A 360 Review of Issues and Concerns Related to the Canadian Investment Marketplace: A Consultation Among MFDA and Dual-Platform Dealers

Prepared for the Investment Industry Regulatory Organization of Canada and the Federation of Mutual Fund Dealers

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Background, Objectives and Methodology

Background

The investment industry is in a period of significant change. Technology, product and service innovations, and more recently the response to COVID-19, have presented dealers and advisors with both challenges and opportunities with respect to meeting client needs.

In this environment, the Investment Industry Regulatory Organization of Canada (IIROC) launched a consultation, and with the cooperation of the Federation of Mutual Fund Dealers (FMFD) engaged mutual fund dealers and dual-platform dealers to better understand the challenges facing investment dealers who are solely regulated by the Mutual Fund Dealers Association (MFDA) and those dually platformed with IIROC and the MFDA, and explore their expectations for how the regulatory environment should respond to those challenges while continuing to protect investors and support healthy capital markets.

Objectives

This research engaged Canadian mutual fund dealers in a thoughtful and unbiased set of conversations to better understand both investor, advisor and dealer needs and expectations in these transformational times as well as perceptions of potential regulatory barriers to providing financial advice and investment products to clients.

The more detailed objectives were to explore:

- Needs and expectations of investors that are having an impact on the advisory process;
- Changes to the industry that have presented the greatest challenges;
- Perceptions of the barriers to successfully competing in the advisory sector;
- Factors that may lead to barriers to offering products to clients;
- Major regulatory challenges faced by advisors and dealers;
- Awareness and perceptions of the CSA review of the regulatory framework governing IIROC and the MFDA, and;
- Recommendations for what the review should consider in order to protect the public interest and support healthy capital markets.

Methodology

Navigator was engaged to undertake this important consultation. Eighteen interviews, completed online or by phone, were conducted among dealers nationwide representing firms that operate in BC, Alberta, the Prairies, Ontario and Quebec:

- Ten of the interviews were conducted among dealers regulated solely by the MFDA.
- The remaining eight interviews were conducted among dealers dually platformed with MFDA and IIROC.

The interviews averaged one hour in length.

Qualitative Research Caution

The research conducted was qualitative in nature. As such, the results provide an indication of participants' views on the issues explored but cannot be generalized to the full population of senior executives representing the MFDA-regulated and dually platformed dealer firms. Rather, the findings from this research provide themes and direction. The findings cannot be used to estimate the numeric proportion or number of individuals in the population who hold a particular opinion because they are not statistically projectable.

Executive Summary

The Current Regulatory Environment is Siloed

The current regulatory environment is seen as ill-suited to fundamental changes in the needs and expectations of investors. In particular, the current regulatory environment is seen as “siloed” and as not lending itself well to investors looking for a consolidated and seamless service experience.

In a period of rapid technological change, dealers suggested that investors expect:

- To be able to access and review all their investments in one place.
- To obtain a variety of products from one advisor or advisory firm.
- Advisors who can provide a holistic advice offering.

Dealers reported that silos in the regulatory environment lead to silos in dealer legal entities, which in turn lead to the siloing of technology platforms and siloing in dealer operations.

Factors Leading to Siloing

The regulatory silos are seen as having originated in a product-based approach to regulation and a lack of regulatory harmonization.

Product-based regulation: The current regulatory structure is perceived by many to inhibit advisors from providing clients with an integrated product and service offering. Exchange traded funds (ETFs) are a key example of how dealers believe a siloed, product-oriented approach to regulation negatively affects the investor.

Some of those regulated by the MFDA observed that while there is an appetite among advisors to offer their clients ETFs, and there is now regulatory accommodation to allow for the sale of ETFs in some jurisdictions, technology platform requirements have the potential to make it technologically too problematic or too costly to include ETFs in their suite of product offerings. Overall, there is a strongly held perception among many dealers that product-based regulation is no longer appropriate in an environment where investors are seeking a seamless experience.

For dually platformed dealers, the need to accommodate differing regulatory regimes through the development of multiple technology platforms that facilitate product and proficiency monitoring, as well as the resources to support these differing platforms, is considered highly problematic.

Dealers viewed this structural outcome of the current regulatory environment as highly inefficient, and as contributory to the difficulty dealers and advisors are experiencing in responding effectively to the evolving expectations of investors.

Lack of Harmonization: Acute frustration was expressed by most of the dealers concerning the lack of harmonization across the regulatory regimes. This is seen to result in:

- Inconsistent client experiences. Dealers indicated that while clients can be offered the same product, the experience in obtaining the product differs significantly;
- Confusion regarding protection bodies. Concern was raised that with multiple dispute resolution groups, including regulators, there is the potential for investor confusion when seeking dispute resolution or restitution;

- Categories of risk being assessed differently across regulatory regimes;
- Advisors potentially being penalized for some activities under one regulatory regime but not under another; and
- Inconsistencies in how products can be marketed and described.

Product Arbitrage: Arising from the perceived lack of harmonization is the issue of product arbitrage. Differing approaches to product regulation across provincial securities regulators and self-regulatory organizations (SROs) is perceived to be leading to unintended consequences. For instance, a perceived unintended outcome of the discontinuation of Deferred Sales Charges (DSCs) for mutual fund products in some but not all provinces is advisors turning to similar products under alternate regulatory regimes (e.g., segregated funds for those who are licensed to sell insurance). This is viewed as leading to an unlevel playing field for dealers and their advisors, and could potentially lead to product recommendations that may not be wholly in the investor's interest.

Challenges to a Vibrant Investor, Advisor and Dealer Marketplaces

Challenges to a vibrant investor marketplace: The cost of regulation is perceived to trickle down to the investor, but it is small book investors who are viewed as being at greatest risk of being negatively affected by regulatory burden. Dealers suggested that the effect of regulatory burden - as evidenced by compliance costs associated with audits, technology platform updates and human resources requirements – drives firms to focus on clients whose books generate sufficient fees to fulfil regulatory requirements and meet the cost of business operations. While this issue is believed to have existed for some time, its intensification due to the pace of regulatory change and increasing regulatory requirements was a key theme in the consultation.

Challenges to a vibrant advisor marketplace: The ability to attract and retain younger advisors has been an emerging issue over the last number of years according to dealers. Concern about this issue has been heightened by the discontinuation of DSC products in most provinces. This fee evolution, in combination with what are perceived to be increasing operational costs for new registrants (e.g., proficiency costs, membership fees, dealer supervisory costs), is seen as making the industry and its compensation model less appealing than in the past. Dealers, particularly those with independent advisor models, believe that alternate compensation structures may have to be introduced to attract and retain new registrants.

Threats to a vibrant dealer marketplace: Higher technology and compliance costs – including the need to comply with frequent updates to the Know Your Client (KYC) and Know Your Product forms (KYP) – costs to support advisor proficiency, costs of advisor supervision, membership fees, and the move away from DSCs, all serve to make smaller dealer firms particularly vulnerable to regulatory burden. Concerns about the ability of smaller firms to survive in this environment were raised frequently during the consultation. It was also suggested that regulatory burden acts as a barrier to new dealer entrants into the marketplace, inhibiting the vibrancy of the marketplace.

Issues in Consideration of a Single SRO

As dealers considered and discussed the CSA "Consultation of the Canadian Self-Regulatory Organization Framework" and the two separate proposals released by MFDA (*Special Report on Securities Industry Self-Regulation)* and IIROC (*Improving Self-Regulation for Canadians: Consolidating the Investment Industry Regulatory Organization of Canada and the Mutual Fund Dealers Association of Canada*), a number of consistent themes emerged.

There is universal support for the SRO model. Further, most believe a single SRO will benefit the investment industry as it is expected to:

- Reduce siloing of operational and technology structures, which will lead to cost savings for dealers and advisors and ultimately benefit investors.
- Eliminate duplicative audits.
- Reduce product arbitrage.
- Allow all advisors to offer clients the same products based on harmonized proficiency requirements.

There remain, however, some issues and questions about a single SRO among dealers, particularly among those currently regulated solely by the MFDA. The main outstanding issues for these dealers are:

- How will operational/structural characteristics permitted for advisors currently regulated by the MFDA (i.e., directed commissions and client name accounts) be considered under a single SRO? Directed commissions, in particular, stand out as an issue that MFDA-regulated dealers view as critical to their advisor operations as needing to be protected under a single SRO.
- While the July 2020 Deloitte report, "An Assessment of Benefits and Costs of Self-Regulatory Organization Consolidation", prepared for IIROC suggests that dually platformed dealers could save significant costs with a single SRO, there is felt to be little information about the cost impact of a single SRO on those operating solely on the MFDA platform. With concerns raised about how smaller dealers are responding to increasing regulatory burden and costs, this issue is of particular interest.

Should a single SRO model be pursued, dealers felt that it should be principles-based, consultative and collaborative in order to promote advisor and dealer openness and transparency. Further, dealers are seeking an SRO that preserves restricted (tiered) licensing, and applies its regulatory framework based on nature, size and complexity of registered firms and products.

Issues and Challenges Facing the Industry – Dealer Perceptions of How Stakeholders are Affected

Evolving Investor Technology Needs

Highlights:

Investors have high expectations for consolidation of all investment-related information.

Multiple regulatory regimes lead to inconsistent and idiosyncratic technology platforms which act as a barrier to meeting client expectations.

Investor-related impact

Client expectations are believed to be changing in response to rapidly evolving technology. Dealers suggested that one element of the evolution is a call by investors to be able to see a consolidated picture of their investments and other financial planning information.

> *"There are the changes in consumer trends and behaviours from a client perspective. Wanting to get all of their information all in one spot and view and interact how they want and when they want. If they can get every single app on their iPhone, why can't they get all their financial questions understood and aggregated and viewed and answered all in one location?"*

This expectation places greater pressure on the industry, and dealers more directly, to find a means to integrate systems and technology platforms. Many dealers felt that a product-based regulatory regime acts as a barrier to meeting client expectations.

Advisor-related impact

In line with investor expectations related to consolidation of financial information, there was a perception that many investors are turning to their advisors for an integrated advice experience, seeking both a breadth of product options for a diversified portfolio and also an overall 'wealth management' approach. This places the onus on the advisor to offer a seamless experience that does not require passing the client off to another advisory channel.

Dealer-related impact

Some dealers suggested that meeting the technology expectations of clients is being stymied by a siloed regulatory environment. Dually platformed dealers indicated that having a number of regulatory regimes (e.g., IIROC, MFDA, individual securities commissions, and insurance regulator) means that distinct and idiosyncratic technology platforms are necessary to address the requirements of the respective regulators. This impairs the ability to provide investors with a consolidated view of their holdings. Fundamentally, the necessity for technological duplication associated resources (e.g., monitoring, human resources) to support the systems was viewed as highly inefficient and costly. Dealers felt that the cost is ultimately borne by the client (investor).

Expectations of Holistic Financial Advice Experience and Where ETFs Fit In

> **Highlights:**
> Investors are looking for an integrated product and service experience.
> ETFs stand out as a product that reflects a siloed approach to product regulation.

Investor-related impact

In addition to expecting their investment and financial planning information to be consolidated in one place, investors are increasingly seeking a more holistic advice experience. They are seeking a "one-stop shop" (e.g., tax planning, estate planning, breadth of product options) where their advisor can offer these services seamlessly, without the need for duplicative onboarding requirements or transferring to alternative advisory resources.

"The switch from the product approach to the advice approach is a key issue. It is now wealth management where we focus on client needs. There is a 360- approach rather than an approach focused on a product. The client now wants to have someone who is capable of talking about investments and financial planning...That is the true challenge for everyone. It is a major switch in the industry and a major threat. That is why having a regulatory environment just focused on product and being segmented on product is not client-oriented."

"In IIROC there was a traditional commissioned-based advisor who picked stocks…We have seen the move to managed accounts and fee-based accounts really being the biggest change in the business, probably more than anything else."

ETFs were identified by some dealers as an example of how regulation based on product affects the ability of investors to achieve a seamless advice experience.

As ETFs have gained strength in the marketplace, there is a perception among many dealers that both investors and advisors want these product offerings as part of a diversified and lower cost investment portfolio. The "buzz" about ETFs is believed to be sufficiently strong that investors want to know more about them, and potentially have them included in their portfolios.

However, dealers indicated that a lack of product harmonization across MFDA and IIROC-regulated platforms has affected investors in two ways:

- They are often unable to obtain ETF products from some MFDA dealers.
- Consequently, should they wish to obtain ETFs, they are forced to go to another advisor stream – potentially unknown to them – and deal with another advisor, thereby disrupting their expectations for a seamless, one-stop advice experience.

Advisor-related impact

Dealers who are solely MFDA-regulated suggested that some advisors under the MFDA's regulatory framework are more likely to be disadvantaged in their ability to serve client wishes related to ETFs. When probed about how the ETF issue is perceived to affect the advisor, the feedback tended to split along several lines:

- Some dealers felt that the inability for some advisors to offer ETFs – because their dealer does not have the platform structure to facilitate such an offering – leads to a break in the continuity of service provision for clients who wish to include ETFs in their portfolios. It significantly disadvantages the advisor who has to inform their client that only through accessing another advisory stream can the client obtain the product, raising questions as to why the advisor is unable to offer these products.

- Some suggested that their advisors have not been recommending ETFs to clients because there are sufficient mutual fund product opportunities to satisfy client needs.
- Others indicated that advisors may avoid discussion of ETFs altogether as they do not want to raise the issue of why they cannot offer the product.

This issue is further complicated by a perception that it may also be affecting the advisor marketplace. A concern raised by some dealer firms is that advisors may migrate away from MFDA-regulated firms to seek positions in IIROC-regulated firms in order to be able to offer their clients these products. It was further suggested that this may leave smaller independent firms more vulnerable as their advisor, and hence client base, is eroded. There is a belief among several of these dealers that the migration could be exacerbated should there be a coming together of the MFDA and IIROC in a single SRO.

"Advisors are going to migrate only if they think there is a business opportunity. The MFDA world is under great stress. They see the trends with ETFs. I know the MFDA is doing some work to make it easier or make it more possible for MFDA-licensed dealers to have access to ETFs. But I think there is a great fear that everyone is going to shift over to an IIROC world and put clients into ETFs, which because it will lower the overall costs is good whilestill getting what they can for the advice component. The advisors are happy to put people in a different product if they are moving into a fee-based account model."

The dealers who raised this issue did not all subscribe to the belief that advisors are migrating to IIROC-regulated firms that offer ETFs, as some MFDA-regulated dealers have accessed platforms or regulatory treatments that allow their advisors to sell ETFs. They felt that the barriers to offering ETFs will erode as access to ETFs improves.

Dealer-related impact

Even if products like ETFs are beginning to be accommodated through MFDA regulatory treatments, some dealers pointed out that the costs to do so under the current regulatory framework is a barrier to entry for smaller firms, thus disadvantaging smaller dealers and their clients.

Overall, the issue of ETFs brought to the fore that dealers are concerned that a regulatory regime based on product regulation has the potential to disadvantage some registrants.

Competition in the Advisory Marketplace: The Role of the Robo Advisory Channel

Highlights:

The robo channel appears to be presenting a weaker competitive threat than originally anticipated.

Take up may be slow because the robo channel is not perceived to fully serve the needs of clients due to the complexity of investment issues.

The channel may effectively serve a role with smaller book, newer investors just entering the market.

In an environment that is increasingly affected by client expectations around digital delivery of services, dealers admitted that there was real concern when the robo-advice channel first emerged in the marketplace that it might present a serious competitive threat to more traditional investment channels. However, a number of dealers indicated that those fears have moderated based on a number of issues.

Investor-related impact

Some dealers felt that a client need for a more holistic advice experience may be a contributor to the relatively slow take-up of the robo-advice offering in the Canadian marketplace. Particularly during the pandemic, dealers suggested that traditional advice channels stood in relief to the robo channel because clients benefitted from being able to speak one-on-one with an advisor and receive reassurance and direction. They felt that the those who are solely invested through the robo channel did not have this benefit and may have suffered more acutely as a result.

"What we have found in our industry is that we have digitized a lot. But it [financial planning] is still a complex thing…you have a pension plan sitting at your company and you have an RSP and you have the client who has to fill out the form T-2033. It is a complex thing with transfers of accounts etc, that we have not been able to very much simplify. You want to pick up the phone… RIFs, LIFs, it is still complex."

Dealer-related impact

Dealers who commented on the role of the robo channel suggested that it may play two key roles in the market:

- A comfortable place for first time and younger investors to obtain managed portfolios and to grow their initial investable assets.
- A channel for small book investors.

Dealers who suggested this latter role for the robo channel argued that the cost of regulation is such that it has become increasingly difficult to cover costs when managing small book clients – particularly for smaller dealer firms. As such, the robo advisory channel – where cost of client management is lower – may be a channel that the industry leans towards for the servicing of lower book clients.

Servicing of Small Book Clients

Highlights:

There is a perceived systemic challenge associated with servicing small book clients. Regulatory burden has intensified the challenge.

Advisor-related impact

The issue of how small book clients are to be effectively serviced in the current regulatory environment often emerged in broader discussions about the robo-advice channel and the cost of regulation for dealer firms.

The robo-advice channel was viewed as a platform into which smaller book clients are slowly being channeled by all types of dealer firms and their advisors – from the large to the small.

> *"The commoditization of portfolio construction and advice. There is more of a cookie cutter approach to advice [with robo channel] than I believe in. I think this is one of the outcomes of client-focused reforms. Clients are individuals. You need individual suitability and the suitability has to be in-depth. I think what robo-advisors do is commoditize that advice and revert to 'persona' approach to advice."*

Advisor-related impact

A number of dealers suggested that there is a systemic challenge associated with servicing small book clients. Particularly for independent advisors, the cost of running a practice with what are perceived to be increasing costs of compliance, technology and proficiency requirements is becoming more challenging. Advisors tend to focus on clients with greater books – the "*mass affluent*" as one advisor described them – in order to generate the revenues needed to meet practice costs. As such, investors with small books are perceived to be underserviced regardless of the regulatory regime under which their advisor practises.

Dealer-related impact

Some dealers suggested that regulatory burden, including compliance and technology requirements, has become so significant that carrying significant numbers of small book clients erodes the capital needed to fund the infrastructure and resources necessary to meet regulatory requirements.

> *"As players continue growing and they continue to try to save money due to regulation, you force the advisor to increase the value of their book, so anything under a certain amount is funneled down to order-execution or a robo advisor. I think that will accelerate [with a single SRO]…As compliance costs go up, back office costs go up, you look at the advisor's book, you have to say you are not making money from these accounts, so you need to push them toward order execution or here is an option, they can use a robo advisor going forward or something like that…There are 10s of thousands of these accounts in the MFDA channel."*

"The cost has become so high, that is the issue for the small client because they are not well served because it is not financially viable to serve them properly. So the poorest people get the worst service because of the burden they put on us."

Investor Protection Mechanisms

Highlights:

Potential investor confusion about where to seek information about complaints and restitution.

Multiple investor protection channels limit the industry's ability to pool resources to develop more robust communications and education resources for investors about the complaints process.

Investor-related impact

Some dealers suggested that there is potential confusion in the investment marketplace for investors should they have a complaint about a registrant or firm. It was observed that multiple regulatory regimes have the potential to limit investor clarity on where to complain or seek restitution for losses.

Advisor-related impact

There was little commentary about how investor protection mechanisms are impacting the advisor, with one exception. One dealer noted that the requirements for informing clients in a very detailed manner about all the compliance issues that must be completed along with the detailed overview of the complaints channels and process available to investors make for an onboarding process that detracts from relationship building and positions advisors and the industry in a negative light.

Dealer-related impact

A number of dealers expressed concern about the challenges associated with multiple channels for addressing investor complaints. They noted that the multiple channels (IIROC, MFDA, OBSI) limit the broader industry's ability to pool resources for communications and information about the complaints process. These dealers felt that a single complaints process could be more easily and effectively communicated to the public, which would in turn raise investor awareness and use of the complaints process and serve the public interest mandate of the regulators.

Regulatory Lag and the Issue of Document Digitization

Highlights:

Perception that regulators have traditionally been slow to respond to changes in investor needs.

Positive impressions of regulator response to COVID-19 through accommodation of digitization of transaction documents.

Expectation that strides made by the regulators in response to pandemic will be maintained moving forward.

Dealers suggested that that COVID-19 has impacted every part of the advice relationship including client communications and document management. The issue of e-documents was often raised in the context of changing technology needs and the impact that the pandemic has had on investor-advisor interactions.

Investor-related impact

Investor interest in and increasing expectations to be able to conduct investment-related paper-work online has driven many dealers to update their systems and provide platforms that allow advisors to provide their clients with digitized document options.

Some felt, however, that regulators have been slow to respond to these investor expectations. Specifically, a number felt that until COVID-19, regulators were viewed to be moving very slowly on e-signatures and other digital document delivery issues.

> *"Client expectations do change. It leads firms to react because they are the front line as they drive toward the expectation. Whenever we get to the regulatory world, the pace of change is much slower. Businesses have an ability to act much more quickly and to be more nimble."*

Advisor-related impact

Dealers felt that COVID-19 had the effect of closing the gap between dealer development of online tools and advisor adoption of those tools. Dealers reported that advisors were slow to relinquish their use of pen-on-paper prior to the pandemic. While some dealers had been marketing digitized processes for some time, advisors were seen to be slow in adopting them.

The pandemic forced advisors to migrate to these digital practices, and many dealers suggested that advisors are now embracing the associated benefits and conveying that they do not wish to go back to their old practices.

> *"For years we have been preaching to the advisors to sign your clients online and give them access to accounts online. There is no need to drive a hundred kilometres to see a client. Use the online tools. The beauty of the pandemic was the 180-degree change. Suddenly, advisors couldn't have enough. It forced them to take up tools that they didn't know they had. The ability to e-sign. The electronic delivery of documents. The things we wanted our advisors to take up. I think their customers, to some degree, wanted them to but it took this [pandemic] for the advisors to change their ways."*

Dealer-related impact

Many of the dealers noted that COVID-19 had the fundamental effect of compressing the regulatory lag between dealer development of digitized document delivery processes and the development of a regulatory response and guidelines.

Dealers felt that the both the MFDA and IIROC responded effectively to dealer and advisor needs to offer investors digital options such as e-signatures. Some of the dealers specifically praised the regulators for moving so quickly.

> *"The regulators actually did pivot really quickly. I was pleasantly surprised at the regulators' ability to understand what was going on in the [COVID-19] situation. We have taken that opportunity as a firm to ask if these are temporary measures that can be expanded. Is this the new norm? We are pleased with the regulatory approach to determine if there are better ways to do business."*

However, some raised the concern that regulators may retrench and limit the use of digitized documentation and signature options once COVID-19 recedes. Dealers encouraged regulators to work together to evolve the regulatory regime in a manner that fully embraces digital options and harmonize their regulatory approaches on this issue. Further, dealers are looking to regulators to foster a regulatory regime that is more responsive to evolving digital practices.

> *"One of the things that I found through the pandemic is that both groups [MFDA and IIROC] started to move forward in their thinking about some of the restrictions that were at play for clients and advisors who were unable to meet in person, and some of the past way of doing business. I think they will have to move forward with the lens of what the new technology is and how it can be used to benefit and streamline opportunities within the industry as opposed to playing catch-up."*

Lack of Harmonization and Associated Costs

Highlights:

Perception that regulatory environment leads to inconsistent product marketing.

A siloed approach to regulation fosters inconsistent client onboarding and fee experiences.

Advisor disciplinary approach differs across regulators.

There is inconsistency in how client risk is evaluated.

The single most frequently cited frustration among dealers throughout the consultation was the lack of regulatory harmonization in the investment marketplace. Dually platformed dealers were particularly emphatic about the negative impact that this issue has on their operations, and by extension on investors and advisors.

> *"We don't like the idea of regulatory arbitrage….sometimes you look at those who are dually licensed and in theory there is an advantage if one regulator is being more strict than another. So a harmonized set of rules is good philosophically."*

Investor-related impact

A number of dealers raised the issue of a lack of harmonization or standardization in how products are required to be communicated to the investor. This lack of consistency in the way in which fees, product characteristics and benefits are represented – driven by differing standards across the regulatory regimes – means that investors are "comparing apples to oranges", as one dealer put it.

"There is so much out there that it can be very confusing for investors. There is a lack of standards between different platforms so that everything is not consistent and transparency [what dealers can say] differs across those platforms. For instance, insurance companies say they have their guaranteed segregated funds and lower fees, but they are not regulated by those that regulate us. So it is like comparing apples to oranges. Similarly [it happens] when a bank is enticing a client by saying you won't have any fees here. Well they have the same embedded fees that we have here so the information is not necessarily transparent in the same way that we have to be. The transparency has to be equal."

"The concept of fees and what you get when you are paying for advice. I would point to [specific firm name]...how are you allowed to advertise a 30% benefit to Canadians? It begs the question, when compared to what? Obviously the 30% is not reflective of a 30% rate of return. I think what the robo channel is trying to compete on is fees while promising the same level of service. To me that just doesn't mesh."

Some indicated that two regulatory regimes also lead to inconsistent client experiences and fee structures. Several dealers highlighted the example of fees and product onboarding, suggesting that the experience in signing up for the product differs significantly under the two regimes.

"A five thousand or ten thousand-dollar starter RSP or TFSA in a client name account costs zero as a trustee fee. Nominee, it is one-hundred or one hundred and fifty dollars at an IIROC firm for an RSP. So client name, there is no fee, so the client is clearly going to benefit [from doing it at the MFDA firm]."

"On one side [the client] has one experience and, on the other side, a totally different experience. It doesn't make sense. For me as a client, I can go to one place and fill out all this paper and then I go to another place – under a different regulator, in another environment – and there is no need to go through that process."

Advisor-related impact

Further, it was felt that lack of harmonization affects the activities/behaviours for which advisors may be disciplined. Several dealers referred to the fact advisors are penalized for certain activities under one regulatory regime, whereas those regulated under the other regime are not.

Dealer-related impact

Categories of risk were identified as an area where a lack of harmonization exists. For dually licensed dealers and their advisors, this presents a need to develop and support differing KYC and KYP training and materials as well as technology platforms.

> *"You set up two different operational structures. You are putting people on different systems so duplication [on technology platforms]. You have different governance oversight rules in terms of how you view risk on a household portfolio versus product basis. So you add on different nuances of what is considered risk or planning & service that again, due to a license, should not be that different from a consumer lens. So they view it from a regulatory lens rather than from a lens of the customer or investor."*
>
> *"By having both [SROs] and in segregating services and having different styles of oversight and reporting, in this environment, those costs just continue to go up. Unless you do consolidate that and get some scale on it internally, how many of the independents can really continue down that road especially as they have to look at putting those digital capabilities, risks and portfolio management aids, whatever, on the new platform so that it is understood and available a couple of times. It makes it very cumbersome and then very difficult from a cost and oversight perspective."*

Every dealer spoke to the need to enhance harmonization among all the regulatory bodies, not only IIROC and the MFDA, but the individual securities commissions for those dealers licensed in multiple provinces.

The dealers who participated in this consultation expressed views on this issue similar to those articulated in FAIR Canada's submission to the Ontario Task Force (*Submission To CSA on The Proposed Scope of the Review of Self-Regulatory Organizations*, March 27, 2020).

> *"Many of the Taskforce's proposals would require changes to the Securities Act (the "Act"), securities regulations and related instruments. FAIR Canada urges the Task force to recognize in its final report that those changes should be coordinated with the other Canadian Securities Administrators (CSA) members to the greatest extent possible, in order to preserve harmonized national rules and a consistent regulatory approach. Certain other initiatives, such as SRO reform, also require a national consensus. Increasing the number of differences in rules and policies among provinces would not benefit investors or the industry, nor would it support developing stronger and healthier capital markets."*

Product Arbitrage

Highlights:

Product arbitrage is not in the client interest.

The discontinuation of Deferred Sales Charges (DSCs) in most provinces is leading to migration to the sale of segregated funds among those who have dual fund and insurance licenses.

Investor-related impact

Some dealers suggested that advisors are making decisions about the products to recommend to their clients based on product fee structure or other regulatory considerations and that this form of arbitrage is not in the best interest of the client.

> *"There are different sets of rules for advisors depending on the SRO. That is just wrong. You have advisors making arbitrage decisions between different SROs based on the rules of those SROs or the tax consequences based on whether they can incorporate based on an SRO regime. From a regulatory perspective, I have a hard time understanding why we don't have one set of rules because that would be in the client's best interests."*

Advisor-related impact

An example of product arbitrage often raised was the sale of segregated funds in lieu of mutual funds with DSCs. With DSC mutual fund products being discontinued in most provinces, it was reported that advisors who are dually licensed to sell both insurance and mutual fund products are leveraging their access to segregated funds as a means of accessing deferred charge products.

> *"Arbitrage is a problem. Let's not open the door to insurance. We have advisors who say I can't do DSC on the mutual fund side so I will sell seg funds. That is not client-focused."*
>
> *"People are not doing it from a place of ill intention… Inadvertently, what I believe is going to happen, we may see a shift with advisors saying I will just move it over to a seg fund…and into a no-load seg fund so I am still building up my trailers and in the future I can move it back to a no-load fund and I can still get my trailers."*
>
> *"Segregated funds versus mutual funds. The regulation of segregated funds is completely different [for mutual funds] – from cost disclosure to CRM2"*

Impact of Regulatory Regime Changes on Smaller Dealer Entities

Highlights:

Regulatory burden and changes to fee structures act as barriers to small firm representation in the investment marketplace.

Higher technology and compliance costs – including the need to comply with frequent updates to the KYC KYP – costs to support advisor proficiency, costs of advisor supervision, and membership fees, and the move away from DSCs all serve to make smaller dealer firms particularly vulnerable to regulatory burden.

Concerns about the ability for smaller firms to survive in this environment were often raised during the consultation. It was also suggested that this level of regulatory burden acts as a barrier to new dealer entrants into the marketplace, inhibiting the vibrancy of the marketplace.

"It is the cost barriers to entry. The regulatory burden, the compliance burden, the technology burden have become so significant it is hard for small firms or small entities to start up. Those firms are disappearing because of the cost, so there is a cost to the community…it is not good for society overall."

"Certainly it is an industry where scale helps on some elements. Obviously the technology costs just keep going up. Scale really helps on that. The banks have their distribution network which is making it tougher and tougher on small players. That scale and that reach are making it tougher for the smaller firms for sure."

"Now [with the discontinuation of DSCs] we have to determine what our best course of action as a dealership will be. There could potentially be more amalgamations of smaller and larger dealerships because regulations are changing. With all the changes and amalgamations, what ends up happening is that smaller dealerships are not competitive from an operational standpoint. Margins are slimmer for us because advisors are now attracted to the larger payouts at larger firms based on volume…we may see a number of small dealers who will not exist."

An Aging Advisor Base and Cost of Entry Challenges for New Registrants

Highlights:

Dealers believe the discontinuation of the DSC makes it more difficult for younger dealers to fund their practices.

Longer-tenured dealers may not be sufficiently focused on succession planning.

Dealers may have to introduce new remuneration models for advisors.

Investor-related impact

Across the firms in this consultation dealers suggested that it is increasingly difficult to attract new registrants to the industry. They felt that the result is an aging advisor base.

This perception has been supported by 2018 research released by Investment Executive. It found that the average age of advisors was 50.4 years, while in 2009 the average age was significantly lower at 46.7 years.

According to some dealers, fewer registrant entrants may lead to a growing segment of investors who are not fully served through the advisory stream as advisor resources will be diminished and will likely be focused on investors with larger investment portfolios.

Advisor-related impact

Dealers felt that several factors may be contributing to challenges associated with attracting young advisors:

- **The discontinuation of DSCs**: DSCs have traditionally provided younger advisors with a revenue stream as they begin their practice. Without the revenue that these fees provide to new entrants, it is perceived to be very challenging to cover start up and running costs for independent advisors (e.g., fees for accreditation within a certain period of time, regulatory fees, investor protection fees, office start-up costs, fees associated with technology to meet regulatory requirements) in the first years of practice. Whether the cost is borne by an advisor or a firm, the costs to meet regulatory requirements – when combined with running a practice – are increasing and make it challenging for an advisor to earn a good income.
- **The lack of succession planning in the industry**: Some suggested that many advisors who have been in the business for a significant period of time have not yet engaged in succession planning, probably because they are not eager to wrap up their business. Having developed a significant book of assets under management that is relatively easy to maintain and provides a comfortable income, it was felt that there is no incentive for these advisors to either scale back or retire.

"Most advisors in our industry have no succession plan. And it takes a lot of trust for tenured advisors who are coming to the end of their career to give up their book of business and they realize they have grown their AUA [assets under administration] and don't have to work that hard and still generate a comfortable lifestyle. And to give that up to a junior advisor is a difficult transition for most people."

Dealer-related impact

The impact of the aging advisor base may prompt firms to change their structures and move to different compensation models in order to appeal to and retain potential registrants. Adding to concerns about overall cost of operations, some felt that new compensation models for advisors will only add to the organizational capital needed by firms, which will have a greater negative impact on smaller firms.

"For [certain types of dealers], where they tend to recruit new people, a new person coming in strictly on commission with no DSC, how do they afford it? Now what happens. The company is going to have to come up with some very expensive structure… We are already seen a decline in the number and quality of people coming into this business. That has been going on for a number of years. How does an organization have to change? Do they have to look up a call-centre type of model and then where is that value of advice?

"The whole independent side of the business is changing…should we move down the road where we become fee-based? Now, as an operation, the new advisors that we bring on may have to be employees rather than independent advisors to stay in operations because of the slim margins."

"That is a big concern. For an exclusive dealership, when you look at those firms that tend to recruit people in, a new person coming in strictly on commission with no DSC up front, how do they afford it? The company is going to have to come up with a very expensive structure."

Impressions of CSA Review of Self-Regulatory Organizations

There was universal endorsement of the SRO model of regulation for the industry. Further, almost all of those who participated in the consultation supported a single SRO.

Dealers welcomed the opportunity to provide their impressions and concerns about the CSA Review of SROs. Many of the dealers, in response to probing about the issue of bringing together SROs into a single entity, expressed their appreciation to IIROC and the FMFD for their efforts to consult with the industry on the issue. Registered firms felt that the manner in which the consultation was conducted (on a confidential and not-for-attribution basis) provided them with the opportunity to voice their opinions and concerns without fear of adverse effects on their relationship with regulatory bodies.

As dealers considered and discussed the CSA "Consultation of the Canadian Self-Regulatory Organization Framework" and the two separate proposals released by MFDA (*Special Report on Securities Industry Self-Regulation)* and IIROC (*Improving Self-Regulation for Canadians: Consolidating the Investment Industry Regulatory Organization of Canada and the Mutual Fund Dealers Association of Canada*), a number of consistent themes emerged. They are presented on the following pages using a "SWOT" framework: 'Strengths', 'Weaknesses', 'Opportunities' and 'Threats'.

Perceived Strengths of a Single SRO

Dealers suggested that a single SRO will address many of the challenges currently affecting the industry set out earlier in this report:

- **Reduce the 'siloing' of operational and technology structures** required under the current regime for dealers who are dually platformed. This reduction in duplicative processes will lead to cost savings that will ultimately result in enhanced investor-related benefits and service.
- **Eliminate duplicative audits** and the associated costs and human resources needed to prepare for and respond to those audits.
- **Reduce product arbitrage** through harmonization of regulations.
- Allow all advisors the **opportunity to offer clients the same products based on harmonized proficiency requirements**.

For dually platformed dealers (under IIROC and the MFDA), there was a consistency of vision: a need for a single regulator that **facilitates graduated, and restricted licensing of registrants** but allows dealers to operate under one regulatory regime. There is a belief that a single SRO will reduce the siloing required under the current set of regimes and will lead to cost savings that will trickle down and lead to enhanced investor-related benefits and savings.

"There needs to be a regulatory body that has an overall function for those who are licensed to give advice. When you become a doctor, you have one licensing process to go through to become a GP. And then you can take on other courses to specialize in other areas, but you are a doctor and you have the same rules and guidelines and you come to the same oversight and

governance. Whereas here [investment advisors] we have set up the oversight and governance based on the specialty and not really looking at it – risk profile, advice, guidance and oversight – from a client perspective. At a minimum, we need to be able to move into the direction where we have governance and standards that are consistent based on the client's needs, risk and products based on the SRO."

For those solely regulated under the MFDA platform, there are outstanding issues and questions about a single SRO. These dealers felt that "the devil will be in the details". The main outstanding issues for these dealers are:

- Will directed commissions and client name accounts be grandfathered?
- Will MFDA registrants be required to upgrade their proficiencies?
- What will be the regulatory costs to firms once a single entity emerges? While there has been evidence presented that dually platformed dealers could save significant costs with a single SRO, there is no information about the impact on those operating on one platform.

Potential Weaknesses of a Single SRO

In assessing the two proposals (IIROC and MFDA) for the development of a single SRO, dealers identified potential weaknesses in the introduction of a single SRO into the marketplace as well as potential issues that may arise in driving toward a single regulatory regime. These included:

- **Key operational structures currently allowed under MFDA regulation (i.e., directed commissions, client name accounts) could be discontinued, substantially disadvantaging advisors who have set up their practices based on the allowance of these structures.** Amongst the dealers who participated in the consultation, directed commissions were considered a critical element of the mutual fund advisor's practice that must be protected under a consolidated SRO.

  Both the issue of client name accounts and directed commissions were seen to present a considerable challenge for a consolidated or new SRO in that if these structural elements are continued for a segment of advisors it could lead to an unlevel playing field for other advisors, or vice-versa.

"What happens to client name accounts? Under IIROC only 3% of your book can be in client name. But in the MFDA world it could be as high 90%. The fund company is picking up the charges. What happens in the IIROC world? They are going to be picking up those charges or their carrier will be charging it back. If you are used to getting all your statements and your confirmations issued by your fund company and all of a sudden you are responsible for that. It is pricey."

- Creating a wholly new SRO has the potential to exacerbate **regulatory lag**. In a period where customer needs and expectations are likely to continue to evolve as a result of COVID-19, the resources and time needed to develop a wholly new SRO or alternately, consolidate IIROC and the MFDA, could inhibit prompt and flexible regulatory response to issues arising out of the pandemic and beyond. This could lead to uncertainty and diminished confidence in the industry and place dealers, advisors and investors in a state of limbo.

  Some dealers felt that the risk of worsening regulatory lag would be greater if the decision is made to create a wholly new SRO.

"I am not so sure that is easier to start with a newco and a blank piece of paper because it never works that way. There is a lot of good in the SROs. Consolidation can take the uniqueness, geographic or by product or by license, and pull that all together and work together through all the differences and come together with a solution. As long as it is done through a client lens."

"The biggest concern I have, the concerns I would have in an amalgamated SRO rests in transition. There are competing priorities here…Saddling us with the implementation of Client-Focused Reforms, and the disjointed view to DSC between a number of securities regulators, and then implement a changing SRO structure, if we were to drag out this implementation out over three years. Having an understanding of how those three cogs would move together is more of a concern. For small firms, in particular, because trying to implement all of that and having to go through the process all at the same time, is where I have the concerns."

- A combined SRO may **pursue policy directions that favour larger dealers** (e.g., banks), leading to unintended negative consequences for dealers and their advisors who have operations that differ in nature, size and complexity from the larger players.
- Even with the potential amalgamation of SROs, **there remains no national securities regulator**, so firms that operate cross-jurisdictionally will still be required to address the regulatory burden and challenges associated with being regulated under multiple securities commissions, the Chambre and Autorité des marchés financiers (AMF) in Quebec, in addition to a consolidated or new SRO.

"We lack a national securities regulator in any true form. Even the amalgamation of SROs doesn't necessarily reduce regulatory burden for firms that have to deal with [provincial securities commissions]. I would be hard pressed to suggest that the amalgamation of the two SROs would increase the regulator burden. I think it would decrease it. I think that any firm that had decreased obligations would probably benefit from that from a viability perspective at least."

"We don't want to have to rebuild those levels of trust with a new regulator. I would be very disappointed if that would have to be rebuilt again."

- Several dealers expressed the expectation that in an updated SRO (consolidated or newco), dealers will have some **continuity in the risk assessments that have been ascribed to them by the legacy SRO**.

Opportunities that Arise from a Single SRO

Given the potential for a new or consolidated SRO, dealers identified a number of areas where that SRO could improve or provide greater value to the marketplace.

- Adopting a **principles-based** regulatory approach which is sensitive to the size, nature and complexity of the dealer firms. There was a perception that an adaptive approach to regulating dealers should become formalized and pervasive in a single SRO. A regulatory approach that considers the characteristics of registered firms was perceived to have several important implications:
    - It limits undue compliance burden (which has an effect on profitability and competitiveness).
    - It contributes to the entry into, or viability of dealers in the marketplace.
    - It contributes to the reduction of potential regulatory risk in the system.

  There was a perception, even among some of those currently regulated solely by the MFDA, that IIROC has adopted a more principles-based approach in its regulatory regime.
- **Fostering a regulatory culture that is collaborative and consultative**. Some dealers noted that risk mitigation is enhanced when registered firms and registrants are able to be candid and transparent with the regulator without fear of retribution and that a collaborative culture within a regulatory body fosters this more open discourse.
- Pursuing a more "**advice-based**" versus "product-based" regulatory approach. A number of dealers felt that the MFDA has particular expertise in this area.
- In the consultation process, dealers were offered the opportunity to bring forward recommendations on a not-for-attribution basis, even if those recommendations are not held among a number of dealers (i.e., are not thematic). Two of these recommendations arose:
    - One dealer suggested that the governance structure of a new SRO should include individuals who have a strong base of direct experience in the advisor and dealer worlds.
    - Another dealer suggested that should a combined SRO emerge, that SRO could develop resources to assist smaller and more specialized dealers with integration into the updated regulatory regime.

Threats Associated with a Single SRO

The coming together of the MFDA and IIROC into a single entity was felt to present a number of potential threats to investors, advisors and dealers – particularly smaller dealers.

- A migration of advisors who have traditionally been with smaller MFDA-regulated dealers to firms that have been regulated by IIROC. Several dealers believe that a single SRO will lead to a framework where it is easier for MFDA-only regulated advisors to migrate, leaving smaller firms more vulnerable.

"You find more advisors moving from the MFDA platform to the IIROC platform more so than the other way. [MFDA advisors] will have access to more products, better technology. Everyone is chasing down the next generation because they will be getting a trillion dollars from their grandparents."

"If [a consolidated SRO] is pursued under this new model, they are just going to cherry pick all the top advisors among the MFDA firm and smaller firms will throw in the towel…That will leave a smaller number of dealers on the MFDA side holding the bag for a big fixed cost infrastructure. They could lose 30-40% of their assets but they still have 100% of their salaries and operating costs to pay for. So it could be a substantial increase in fees to dealers that they pass on to advisors which ultimately will be passed on to clients."

- **The potential to adopt a prescriptive and punitive regulatory regime** is of particular concern should a single SRO emerge out of the CSA review. Many dealers indicated that they felt this type of regime already exists under the MFDA, and that this approach to regulation has negative consequences for the industry. Described as a "gotcha" approach to regulation, it is perceived to detract from the potential for a collaborative and consultative relationship between regulator and registered firms. Further it is associated with audits which seek to blame and find fault rather than taking an unbiased approach to problem identification and a fear that the regulator will use sampling exceptions (i.e., outliers) as the basis for policy development rather than using normative information.
- Smaller dealers who are currently solely regulated on the MFDA platform will **have to take on higher costs of SRO membership**. In conjunction with all the technology and compliance costs, this has the potential to threaten the viability of these firms and lead to consolidation in the industry. Ultimately, this is viewed as having a negative impact on the investor.

"By having both [regulators], in segregating services and having different styles of oversight and reporting, in this environment costs just continue to go up. Unless you do consolidate and get some scale on it internally, how many of the independents can really continue down the road, especially as they have to look at putting those digital capabilities, risks and portfolio management aids, whatever, on the new platform so that it is understood and available a couple of times rather than doing once and tying it into different systems. It makes it very cumbersome and then very difficult from a cost and oversight perspective."

Final Thoughts

Across all the interviews, there was a sense that Canada's investment SROs have been posturing on the issue of a single SRO, and they are perceived to be engaged in a turf war. All the dealers indicated that the CSA and the respective SROs need to be attuned to how regulatory burden is affecting investors in order to evolve the regulatory environment to meet investor needs. With this lens, a single SRO has a strong potential for success.

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