in Mutual Fund Based on Where It Was Purchased

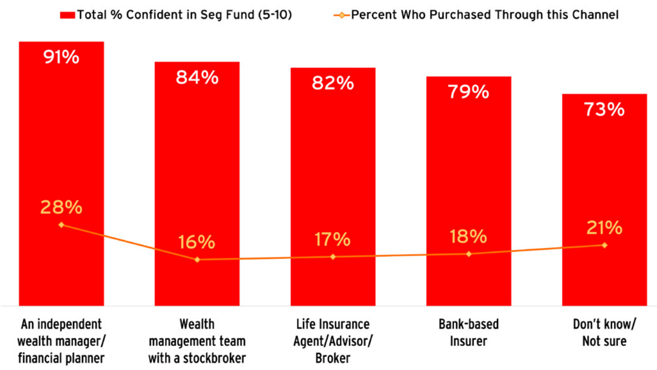


Source: Brondesbury-Golfdale Research, 2022. Asked of those who owned now or in the past: "For the next few questions I would like you to think about the last time you invested in a mutual fund. When buying those mutual funds did you buy them from a…?" by Using a 10 point scale, where 1 means 'not at all confident' and 10 means 'completely confident'; overall, how confident are you that each of the following investment products would help you meet your household's financial goals? … Mutual Funds

19 Ibid.

and used a wealth manager/financial planner were clearly the most satisfied (Exhibit 8), followed by those who purchased from a life insurance agent.

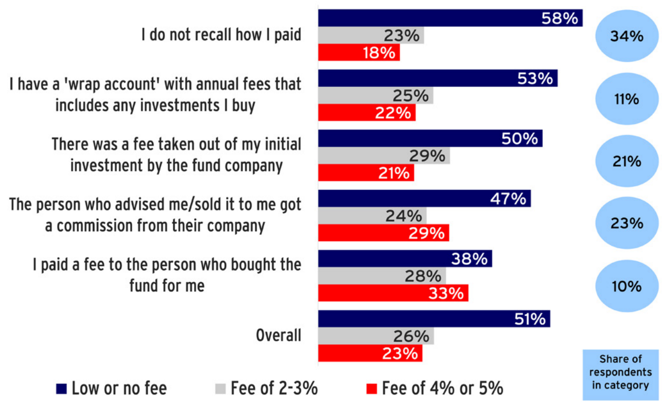
Exhibit 8: Confidence in Segregated Fund Based on Where It Was Purchased



Source: Brondesbury-Golfdale Research, 2022. Asked of those who owned now or in the past: "For the next few questions I would like you to think about the last time you invested in a mutual fund. When buying those mutual funds did you buy them from a...?" by Using a 10 point scale, where 1 means 'not at all confident' and 10 means 'completely confident'; overall, how confident are you that each of the following investment products would help you meet your household's financial goals? ... Segregated Funds

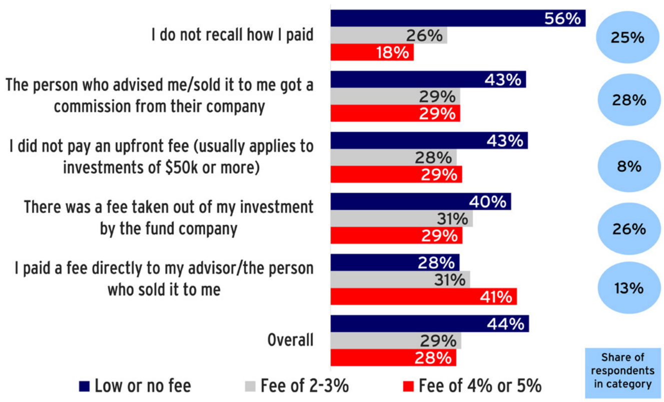
In the Brondesbury-Golfdale Research 2022 survey, and similar to findings in the CIRANO studies, some investors simply do not want advice at any price, but those that have experience with an advisor and knowledge of how their advisor is compensated are more willing to pay a fee equal to what most advisors say is required to adequately research and advise a client on the basis of their needs, roughly $400-$500.[20] In Exhibits 9 and 10 on the right, mutual fund and segregated fund investors were asked how much they would be willing to pay for advice on a potential future investment of $10,000. The idea that investors do not know that their advisor is paid either directly or indirectly for advice is clearly not in evidence. 66% percent of mutual fund investors and 75% of segregated fund investors were able to state how their advisor was paid. Those that paid indirectly in the past (either as a portion of the invested funds or through commissions) are less willing to pay upfront fees than those that currently have a direct payment relationship with their advisor and those that paid a direct fee are the most willing to pay a fee of $400-$500 on a potential future $10,000 investment. However, even among those most inclined to pay an upfront fee, only one-third would do soon a new investment of $10,000.

Exhibit 9: Willingness to Pay Upfront Fee by Past Commission/Fee Experience: Mutual Funds



Source: Golfdale Consulting/Brondsbury Group, 2022. Asked of those who owned now or in the past: "Suppose you had an additional $10,000 to invest in a [MF/SF] but had no choice about how to pay for it. You have to pay an upfront fee to buy it instead of a commission or an amount taken out of the fund itself. Would you still buy a [MF/SF] if the upfront fee was the following amount?"

Exhibit 10: Willingness to Pay Upfront Fee by Past Commission/Fee Experience: Segregated Funds

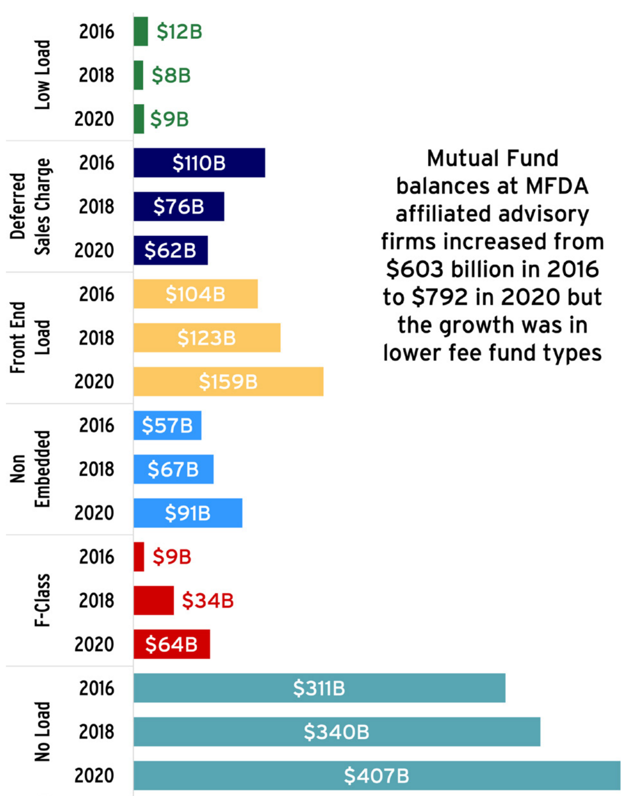


Source: Golfdale Consulting/Brondsbury Group, 2022. Asked of those who owned now or in the past: "Suppose you had an additional $10,000 to invest in a [MF/SF] but had no choice about how to pay for it. You have to pay an upfront fee to buy it instead of a commission or an amount taken out of the fund itself. Would you still buy a [MF/SF] if the upfront fee was the following amount?"

20 Brondesbury-Golfdale Research, 2022, "Mutual Fund and Segregated Fund Owners in Canada;" Montmarquette, C. and Viennot-Briot, N. 2015. "The Value of Financial Advice," Annals of Economics and Finance, 16(1), 69-94; Montmarquette, C. and Viennot-Briot, N. 2016. "The Gamma Factor and the Value of Financial Advice." CIRANO Working Paper 2016s-35; and Montmarquette, C. and Prud'Homme, A. 2020. "More on the Value of Financial Advisers" CIRANO Project Report 2020RP-04.

The Impact of Canadian Regulatory Reform of Mutual Fund Compensation on Financial Advisors

Exhibit 11: Distribution by Mutual Fund Load Structure in Canada



Source: MFDA of Canada, Client Research Report 2022.

Prior to the effective date of the ban on DSCs, two notable things occurred. First, investors shifted their investments to lower cost funds without the regulatory changes in place. Second, the number of smaller financial advisory firms that were members of the Mutual Fund Dealers Association (MFDA) fell sharply, while the number of advisors rose but only at the largest firms. More people received help from advisors but the average asset balance at the larger firms implies that many smaller investors may be getting squeezed out of the more personal advising opportunities.

Investments in DSC and similar low-load mutual funds declined rapidly from a combined $122 billion in 2016 to $71 billion in 2020 according to a report by the MFDA (Exhibit 11).[21] Other mutual funds with a front-end load fee grew in popularity, gaining $55 billion in assets to reach $158 billion in 2020, but they grew by far less than funds that had no point-of-sale commission. The two lowest cost fund types, F-class funds which have an embedded management fee but no embedded trailing fee and NE funds, with neither management nor trailing fees embedded grew from $9 billion in 2016 to $64 billion in 2020 and from $57 billion to $91 billion, respectively. Lastly, the largest segment of mutual funds in Canada, no load funds, which have no upfront commission but embed management and trailing fees, grew from $311 billion to $407 billion over the 2016 to 2020 period.

Lessons From Financial Asset & Advisory Regulation Changes in the UK

Financial regulation in the UK has evolved greatly from 2012 to the present. Intended to make costs transparent, increase advisor training and credentialing requirements to improve advisor quality, and create suitability standards, the regulations have tackled a wide range of financial services. Below the most significant changes are highlighted as they relate to similar concerns raised by Canadian regulators.

21 Mutual Fund Dealers Association of Canada Client Research Report 2022. Report is available here

2010-2013 Policy Changes

In 2006, the Financial Services Authority, the predecessor for the Financial Conduct Authority, began the Retail Distribution Review (RDR) to identify ways in which the retail investment industry should be changed to improve investment advice given to investors. As a result of the Review, the FSA established new FDR policies that became effective in January 2013. Some of the key provisions include:

Independent Advisor Transparency: the RDR defined the requirements for an advisor to be considered as an "independent" or "restricted" advisor. An independent advisor must consider all products and market segments when making investment advice, whereas a restricted advisor is limited to recommending products from a particular provider and can focus their advice on certain market segments. Both are required to explain the type of advice they offer.

Advisor Credentials: the RDR increased minimum qualification levels and requirements for continuing professional development. This policy was intended to increase the knowledge of financial advisors and to build trust and confidence in advisors among investors through rigorous licensing standards.

Remuneration Transparency: the RDR banned commissions or payments of any kind to advisors for recommendations on retail investment products and any related services can only be paid by advisor charges.[22] This is intended to reduce advisor conflicts of interest by separating their compensation from their recommendations.

2018 Policy Changes

In addition to the RDR policies adopted by the UK from work of the FCA, the UK adopted the Markets in Financial Instruments Regulation (MiFIR) II rules put forth by the European Commission. These rules went into effect in January 2018 and among them were:[23]

Cost Disclosure: "Advisers need to disclose all costs and charges that relate to their retail recommendations. Indications of expected (ex-ante) costs and charges need to be provided pre-sale, and details of the actual costs and charges need to be provided post-sale (ex post), where applicable on at least an annual basis. These need to be aggregated, [sic] and expressed both as a cash amount and as a percentage."

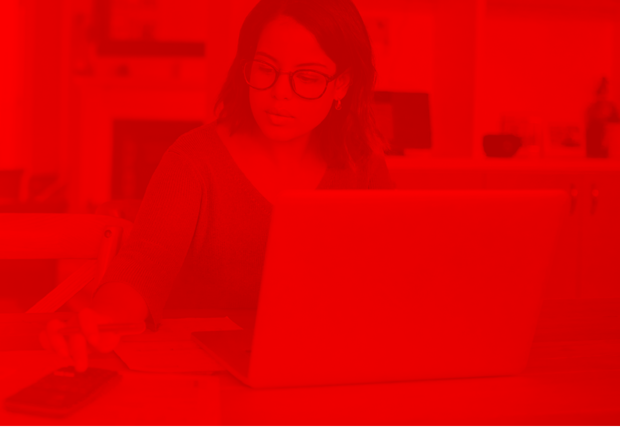
Suitability: "...a recommendation to hold a MiFID financial instrument is subject to the suitability rules and will require a suitability report." "...Where firms are offering a periodic assessment of the suitability of their advice, this assessment must be carried out at least annually."

Firms must also ensure they assess whether equivalent investments or services, including less complex and those with lower costs, can meet their client needs.

In aggregate, these regulations increase the burden on advisors through greater documentation, liability, and licensing costs. Absent any other factors, economic theory suggests a lower supply of advisory services, with higher fees charged to advised investors and fewer advisors in the market.

22 Pinset Masons (2010), "The RDR: adviser charging," citing Conduct of Business Sourcebook, 6.1A.4R Report is available here

23 Financial Conduct Authority (2018), "MiFID II: retail investment advice firms," Regulation Roundup January 2018. Report is available here



> In the UK, ongoing charges to clients more than doubled between 2016 and 2021 to £3.74 billion.

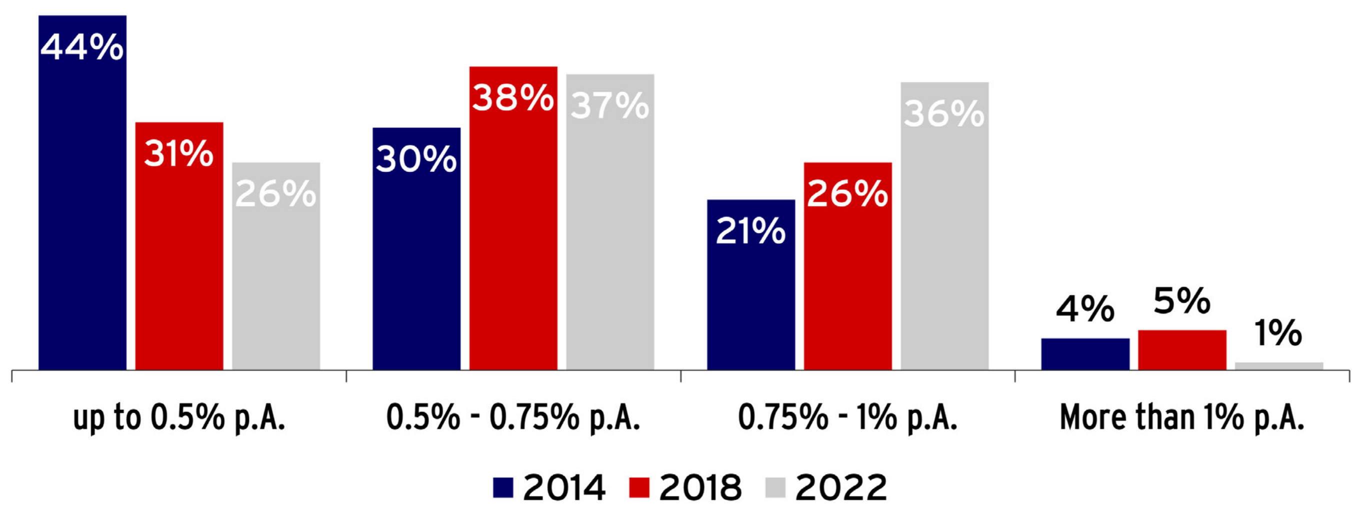
Looking at the Impact of Regulation through Data: UK Post RDR and MiFID II

One of the stated goals of the reforms was to lower the costs of obtaining quality financial advice. By removing embedded commissions and requiring annual disclosure of the costs of fund management, the FCA expected investors to select the lower cost funds among otherwise equal choices and for competitive pressure to reduce the total fees charged. In aggregate this expectation has fallen short.

Fees have gone up

Fees have increased significantly since implementation of the RDR and MiFID II regulations. For firms that charge fees as a percent of assets under management, the share has shifted heavily to higher expense ratios (Exhibit 12). In 2014, 44% of firms charged up to 0.5% per annum and 21% charged between 0.75% and 1% per annum.[24] In 2022, the shares were flipped, such that only 26% of firms charged a low fee of less than 0.5% while 36% were now charging 0.75% to 1% per annum.

Exhibit 12: Approximate average % fee based on assets for UK Financial Advisors

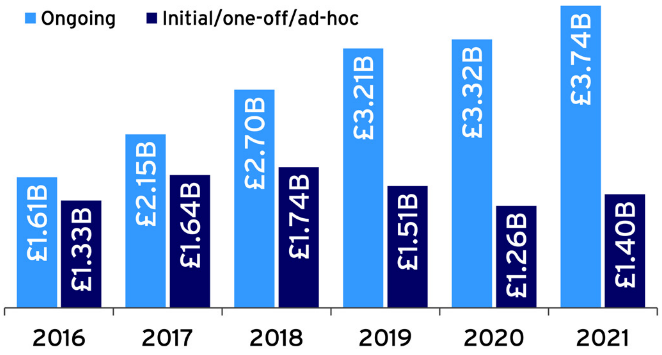


Source: Schroders 2022 UK Financial Adviser Annual Survey Adviser Report.

[24] Schroders, 2022 UK Financial Adviser Annual Survey Adviser Report. Report is available here

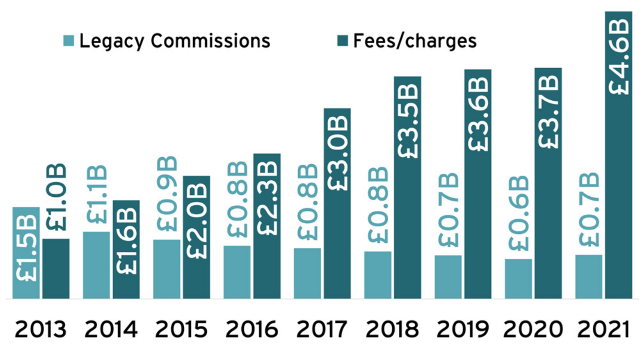
To put in perspective how much these fees add up to, ongoing charges to clients more than doubled between 2016 and 2021 to £3.74 billion (Exhibit 13). Charges for initial, one-offs or ad-hoc consultations remained fairly flat over this time, increasing from £1.33 billion to £1.40 billion.[25]

Exhibit 13: Total Advising Charges for All Retail Investment Advice Firms in the UK



Source: Financial Conduct Authority, Data from the Retail Mediation Activities Return (RMAR)

Exhibit 14: Revenue from Commissions and Fees for Financial Advisory Firms in the UK



Source: Financial Conduct Authority, Data from the Retail Mediation Activities Return (RMAR). Commissions were banned starting in 2013 but could remain for existing clients.

In Firms focused on financial advising only, total charges went from £2.6 billion in 2016 to £5.4 billion in 2021 (Exhibit 14). Legacy commissions were allowed to remain in place, and as invested funds and fee structures have shifted over time, revenue from these commissions has fallen by more than half for clients of financial advisory firms. However, total fees have risen four-fold over the same period.[26]

Consolidation of services

Another result has been greater consolidation of services, which has meant less choice for consumers. Between 2018 and 2021, the number of retail investment adviser firms decreased by 175. Two firm types increased in number, bank and building society firms and stockbroker firms. Financial adviser firms and investment manager firms dropped a combined 333 firms over the four years. Only two firm types added staff during that time, financial adviser firms, which gained 1,162 advisers, and bank/building society firms, which gained 2,818 advisers, with a net gain across all firms of 1,011 advisers. (Exhibit 15).[27]

Exhibit 15: Retail Investment Advisor Staff in UK Firms

Type of firm	2018		2019		2020		2021		Change 2018-2021	
	Number of firms	Number of staff	Number of firms	Number of staff	Number of firms	Number of staff	Number of firms	Number of staff	Number of firms	Number of staff
Financial Adviser	5,246	26,677	5,236	27,557	5,137	27,501	5,118	27,839	-128	1,162
Bank and Building Society	33	3,241	32	2,928	241	6,029	244	6,059	211	2,818
Investment Manager	223	2,188	224	2,519	19	1,902	18	1,844	-205	-344
Stockbroker	36	1,816	31	1,761	120	335	116	352	80	-1,464
Insurance intermediary	123	305	97	215	46	207	49	206	-74	-99
Other firms	171	1,436	173	1,421	115	403	112	374	-59	-1,062
Total	5,832	35,663	5,793	36,401	5,678	36,377	5,657	36,674	-175	1,011

Source: Financial Conduct Authority, Data from the Retail Mediation Activities Return (RMAR)

25 Financial Conduct Authority. Data is available here 26 Financial Conduct Authority. Data is available here 27 Financial Conduct Authority. Data is available here

The number of advisers fell precipitously

However, looking over a longer horizon, a different conclusion emerges. Prior to the implementation of the RDR in 2011, there were an estimated 40,500 financial advisors providing advice at financial advisory firms (Exhibit 16). In 2021, after the implementation of both the RDR and the MiFID II reforms, there were just 25,656 financial advisors serving clients at financial advisory firms, a 37% decline.[28]

Compliance costs and risk rose sharply

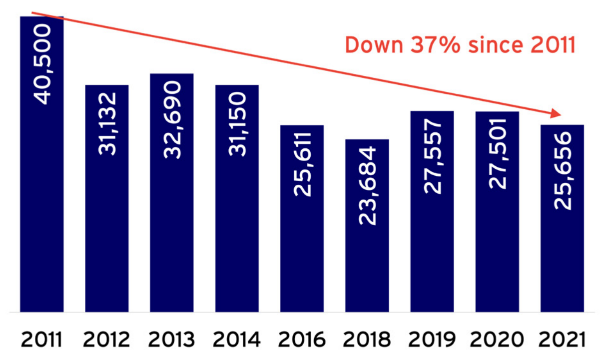
With MiFIID II reforms came additional duties on disclosure and greater fines for noncompliance. These compliance costs are significant, and decrease with firm size, encouraging consolidation of services. In 2022, the average financial advisory firm in the UK spent 18% of revenue on compliance costs, or about half what they spent on salaries (Exhibit 17).[29]

Firms carry personal indemnity insurance to cover this risk, and, as a result of the higher compliance risk, insurance companies have rapidly increased premiums for all but the largest firms (Exhibit 18).[30]

These costs are then passed onto clients in the form of higher fees or higher minimum asset balance requirements.

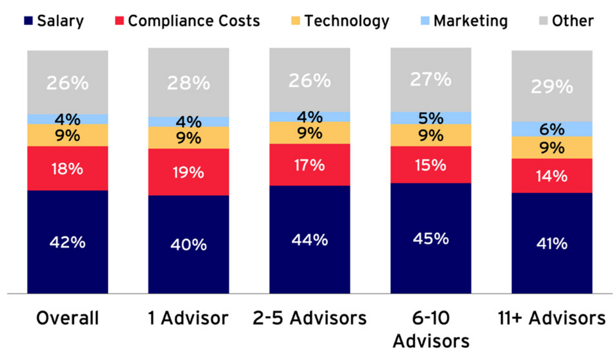
When asked their ranking of business risks over the next 18 months, financial advisers cited regulatory disruption, nonrenewal of personal indemnity insurance, and Financial Services Compensation Scheme levies, an insurance pool to ensure that investors are made whole should a financial services firm fail. In sum, their top three concerns are all compliance based.[31]

Exhibit 16: Number of Staff Advising Clients at Financial Advisory Firms in the UK



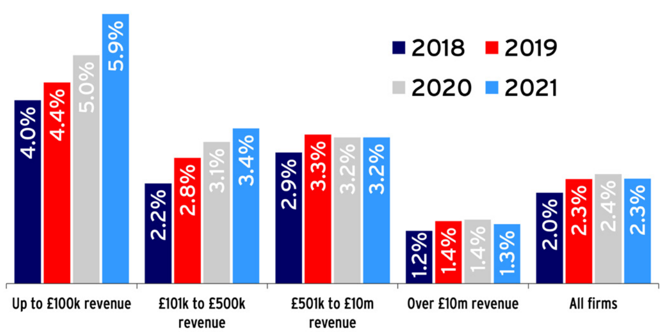
Source: Europe Economics. (a) 2014. "Retail Distribution Review – Post Implementation Review." Figure 5.8 and Financial Conduct Authority, Data from the Retail Mediation Activities Return (RMAR)

Exhibit 17: Approximately What Proportion of Your Firm's Revenue Goes Towards the Following Activities? By size of firm, number of advisors



Source: Nextwealth Financial Advice Business Benchmarks 2022.

Exhibit 18: Cost of professional indemnity insurance premiums for financial advisory firms in the UK post MiFID II reforms as a share of regulated revenue



Source: Financial Conduct Authority, Data from the Retail Mediation Activities Return (RMAR)

[28] Europe Economics. (a) 2014. "Retail Distribution Review – Post Implementation Review." Figure 5.8 Report available here and Financial Conduct Authority Data is available here. [29] Nextwealth Financial Advice Business Benchmarks 2022. Report is available here. [30] Financial Conduct Authority. Data is available here
[31] Nextwealth Financial Advice Business Benchmarks 2022. Report is available here

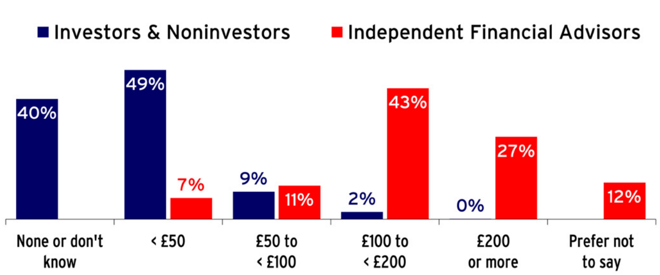
Willingness to Pay and the Price for Advice in the UK

In survey data, potential and active investors have not been keen to pay an upfront flat or hourly fee for the financial advice they might receive. Prior to the RDR reforms, a survey by Rostrum Research found that nine out of 10 consumers would only pay up to £25 for an hour's financial advice, compared with the £50-£250 an hour fee range expected in the review.[32] A 2013 study by professor A. Clare found that only 11% of survey respondents would be willing to pay more than £50 an hour for financial advice yet only 7% of independent financial advisers said they would accept less than that sum (Exhibit 19).[33] The disconnect is worse between non-investors and those that are investors but who have no previous experience with an adviser for what the out-of-pocket cost is worth upfront for financial advice. In 2022, the average rate for advising services in the UK was £192 per hour according to VouchedFor, well in excess of what most potential investors have indicated they would be comfortable paying for financial advice.[34]

But such research is perhaps misguided as few firms use hourly fees to advise clients. In 2022, a survey by Nextwealth (Personal Finance Society) found that just 4% of UK financial advisors used hourly fees all the time or most of the time (Exhibit 20) and47% indicated that they never used hourly fees. Instead, most financial advisors use a percentage of assets under management or a tiered fee structure.

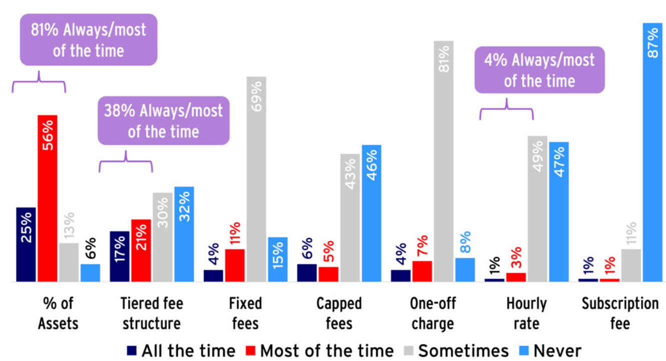
Developing a new client relationship is expensive. In the UK, on average it costs an advisory firm over £1,500 to onboard a new investor client.[35] The average time spent advising a new client is more

Exhibit 19: What UK Investors or Potential Investors Say They Are Willing to Pay for Financial Advice vs What Advisors Say They Charge (hourly rate)



Source: A. Clare (2013) "The Guidance Gap: An investigation of the UK's post-RDR savings and investment landscape," Fidelity Worldwide Investment report in association with Cass Business School

Exhibit 20: Fee Structure Use Distribution for UK Financial Advisors in 2022



Source: Nextwealth, Financial Advice Business Benchmarks 2022.

32 Pinset Masons, 2013, "Survey reveals opportunities and challenges facing retailers looking to break into retail investment advice" market Report is available here

33 A. Clare (2013) "The Guidance Gap: An investigation of the UK's post-RDR savings and investment landscape," Fidelity Worldwide Investment report in association with Cass Business School. Report is available here

34 VouchedFor, 2022, "The Cost of Advice," Blog report Report is available here

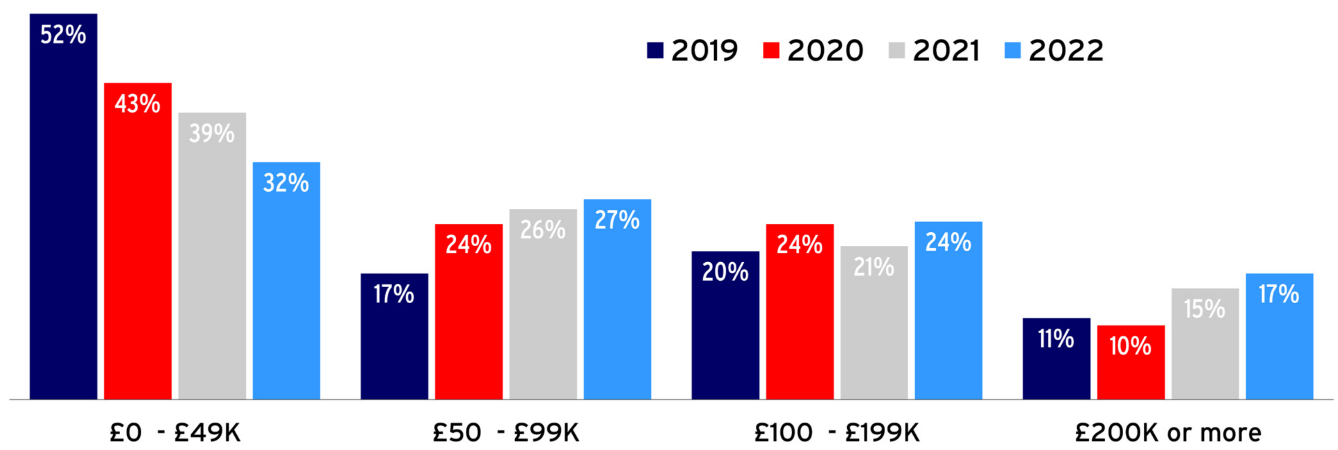
35 Nextwealth, Financial Advice Business Benchmarking Report 2019 Report is available here

than 22 hours,[36] and it takes on average 5.5 hours for a financial advisor to complete annual review documents for each ongoing client.[37] These onboarding costs/time spent do not vary with firm size, are largely unaffected by technology, and occur whether or not the potential investor becomes a client. Rather they stem from the lengthy process of gathering and interpreting information on potential client assets from other providers, who are often reluctant to share such information, and documentation on suitability of all investments considered.

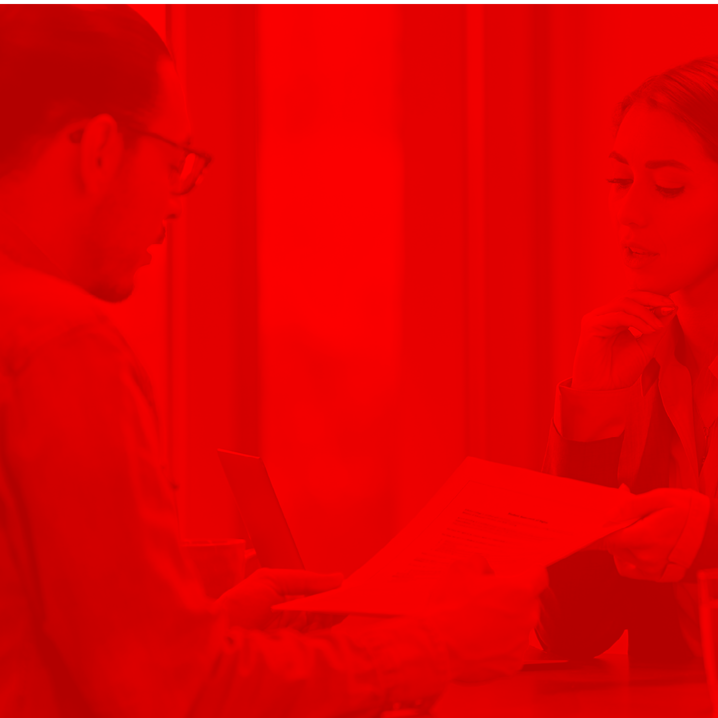
Minimum portfolio sizes have increased

As compliance costs and additional requirements have been implemented, firms have increased the minimum portfolio size for new clients. According to the 2022 Schroders annual financial advisor survey, just 32% of firms would take on a new client with less than £50,000 in assets, down from 52% in 2019 (Exhibit 21).[38]

Exhibit 21: UK Financial Advisers in 2022: Minimum Asset Size for New Clients



Source: Schroders 2022 UK Financial Adviser Annual Survey Adviser Report



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[36] Nextwealth, Financial Advice Business Benchmarking Report 2020 Report is available here
[37] Nextwealth, Financial Advice Business Benchmarking Report 2022 Report is available here
[38] Schroders, 2022 UK Financial Adviser Annual Survey Adviser Report is available here

A Summary of the Impact of UK Financial Services Regulation Impacts: Good Intentions Meet Hard Market Realities with Unintended Consequences

UK financial regulation changes aimed to improve transparency, advisor quality, and suitability standards. These included independent advisor transparency, higher qualification levels for advisors, and remuneration transparency from the RDR. Additionally, they then included investment cost disclosure and suitability requirements from the MiFIR II. They also intended these changes to have no impact on the availability of advice to vulnerable or lower-wealth investors.

Here is a short summary of the unintended consequences of those regulatory changes:

1. **Access to advisors decreased.**
    - From 2011, before the reforms, to 2021, post-RDR and MiFIR II changes, there was a 37% reduction in the number of retail financial advisors in the UK.
    - Consolidation of services occurred, driven by compliance costs, with a loss of 178 retail investment advisory firms between 2018 and 2021.
2. **Who gets access changed, with moderate income investors left behind.**
    - Onboarding new clients is expensive, with average costs of over £1,500 per new investor client.
    - Firms have increased the minimum portfolio size for new clients, with only 32% accepting clients with less than £50,000 in assets in 2022, down from 52% in 2019.
    - Overall, there are higher minimum asset balance requirements for clients.
    - The FCA has noted the advice gap as an unfortunate outcome, suggesting that low and moderate-wealth consumers could be served by robo-advisors as a solution.
3. **Consumer fees increased.**
    - Fees have increased by an average of 0.25 to 0.5% per annum on assets under advisement since the implementation of the RDR and MiFID II regulations, largely due to compliance costs that are passed on to consumers.
    - Survey data shows a substantial disconnect between what and how potential investors are willing to pay for financial advice and the actual fees and fee types charged by advisors.

Concluding Thoughts and Recommendations

Since the 2008 global financial crisis, financial services regulators in Canada and other countries have worked to strengthen consumer protections and to increase confidence in financial advisors. Studies have consistently shown that households served by a financial advisor are more disciplined savers and grow wealth substantially faster than those who are either denied advice services or unaware that they could receive or afford them. However, the societal unintended consequence of some of the changes has been a widening of the advice gap between those of modest means and the affluent.

Financial regulation in the UK serves as a good proxy for the impact of regulating financial advice based on theory and intuition versus practicality and evidence. Higher compliance costs there have led to greater consolidation of services, higher fees, and larger investment asset balances needed for access to advising services. While the affluent may be better served, too many households of modest savings keep their assets in cash deposit accounts or other low-return accounts where inflation erodes value and opportunities for wealth creation are foregone.

In Canada, balances in cash and other deposit accounts grew by 62% between 2015 and 2022 and remain the single largest class of investment funds at just over $2 trillion. Absent affordable and accessible financial advice, Canadian households will continue to over-save in low-return deposit accounts instead of investing prudently for the long run. Some miss out on saving regularly and taking advantage of tax advantaged vehicles such as RRSPs, RESPs and TFSAs altogether.

Regulate with least harm

Strict regulations on credentialing, duty to serve, and compliance documentation have greatly increased costs and cut the number of financial advisors by 37% in the UK. Better credentialing of advisors is admirable and serves an important goal. But quality advice need not come from the highest levels of credentials - many may be adequately served by proportionately credentialled advisors who focus on certain types of products and services as long as their offering limitations are explained, much like how advice nurses can solve many simple medical issues rather than relying on board-certified doctors to weigh in.

Complex duty to serve requirements increase costs for advisors leading them to abandon small balance investors. Either regulators or professional associations can establish fiduciary duty to serve guidelines and allow verified advisor firms to attest that they follow the duty-to-serve model, and this can apply to both independent and restricted adviser firms with much lower cost than heavy-handed rules. Coupled with restrictions to compensation, these forced measures severely inhibit service to modest consumers.

The US has largely followed a more relaxed regulatory framework, and the result has been to drive costs lower through fee, risk, and cost disclosure which has led to more market competition.

Technology is not a replacement for human interaction

Some advocates for greater financial regulation believe that low-means investors can be served by robo-advisors, a technology enabled platform. While still a new offering, uptake has been slow because these platforms are not trusted nor particularly liked by investors, and they fail to provide one of the most important aspects of financial advisor-client relationships: coaching the investor to achieve greater savings discipline and to stay the course when appropriate if the markets become volatile. This gamma factor of investment is fundamental to the success of investors, and perhaps the most significant part of the value of financial advice.

Disclosure is better than banning

Initiating a new client relationship is expensive for a financial advisor and there is no guarantee that a potential client will become an investor with the advisor following the initial consultation. By providing a menu of ways in which financial product providers can compensate advisors, more potential investors with small investable asset balances would be served. Clear, easy to understand disclosure of all investment costs, how those costs are borne by the investor (the fee structure and timing of charges), affiliation of the advisor and the relative risk ratings for recommended investment options serve the appropriate purpose of educating the investor. In turn, demand for high-cost investment options will decline in favor of lower cost alternatives.

In Canada, proposals to ban embedded DSC commissions in mutual funds and most recently in segregated funds has been celebrated as a win for consumers. While the recent ban enacted on deferred sales commissions in mutual funds may have accelerated the elimination of this commission model, the market and other regulatory requirements were already eroding demand for this product. At the rate demand was falling, DSC mutual funds would likely have been eliminated by market competition within a few short years without regulation.

Embedded compensation does not cost more than other investment fees on net and are not unfair to investors when the full investment costs are disclosed for the investor to make an informed comparison. Surveys have shown that most investors understand how their advisor is compensated and value advice services. Allowing product manufacturers and distributors flexibility in compensation is important to encouraging innovation and to reducing the advice gap.

About the Author

Dr. Amy Crews Cutts is an internationally recognized thought leader and chief economist focused on providing strategic economic analysis rooted in practical business terms. Amy is the President and Chief Economist of AC Cutts & Associates LLC, an economic and policy consulting firm. She was previously Senior Vice President and Chief Economist for Equifax and Senior Director and Deputy Chief Economist at Freddie Mac before that. With over 25 years of economic analysis and policy development experience, Amy is a passionate advocate for building the financial security of families and expanding consumer and small business access to low-cost, nonpredatory credit. She is a noted expert in credit reporting, consumer and small business credit markets, loan servicing, securitization, residential real estate including home equity and price indices, and trends in employment and compensation. She is a regular panelist in the Wall Street Journal and Blue Chip Economic Indicators surveys of economists. She earned her PhD from the University of Virginia and is a Certified Business Economist®, a distinction of professional achievement from the National Association for Business Economics (NABE).