Commentary on the National Post article 'Serious consumer protection concerns': Insurance watchdog moves to ban controversial fee

I wonder how many readers of articles like the one above pause to examine what is being said, how it is said and the full-context implications? Are financial journalists reporting accurately and in a balanced fashion? Are regulators considering the full context of proposed changes including purported benefits and possible damage done? Let's dig in, following the article in its order of presentation and choosing a few phrases to dissect.

Phrase #1: "...potentially hefty commission levelled on customers who withdraw funds before the end of a contract."

I find several words problematic in this short phrase, starting with "**potentially**." Omitted from the article is a clear definition of a deferred sales charge (DSC), which I would describe as a compensation mechanism where the product provider pays the advisor a commission up front, typically 5%, and recovers it over time through the fees it charges the product, while paying one half of one percent (0.5%) per year as a service fee to the advisory firm. This mechanism is disclosed and explained up front and should only be used in suitable situation, where the money is expected to remain invested for the long term, usually defined as more than five to seven years.

Normally companies allow for 10% per year to be withdrawn with no DSC charges, so over five years a client could withdraw 50% of the investment with zero DSC charges. If the client withdraws more than 10% of the funds before a set time period such as five or six years, then a declining fee is charged to the client, allowing the product provider to recover the balance of the initial advisor compensation. Combining the total advisor compensation over a ten year period, we would typically see 5% up-front and 0.5% per year for a total of 10%, or an average of 1% per year.

A common withdrawal fee is a 5% charge applied for a withdrawal in the first year or two, declining by 1% per year to zero after five or six years. Since there can be a great deal of work done before an investment is placed and less work over the next several years, this mechanism allows a time-matching of work done and value created. Yes, there is a potential transaction commission the client could pay, but it is known in advance, is largely under the client's control and if suitable planning is done is never triggered.

The most common alternative to a DSC is known as the service fee only model, also known as front end zero or FE zero. In this case the advisor is normally paid 1% per year from the management fee of the product with zero up-front compensation. Note that over time this works out to be the same 1% per year as the DSC described as above, and over the long term is an excellent alignment of client and advisor interests: the advisor is paid nothing for

transactions, only for ongoing service, and is only paid at all so long as the advisor retains the client's trust and the client perceives value in the advice. At any time the client may switch to another advisor with no cost.

I used the DSC mechanism in the first several years of my career. I was a father of two and a husband, starting as an advisor after six years in teaching, and the sole provider for my family. I invested many, many hours prospecting for clients, working with them to collect information, identify goals and priorities, make quite comprehensive plans and then implement them with those who chose to work with me. I believe that in my first two and a half years I earned a total of $70K with 60-70 hours of work per week and went deeply into debt. There was a time when I would put $10 of gas in the car because I was not sure I could pay for rent, food and utilities. It was extremely hard work but I persisted because I thought it was a long term investment in my business and the lives of my family through improving the lives of my clients. If I had no DSC option and instead used the FE zero model, I would have been earning $1,250 per month or $5.21 per hour by the END of that 2.5 years, assuming 60 hours per week, and far less than that in the earlier months. Can you see that even with the DSC my income was very low and that I never would have survived without it?

I always explained (three ways: verbally, in writing and in fund documents) how clients would pay me through the DSC and 0.5% service fee and why that made sense in their context. It took me about seven years to get to the point where I had grown my client base to the point I realized I could survive on just a 1% service fee and no longer needed the up-front portion of a DSC. My income dropped at first when I made the switch because new commissions went to zero, but over the years as I moved assets from DSC to FE zero my income eventually recovered. I explained to clients why I was making the change and how our interests would continue to be aligned, but in a slightly different way. I would never have survived long enough to make a career as an advisor with zero up-front compensation and thus all the advice I have provided to client families for three decades would never have existed - there would have been one less dedicated long-term-thinking advisor out there.

Now back to our first word, "**potentially**." There are two alternatives for clients not mentioned in the article: 1) if they wish to change advisors then in many cases a new advisor can simply assume responsibility for the investment account, and not a single transaction is needed nor cost incurred; and 2) even if the new advisor cannot handle the existing investment, the new advisor could use a commission rebate to cover some or all of the DSC charge incurred on the other end, subject to negotiation with the client. In my early years I did this several times for new clients leaving another advisor. A potential is not the same as an actual, and in my case and many others the potential of a fee was traded for the **actual value** of up-front advice and enabled the creation of a long career in advice. In the full context I've discussed, is a potential charge a bad thing with no advantages? Do the actual advantages perhaps outweigh the

potential cost? Who is to decide this if not the client and advisor, really the only two parties personally engaged in the exchange.

The very next word is "**hefty**" which is a synonym for large. In the context of a DSC, even if the client goes through all the work of establishing a relationship of trust with an advisor, places an investment knowing there is a potential charge for an early withdrawal, and then life changes of the client choose to change investments, the highest potential DSC I ever saw was 6%. Further, the client could switch among the investments available by the same company with no charge. Assuming just a few years have passed since the investment was made, a 3% DSC amount would be reasonable. Thus, the client would have 97% of the investment remaining. In the categories of balanced funds or equity funds, a 3% fluctuation per quarter is very common, so in this context the market value may easily drop 3% and the client must be willing to accept this as part of the long term investment process. Understanding the basics of investing, almost everyone accepts this without blinking. Yet somehow, a potential charge of 3% in return for hefty actual valuable advice is viewed as only having a negative effect and the hefty positive benefits are to be ignored. Does this seem to be a balanced perspective to you?

The fourth word in the quote is "**levelled,**" used in a way to connote something damaging to the client. When we say an athlete in hockey, football or similar sports is levelled, we mean forcefully knocked to the ground. An accurate description of the case where a client actually triggers a DSC charge would be "paid the agreed-upon fee for withdrawing more than 10% of the investment before the DSC schedule ended, due to unexpected circumstances." Again, it is a potential fee, usually not an actual fee. Industry data shows that segregated funds are held much longer than the average mutual fund, consonant with their use as insurance products containing some long term guarantees and most suitable for long term goals. I believe the average holding period is about eight years, so even in cases where a DSC is used, most investors would pay little or no DSC charges for withdrawal.

Still staying with the first phrase extracted from the article, consider the use of the word "**contract**," as in "withdraw funds before the end of a contract." The article is about segregated funds, which are a form of insurance contract that only ends when the investor closes the account or the insurance company terminates the product. Here we can see the journalist's use of the word "contract" is not accurate and provides a misleading negative impression to the reader by focusing only on the DSC and not the actual product.

Phrase #2: "In some cases, regulators found, seniors had been sold mutual funds with contracts of up to seven years and were charged significant fees if they took out their money any sooner."

My first word to focus on is "**some**." A quick search for the word definition yielded "an unspecified amount or number of" and I think it is accurate. In the context of mutual funds and

the DSC, it would be far clearer to be specific and identify the full context. For example, IFIC says there is about $1.8 trillion in Canadian mutual fund assets spread over an undisclosed number of accounts that I think must number in the tens of millions. Of these assets and accounts a small minority is in DSC-based funds. In a January 2020 article, before the DSC ban, 10.9% was in DSC funds and this had been shrinking for many years as the industry matured. Thus, a maximum of $196 billion was in DSC funds, likely in millions of accounts.

I wonder how many of these millions resulted in a client actually paying a DSC and of those how many lodged any type of complaint? Let's speculate a bit and assume the average DSC account size is $100K, meaning 1.96 million accounts. The 2020 MFDA annual enforcement report says 143 cases were opened that were initiated by members of the public. I note that mutual funds are also held by IIROC advisors to let's generously guess that MFDA assets are only one third of the industry total and triple the number of cases to 429. The MFDA says 16 of the 143 cases were about commissions and fees so to make a worst-case scenario let's assume every one of these was about the DSC, triple it to allow for IIROC accounts, heck let's round it up to 50, and this would mean a factor of 0.000025 of the accounts, or one in every 39,000. If you lineup people up with their arms spread wide so their fingertips touched, 39,000 of them would form a line 78 km long. Among these, one of them would create a regulatory case about commissions in a year. If you lined up people to span Canada from Cape Spear in the east to the far edge of the Yukon, there would be just 71 cases of people regarding commissions. This worst-case would be a remarkably low level, likely the envy of any other industry.

What about the word "**found**?" Is it a surprise to find a client and advisor using a DSC mechanism sometimes - a small and decreasing proportion of the time? Somehow the word "found" is supposed to indicate that clever and resourceful regulators, acting as intrepid detectives, were able to identify some such cases. It does not take a regulator to detect such an agreement since it is a very rational choice when there is a combination of an early-career advisor and a senior client. I had many senior clients in my early years while using the DSC mechanism, many of them are still alive and clients today and they never incurred an actual DSC transaction charge. A great aunt of mine became a client at about the age of 80. I used a DSC. 19 years later she died having never paid a DSC redemption charge. After all, she was only 80 when we started and was more confident, had better returns and paid less tax than she would have otherwise.

Let's look at the word "**seniors**" in this context. A senior is generally someone aged 65 and older, although I'm a little insulted to know that some retailers think I'm entitled to a senior discount after 55. So let's say I'm a new advisor talking to a 70-year old couple in good health. My handy life expectancy table tells me they have a joint life expectancy of over 20 years - I'm being conservative here. During this long period they will need investments that can protect their purchasing power from the ravages of inflation, have many tax and estate planning

questions to plan for, have many possible life changes that will require financial advice and generally want to remain confident their financial plans are in good shape through many times of turbulence in the world. They will likely experience four equity bear market declines of 20% or more and an unknown number of tempting investment themes like the cryptocurrency of today or the cannabis stocks of recent years. Let's assume they have just recognized the need to think deeply about all of these issues and are seeking personal, individualized advice for the first time.

Given this context, where a considerable amount of initial work is certainly required by the advisor, and that the advisor needs to make a living in the early years in order to be able to provide advice to the couple for the next 20+ years, the advisor explains how the DSC mechanism works and the **senior** clients agree it makes sense. For money targeted for any short-term spending they make sure it is in a fund with no DSC, plus they can always withdraw 10% per year without a DSC and their plan calls for spending of 4% to 5% per year initially so as not to deplete their investments before they die. Now is there a single thing wrong, unprofessional or immoral about this agreement? Is the advisor in a conflict of interest? Or has there been an agreement of interests, an alignment of interests?

What about a common alternative to mutual funds that is seen by consumer advocates and regulators as totally safe and is never considered to be controversial - the venerable 5-year GIC? In this case, the money is usually locked up for five years and the capital is not accessible, perhaps unless you die. If you change your mind or life changes and you need your capital, if the GIC issuer will let you have access to your money they will calculate a penalty based on the change in interest rates between when you bought the GIC and the present. If rates have risen the interest adjustment charge can be as much as a DSC charge, but you never know how much it will be until the time comes. Does every GIC investment transaction include a clear disclosure that if you buy a 2% GIC this year and rates go up to 6% and you need your money you will pay perhaps thousands of dollars in interest adjustment charges if the initial value is $100K? In my experience, this is never explained. Not just sometimes - never. The market value of a GIC fluctuates just like a bond does, except you can always sell a bond but not a GIC. Is this **potential** charge to be **levelled** on **seniors** a **significant** regulatory concern?

My next important word is "**sold**." The decision to invest in a mutual fund is obviously one that can only be made by the client. No one forces people to make investments. One could just as equally say that "**seniors had bought or chosen mutual funds**" but this would not serve the journalistic and regulatory goal of making it sound bad. Somehow, the word "sell" is intended to project a one-sided transaction when in fact there is obviously a buyer and seller involved.

One more word from this brief quote: "**significant**." A quick definition search yields "sufficiently great or important to be worthy of attention." This is obviously contextual. In the discussion of MFDA consumer cases discussed above, a factor of 0.000025 was calculated. It is not zero…

is it high, low… or is it significant? In the case of a significant fee, would the 3% example used earlier qualify? It would seem significant if it had never been disclosed and thus possibly disrupted the client's plans for the money. But then how does it compare to the full context, where the client had the value of advice? Is the client's life improved by 3% of the transaction in question? What if the client has some combination of a better return, a decreased stress, higher confidence and an advisor to talk things over with that is worth that 3% or much more? Would the amount still be significant? It seems to me the use of the word in this context is intended to carry a negative weight, even to exaggerate, since it is declared in the absence of value obtained in exchange. By the way, the word we used for such instances where full context is not considered is "**biased**."

Phrase #3: "the commissions raise "serious consumer protection concerns" because customers may need access to their investments before the end of a contract"

Start with the word "**serious**." This fits in nicely with the previous discussion of "significant" and "some." If the incidence of consumer complaints is so small as to be one in forty thousand and all of the values gained by clients having advice are ignored, can we rationally call the concerns serious?

What about "**concerns**"? A good definition for this word is "a matter of interest or anxiety." I concede that a DSC is worthy of interest and consideration to weigh the advantages and disadvantages, but it may not be something rising to the level of anxiety, given the context provided already.

Finally, I offer the word "**access**", which in this context is used to imply that clients may not have access to their investments, which as previously explained is completely untrue. Thus, in this phrase we have an example of words chosen and used in a way that deliberately omits proper context, uses statistics improperly to suggest something widespread that is actually minute, and tries to evoke an emotional response where reasonable thinking would suggest calm.

Phrase #4: "investor advocates argued that there was an inherent conflict of interest because the longer-term commitment with the prospect of early redemption fee would be arguably more beneficial to the fund seller than to the investor."

Here I will focus on "**conflict of interest**." The phrase suggests there is a conflict of interest but actually does not prove there is one. Instead, the word "**arguably**" is used to qualify the statement as if the mere existence of an argument proves anything at all. Again, every investment transaction involves a voluntary exchange of values, wherein each party only proceeds if they judge they will be better off making the exchange than they are without it.

A vital aspect is that it was a voluntary, uncoerced, freely chosen agreement between rational, adult beings, usually with at least a high school education and often decades of real world life experience. Consumer advocates and regulators always propose to substitute their ideas for those of millions of clients and tens of thousands of advisors, who apparently are unable to think, decide and act for themselves according to their own individual circumstances. Rather, they are lumped into only two broad classes: consumers with varying degrees of ignorance and advisors with varying degrees of avarice. Consensual win-win exchanges - nah, that's not the way a society should operate, right? We need a handful of people who have special powers of insight and authority to coerce us into making the right decisions about our finances and the relationship we are allowed to have with our advisor, right? Arguably so, because that is the society we live in and regulations are growing steadily, government powers are growing stronger and our freedoms are slipping away. All animals are equal but…

Note that companies that sponsor advisors have come up with an alternative to the DSC, known as an advisor chargeback, where the company pays the advisor up front and if the client withdraws the money the advisor and not the client is charged back over the first years. This strongly incents advisors to ensure the product is suitable for the long term or else surprise chargebacks can occur. This model has also been the focus of consumer advocate and regulatory criticism - it seems they are against most every practical form of up-front compensation.

One final issue comes to mind: the future of financial advice. At a recent panel discussion among regulators I asked the question "Now that you are banning the most popular forms of up-front compensation for advisors, and knowing that almost no advisors can survive the early years without up-front compensation, how do you see new advisors entering the industry? The answer: "that is not our concern." Right, so the very existence of financial advice in the future and the tremendous value it creates in the lives of Canadians is not a vital, nay, essential part of regulatory thinking - is that comforting for you? The average age of a financial advisor is about 57 and has been rising over the last few decades as fewer young people are able to survive providing financial advice. Now that the DSC is banned on mutual funds and will soon be banned on segregated funds, do you think this will prompt more or less of our young generation to become advisors? Will Canadians have more or less access to financial advice? Will this promote the values of freedom, progress and human flourishing that Canadians value so highly? Is this how we achieve accessible and affordable financial advice for all in Canada?

And we get all this from a short article about deferred sales charges being banned on mutual funds, coming soon to segregated funds. I bet you didn't expect a philosophical treatise, right?

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