Why some advisors might abandon mutual funds

Selling products outside the jurisdiction of securities regulators may seem desirable

By Rudy Luukko | July 08, 2013 14:00
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If securities regulators change how mutual-fund salespeople get paid and redefine the duty that they owe to their clients, some of them will take their business elsewhere, industry officials say. Others have already done so. But investor advocates dismiss such concerns as irrelevant to the goal of improving investor protection.

The issue of "regulatory arbitrage" has been raised in comment letters received by securities regulators and in consultation sessions on mutual-fund fees and the "best interests" standard for investor-advisor relationships. The Canadian Securities Administrators (CSA), representing securities regulators across the country, is seeking industry and investor input on whether to make changes affecting embedded advisor compensation, and whether to hold advisors to a higher standard of care.

The Federation of Mutual Fund Dealers, representing an estimated 17,000 advisors and $114 billion in assets under administration, said changes to compensation models for mutual funds would have the unintended consequence of having advisors move assets from mutual funds to segregated funds.

Since the latter are sponsored by insurance companies and structured as insurance contracts, they're outside the jurisdiction of securities regulators. According to the fund dealers' submission on fund fees to the CSA, segregated funds have fewer compliance requirements, pay higher remuneration to advisors and are less costly to administer. They also have higher management-expense ratios because of their insurance provisions.

Sandra Kegie, executive director of the dealers' federation, suggested that a best-interest standard would prompt some advisors to abandon mutual funds because of fears that they will face a greater risk of being sued and put out of business than if they sold other products.

"If the dollar sign really is the bottom line for him and a client sues, which is a nightmare, and (the advisor) loses, he loses everything," Kegie told an industry discussion forum on June 25 in Toronto, convened by the Ontario Securities Commission. "That's why he would move."
The proposed fiduciary duty that regulators are considering should apply to all advisors, not just securities registrants, the Canadian Institute of Financial Planners (CIFP) says.

Keith Costello, CIFP's president and CEO, called on regulators to co-ordinate their efforts with their insurance-regulator counterparts. He noted that many retail investors are served by people who are outside the securities industry, such as insurance agents and accountants.

"We need a consistent consumer experience," Costello told the OSC industry forum, "so that if I go to see my advisor or planner then I can be sure, no matter what their business model, what part of the industry they're in, there's a consistency."

Responding to Costello's comments, OSC legal counsel Jeff Scanlon conceded that regulators have no control over financial-services providers who are not subject to securities regulations. "But we need to balance that against the obligation to ensure that we have the right standard for the securities context."

According to Ottawa lawyer Harold Geller, who specializes in litigation and dispute resolution, securities regulators do wield influence over some sellers of insurance products. Geller, whose clients include both financial advisors and investors, said regulators have authority over individuals who are jointly licensed to sell securities and insurance.

If a standard applies to all advice given by these financial advisors, Geller told a June 18 discussion forum for investors, then that will also affect the insurance side of their business.

Regulatory arbitrage is only one of a number of arguments being put forward in defence of the status quo by the fund industry and those who sell its products.

Trade organizations such as the Investment Funds Institute of Canada and Advocis, The Financial Advisors Association of Canada, contend that eliminating embedded compensation to mutual-funds salespeople would reduce access to advice and be costly and disruptive.

For investor-advocacy groups, the key issues include the conflict of interest inherent in embedded compensation, and the greater protection to investors that would be provided by a best-interests standard for advisor conduct. The prospect of regulatory arbitrage serves only to reinforce their conviction that reforms are needed to better protect investors.

The Canadian Foundation for Advancement of Investor Rights (FAIR Canada) emphatically rejects the notion that regulatory arbitrage should be a consideration for regulators. Marian Passmore, FAIR Canada's associate director, addressed the issue at the June 18 forum on best interests.
"If the industry thinks that it acts in the best interests of the client or it puts the client's interests first and professes that it wants to move to a professions model," said Passmore, "then why would they then say, but if you impose a best-interest standard, we're going to go sell a bunch of high-fee seg funds so we can make more money? It's very disingenuous."

For Julia Dublin, a Toronto lawyer who specializes in securities law and is a consultant to FAIR Canada, the solution for regulators is simple. "Set the example as to the acceptable standard for those who you do regulate," Dublin told the June 18 forum, "and let other regulators worry about their own responsibilities to the consumer."

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