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Canada's trouble with investment advisers

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Editor's note: An earlier version of this story contained references to Tony Warren, an Alberta man who said he had paid tens of thousands of dollars annually in fees and commissions to Canaccord Genuity Wealth Management. In fact, the fees he paid were significantly less than that.

For the first time in nearly two decades, Canada's wealth management industry faces the prospects of a radical overhaul.

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Despite significant reforms in other Western markets, the vast majority of Canadian investment advisers continue to be paid through commissions. Each time they buy or sell shares, their clients must pay them a fee for executing the trades. Canada is fertile ground for these brokers, with a sizeable number of households who have the sort of healthy six-figure portfolios that can support frequent trades.

But the regulators are watching, and, collectively, the provincial securities watchdogs have gone so far as to propose sweeping reforms to the multibillion dollar industry. The groundwork has already been laid for more robust disclosure of the fees that investors pay, and mutual fund companies may have to curtail the amounts they pay to advisers in return for selling their products.

These are, potentially, radical shifts in a business that has been slow to change. Dave Agnew, head of Canadian wealth management at Royal Bank of Canada, calls it the "largest challenge that the wealth management industry has faced in many, many years."

Yet some advocates for reform are skeptical about their chances of success. The major chartered banks are a powerful lobbying force, and they have become more dependent than ever on fees from wealth management – it's a safe harbour as other streams of revenue decline. And despite the regulators' copious legwork, which includes holding hearings and a conducting a thorough study of mutual fund fees, critics are unimpressed. They say they have seen this all before.

In 1994, the Ontario Securities Commission hired retired securities lawyer Glorianne Stromberg to study the industry's problems and to propose fixes. Her report was scathing, but little changed. Today her proposals are even bolder, going so far as outlawing the title "investment adviser." "It's a travesty," she says. Clients hear the word "advice" and think the brokers will always look out for their best interest. A more accurate job title, in Ms. Stromberg's view, would simply be "salesperson."

Canadians have more than $3-trillion in financial wealth, and pay billions in fees and commissions annually. Will the securities watchdogs have sufficient grit to crack down on conflicts of interest in how that money is managed? Or will backroom pressure by financial institutions put the kibosh on their efforts?

Paid according to 'the grid'

The list of critics who believe the current system is a blight on the industry includes some individual investment advisers. Ottawa's Marc Lamontagne came to resent the commission model. "I thought I was a financial planner," he says, reflecting on his early days in the industry during the 1990s, working for now-defunct Regal Capital Planners. "In actual fact, what I should have been was a salesman. That was the only way to make money."

It wasn't long before Mr. Lamontagne, who is now an independent financial planner, shunned commissions for a model that charged his clients a fixed percentage of their portfolio each year. Today his clients have a firm grasp on what they will have to pay, and everything is in the open.

That differs from the prevailing model, which gives investment advisers a strong incentive to maximize their commissions. Across Canada, the vast majority of brokers are paid according to "the grid," a sliding scale that dictates what cut of client fees flow to them, and what percentage their firm keeps. At CIBC Woody Gundy, the retail brokerage arm of Canadian Imperial Bank of Commerce and one of the largest such firms, an adviser whose revenues amount to $375,000 a year brings home, on average, 38 per cent of that, or $142,500, according to a copy of the bank's grid obtained by The Globe and Mail.

While the exact percentage fluctuates from firm to firm, they share a key principle: The more an adviser brings in, the bigger his or her slice of the pie becomes. Brokers who generate revenues of at least $1-million a year are usually entitled to at least 50 per cent of the fees they bring in.

Commissions, not investor returns, also dictate industry status. Retail brokerages typically reward their top advisers by admitting them to special clubs – BMO Nesbitt Burns' is known as the President's Council – even though the designations often have no connection to portfolio performance.

To hit these targets, advisers rely on more than trades. Mutual fund companies offer advisers a split of the annual fees that investors pay them to manage their money. These payments, known as trailer fees, typically add up to 1 per cent annually.

Fund companies argue that these fees compensate brokers for their ongoing research and due diligence. In private, industry executives admit that trailer fees exist only to encourage brokers to sell their products. "If it doesn't pay a trailing commission, it doesn't make it onto [a broker's] product shelf," says John DeGoey, who is one of the most vocal investment advisers in favour of reforms. "That limitation is one that most clients are oblivious to."

Fund companies can remunerate advisers so generously because Canadians cough up some of the highest mutual fund fees in the world. There's plenty of money at stake: Mutual funds remain the country's most widely held type of investment, with assets of $762-billion as of December, 2011.

Advisers can also earn extra commissions for helping their firms sell share offerings. If, for example, Enbridge Inc. sells stock in order to raise money for pipeline construction, the investment banks will entice their advisers to purchase the new shares for their clients by paying them a special 50/50 commission. If the bank earns 4 per cent in fees – or $4-million on a $100-million share sale – the adviser will earn a 2 per cent cut on each share they convince their clients to purchase. An adviser who sells $1-million worth of new shares earns a cheque worth $20,000 – often in a matter of minutes.

Advisers are so richly rewarded partly because investment banks are in an arms race to build the most powerful sales force. National Bank of Canada, for one, has invested heavily in expanding its network of investment advisers by buying investment dealer Wellington West and the advisory arm of HSBC Bank Canada in 2011. And this summer, National more than doubled the size of its network of independent retail advisers, who pay National both for the right to use its back office systems and to participate in the share offerings that its investment bank underwrites. "That's why we're in so many deals," chief executive officer Louis Vachon said recently.

Then there are the less conventional avenues for earning fees. Unlike mutual funds, which earn steady annual management fees, hedge funds earn both a small annual fee from their investors, plus 20 per cent of any returns above a certain threshold.

Earlier this year, senior managers at a Canadian hedge fund met with top retail brokers across the country to pitch their products. Officials with the hedge fund, which asked to remain anonymous for fear of retribution from banks, said the reception seemed generally positive. But when they followed up with advisers to see if there was any sales interest, the message suddenly changed. A top broker at a Big Six bank shrugged the firm off, explaining that "we will only do funds [in which] we participate in the performance fees," according to an e-mail obtained by The Globe and Mail. The adviser wanted a cut for simply placing clients in these funds, even though the investors and the fund managers absorbed all the risk.

A fee-based model

Facing the prospect of a changed rulebook, financial institutions say they have an easy fix: shepherding clients toward fee-based accounts, as Mr. Lamontagne does. Advisers are paid a straightforward percentage of the money they manage – typically about 1 to 2 per cent of the assets under their watch – and they forgo mutual fund trailer fees and commissions on stock trades.

Because the fee structure is simple and clearly stipulated, advisers are free to work in the best interests of their clients. They are also incentivized to earn superior returns for their clients: The more the portfolio grows, the more they get paid. This model is quickly becoming the new norm outside of Canada. Recently the U.K. and Australia banned commission-based accounts, and there is speculation that the European Union will soon follow suit.

Yet fee-based accounts have existed for years in Canada, and only a small fraction of investors have heard of them. Investor Economics, an independent industry research outfit based in Toronto, concluded in June that fee-based accounts "have yet to gain significant traction in terms of assets or adviser penetration," particularly for financial planning shops that mostly sell investment funds. Less than 3 per cent of client assets at these firms are in fee-based accounts. At traditional retail brokerages, fee-based accounts only make up 28 per cent of client assets.

Some investors, however, prefer the commission model exactly because it incentivizes their brokers to buy and sell often and, ideally, earn quick profits.

The fee-based model can also be gamed. Advisers who asked to remain anonymous because their organizations do not allow them to speak to the media told The Globe and Mail that a number of their peers are secretly "double-dipping": running fee-based accounts while still collecting trailer fees and commissions on sales of new securities.

The issue blew up at Royal Bank of Canada this spring, according to a source within the company, prompting the bank to crack down in a number of closed-door meetings. No official notices or decrees were sent out, but a number of advisers were reprimanded. Mr. Agnew, the bank's Canadian wealth management head, acknowledged the actions in an interview, adding that RBC's compliance department monitors client accounts closely to catch such behaviour.

Wealth management bonanza

Regulators have made some headway. This past summer, provincial securities regulators started phasing in new rules that require advisers to disclose to clients the full amount they paid in fees and commissions each year. Financial institutions have backed such reforms. "We support full disclosure," says Rajiv Silgardo, head of BMO Asset Management. Investors "need to know all the costs that they will bear."

But Mr. DeGoey, one of the advisers who backs major reforms to how the industry's 22,000 brokers are paid, worries that the changes will stop there. He argues that the industry only supports "these wussy disclosures that don't really alter behaviours."

Part of the problem is that the existing system has served financial institutions well. Wealth management has become a major profit centre. Sun Life Financial Inc. recently re-launched its asset management business, and each of the Big Six banks made wealth management acquisitions or invested heavily in their existing businesses in the past three years. Wealth management now accounts for 20 per cent of Bank of Nova Scotia's profits, up from 3 per cent a decade ago. As their traditional operations struggle, wealth management makes up between 35 and 45 per cent of some life insurers' bottom lines. The pressure to keep their wealth management businesses growing will not abate any time soon.

The official line is that the current system has served customers well too. "The current advice compensation model in Canada aligns the dealer's and adviser's compensation with the client's goals," Mackenzie Investments wrote in a public letter to the Ontario Securities Commission this summer. A unit of DundeeWealth, now owned by Bank of Nova Scotia, also wrote to warn against the more radical reforms of the U.K. and Australia: "The commission-based model is suitable for some investors while the fee-based model is suitable for others." Canadian regulators "should not dictate that only one option is available."

Reaching consensus on a new rulebook will not be easy. Not only do the provincial securities commissions amount to a patchwork quilt spread across the country, they must collaborate with industry-specific, self-regulating bodies such as the Investment Industry Regulatory Organization of Canada and the Mutual Fund Dealers Association of Canada, each of which have their own priorities.

The groups must also withstand heavy backroom pressure. Ed Waitzer, the OSC chair who hired Ms. Stromberg to conduct her research in the 1990s, recalls facing huge resistance when he tried to act on it. "There was a lot of lobbying going on behind the scenes," Mr. Waitzer said. Financial institutions dragged out discussion of the initiatives for years until the proposals eventually died.

Mr. Waitzer is sympathetic to those who believe nothing will change this time around. "As regulation has become bureaucratized, regulators have gotten in the same habits of politicians: making it look like we're solving problems, rather than actually solving problems," he said.

He thinks the regulators should opt for simple, but powerful, rules. In the U.K., he said, the Financial Services Authority recently implemented reforms that hold senior managers' feet to the fire. If something happens under their watch, the bosses are responsible. Mr. Waitzer also argues in favour of creating standard, low-cost funds that would be the default choice for the risk parameters of the average investor.

For now, the OSC, the country's most powerful regulator, won't say much because it is in the midst of its mutual fund review. In June, the commission held a public roundtable to hear from industry voices, and it is still doing research. The last thing the OSC wants is to seem biased in either way in the midst of the process.

However narrow, there appears to be a window for change. The banks' position is that they are willing to go along with some sort of overhaul. Exactly what that will look like is the question.

"I do not apologize for charging for advice," says Glen Gowland, head of Scotiabank's private client group. "But a client should know what they're paying for, they should be able to understand how much they're paying for that, and then be able to measure, 'Did I get good value for what I paid?' "

Single page

- 1
- 2
- 3

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