Analysis: Will banning trailer fees create chaos?

Early experience in the U.K. suggests that the impact may not be as harsh as feared

By James Langton | July 2013

Although the mutual fund industry is raising fears of an advisor apocalypse if regulators pursue changes to the traditional fund fee structure now under discussion, the evidence for these worries is dubious at best.

In early June, the Ontario Securities Commission (OSC) held a roundtable meeting to discuss some of the issues raised in a consultation paper published late last year by the Canadian Securities Administrators (CSA), which examines the fund industry's fee structure and proposes several possible ways of dealing with the regulatory concerns posed by embedded trailer commissions.

At that meeting, some players in the industry raised the spectre that any move to outlaw embedded commissions - and to have advisors charge explicitly for their services - would result in reduced access to financial advice, particularly for smaller investors.

Indeed, according to the OSC's transcript of the event, Greg Pollock, president and CEO of Advocis, cautioned that "financial advice would become unaffordable, and therefore inaccessible, to the average Canadian."

There also are fears that any move away from embedded commissions could ultimately drive many advisors out of the business. Indeed, defenders of the current system point to the U.K., which introduced new rules outlawing embedded commissions, among other reforms, on Jan. 1. It was suggested at the OSC meeting that the U.K. has lost 25% of its advisory sales force due to its ban on commissions, with several large financial services institutions dropping out of the retail investment advice business altogether.

But it's not clear that the situation in the U.K. is quite as dire as some portray it to be. Although it's still too early to assess the impact of the U.K. reforms (known as the "retail distribution review," or RDR), given that the new regime took effect only at the beginning of this year, it appears that the worries of those in Canada's fund industry may be overblown.

First, the drop in advisor numbers is less severe than was feared. There also isn't a straight line between the commissions ban and advisors' exodus. And it appears that although many players may have pulled out of the market, others are benefiting.
According to data from London-based Matrix Solutions Inc., since the RDR took effect on Jan. 1, the number of authorized investment intermediary firms is down by about 6% as of May; the total number of registered individuals in this sector is off by 9.5%; and the ranks of so-called "customer-facing staff" is down by 12.3%.

Those figures are much lower than was suggested at the OSC's January meeting, and it appears that the immediate effects now are being reversed a bit. In fact, the data show that the number of registered reps rose in May month-over-month, and the number of customer-facing reps rose for the second straight month.

Also, it's not clear that the drop in advisor numbers is entirely due to the ban on embedded commissions. The RDR brought other changes as well, including higher proficiency requirements. These other aspects of the U.K. reforms surely are affecting advisor numbers - and it's impossible to isolate those effects.

In addition, all this is occurring in an environment of tremendous volatility in the wake of the global financial crisis, both in the economy overall and in the financial services industry generally. The crises had driven strategic changes at some of the largest financial services institutions in the U.K. in their aim to reposition their businesses irrespective of the regulatory reforms (which predate the crisis).

So, it's not as simple as drawing a straight line from the ban on embedded commissions to firms' larger, strategic decisions.

Moreover, it's not clear that the reduction in the overall number of advisors equals a major shortage in meaningful advice for investors. It may be that advisors who couldn't meet the new proficiency standards or adapt their business model, weren't providing advice that was worth having in the first place. Indeed, while the quantity of advisors is down, their average quality may be up as a result.

To be sure, there are signs that the U.K.'s higher-quality advisors are benefiting. For one, the U.K.'s Personal Finance Society, a trade group for the advisory business, reports that it has seen a 25% increase in chartered financial planning firms over the past year as more firms aim to bolster their professionalism.

And various scraps of market research that have been carried out since the RDR took effect suggest that the remaining advisors may be capitalizing in the post-RDR world. Although much of this research relies on both opinion surveys and relatively small samples, it nevertheless represents some evidence that independent advisors are optimistic about their future and are seeing opportunities in the current economic and regulatory environment.

Investor confidence may have been bolstered by these reforms as well. Another British industry group, the Chartered Insurance Institute, published research earlier this year that found that 61% of existing clients said the RDR improves their confidence in the quality of advice; and, of those that don't currently use an advisor, 36% said they'd now consider
it, given the changes wrought by the RDR. This suggests that client demand may well rise in response to the new regulatory regime.

Another early beneficiary of these changes in the U.K. may be firms with low-cost products that had a hard time getting distribution under the previous industry model.

Atul Tiwari, managing director of Vanguard Investments Canada Inc., reported at the OSC meeting that his firm's U.S. parent is gaining traction in the U.K., as the fact that the firm doesn't pay trailers is no longer a factor keeping it off of the major fund platforms in that market.

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