Fiduciary duty report

Understanding today to prepare for tomorrow

Executive summary

Trust, reliability and care are the foundations of the relationship between advisor and client. For a client, the integrity of that relationship is vital. What's at stake? The client's future, whether that means retirement, a child's education, a vacation property or a financial legacy.

Global regulators are closely scrutinizing this relationship. Their aim is to ensure clients are receiving the best advice possible. In keeping with the approach of conflict-free advice, regulators are considering, or in some instances have already instituted, a change from a client suitability model to a best-interest model. In some countries, this could result in a fiduciary duty for advisors.

We believe anytime a regulator adopts either a best-interest model or fiduciary standard for advisors, it should be viewed as a positive for the industry, especially for investors. Any form of conflict of interest, whether actual or perceived, should not make its way into an advisor's investment decision-making process. When it comes to helping clients meet their financial goals, unconditionally putting their best interests ahead of all else is paramount.

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THE CURRENT LANDSCAPE

An advisor's duty to their clients will be a key topic in the financial industry in 2018. How should regulators eliminate potential conflicts of interest, enhance protection for investors and regulate advisors to better serve their clients?

Some regulators believe a best-interest model is the solution. Countries such as the U.K. and Australia, through their *Retail Distribution Review* and *Future of Financial Advice* reforms, respectively, have already modified their financial advice standards to this model.

Seem easy? Not so fast. There is a complex legal implication when a best-interest model is instituted. While the term "fiduciary duty" may not explicitly be stated in all countries' securities regulations, adjusting the standard from a "suitability" to "best-interest" model implies a fiduciary duty owed by advisors to their clients.

The legal implication of "fiduciary duty"

Fiduciary duty has important implications for securities regulations, even if it may not be explicitly stated. Under this duty, a fiduciary is obligated to manage another party's affairs in the best interests of that party. According to Canadian common law, fiduciaries must not personally profit from their position and must not allow personal interests to conflict with their duties[1].

Suitability versus best-interest

How does the current suitability standard compare? The suitability standard holds an advisor to make recommendations that are acceptable to a client's objectives and needs. However, the best-interest standard would also obligate the advisor to place his or her own interests below the client's. For example, an advisor would be prohibited from making trades that would result in higher commissions, even though the trades are suitable from the client's viewpoint[2].

Canada and the U.S. will likely follow the U.K. and Australia

It appears Canada and the U.S. are not far behind in regulatory reform. The reason is simple. There are investor protection concerns in the client-advisor relationship that must be explicitly addressed:

1. Disclosure may not be effective in mitigating conflicts of interest
2. Clients incorrectly assume advisors must always work in their best interests
3. Advisors typically have far more industry and investment knowledge than clients
4. Clients are not getting the value or investing returns they could reasonably expect
5. Clients are not getting outcomes the regulatory system was designed to give them[3]

To alleviate these issues, regulators are leaning toward a best-interest model. Securities regulation will distinguish between providing clients with merely suitable products, versus providing clients with products that are unconditionally in their best interests.

Securities regulations and common law overlap when it comes to fiduciary duty, but also contain subtle differences that need to be understood by those in the financial services industry.

***46%** of Americans believe investment advisors are already required by law to act in a client's best interests.*

THE U.S.

Moving forward despite roadblocks

The Department of Labor has expanded the definition of fiduciary under the *Employee Retirement Income Security Act* ("ERISA") to include investment advisors dealing with retirement assets and investments[4]. With approximately 50% of U.S. financial assets in retirement accounts, the rule will drive significant changes within the industry[5]. The full and complete adherence to this new regulation, originally scheduled for January 1, 2018, has been delayed for 18 months, to July 1, 2019.

The final implementation into ERISA, however, remains uncertain. It's still up for debate, could include further changes and may possibly be repealed. Despite the uncertainty, some firms, such as Merrill Lynch Wealth Management and JPMorgan Chase & Co.[6], have already incorporated the regulations into their delivery of retirement advice in anticipation of the actual implementation of the rule.

The proposal would apply the regulatory as well as legal definition of fiduciary to retirement investment advisors. This means advisors would need to unconditionally put their clients' best interests ahead of their own[7]. Surprisingly, 46% of Americans believe investment advisors are already required by law to act in a client's best interests[8].

CANADA

Surprisingly, Canada is taking a more lenient approach.

The Canadian Securities Administrators ("CSA") proposal – which is currently supported only by the Ontario Securities Commission and the New Brunswick Financial and Consumer Services Commission[9] – does not seek to explicitly implement a standard of fiduciary duty but to institute a best-interest model. This would essentially keep enforcement of fiduciary duty in the realm of the court system.

The CSA believes a best-interest model would eliminate conflict of interest and provide investors with better protection. The focus in Canada would be on:

- Knowing the client
- Knowing the product
- Full transparency of costs and fees
- Providing the client with a suitable financial plan that is in their best interest

Most Canadian provincial and territorial securities regulators appear unwilling to make the change, for a variety of reasons. However, many investment advisors seem to be in favour of a best-interest model. According to the Investment Executive *Brokerage Report Card 2017*, 71% of investment advisors surveyed support the CSA's proposal to introduce a best-interest standard.

Canadian investment advisors believe the industry needs to elevate its standards, while increasing transparency in their relationships with clients. But, the survey did note many of these investment advisors are unsure of what this standard would mean for their business[10]. Clearly, there is a disconnect between the regulators and advisors.

Along with its best-interest model, the CSA has made additional proposals targeting specific reforms that will impact the model and increase the obligations of advisors to their clients[11]. However, the CSA has introduced them in a separate proposal should one or the other not pass into regulatory legislation[12]. The targeted reforms cover:

- Suitability
- Proficiency
- Business titles
- Know your client
- Know your product
- Conflicts of interest
- Relationship disclosure
- Professional designations

The target reforms would apply heightened standards for advisors and be explicitly stated and defined in regulatory documents.

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INTERNATIONAL

Regulators from abroad are leading the pack

In the U.K. and Australia, regulators instituted a best-interest standard within the last few years amid sweeping changes to the financial advice industry. The U.K. has defined it as a suitability standard, which has a different meaning than in Canada or the U.S., but does represent a best-interest standard[13]. It does not, however, automatically presume fiduciary duty. Given the similarities between these countries' laws and regulations, Canada and the U.S. are obviously being mindful of the changes and how they will impact the industry and the investor.

Where do embedded commissions fit into all of this?

The shift from a suitability model to a best-interest and/or fiduciary model, is closely intertwined with the debate about embedded commissions. Both attempt to eliminate conflicts of interest for advisors.

While the U.K. and Australia have already banned embedded commissions, the U.S. and Canada are considering a ban, or reform. In Canada, the CSA developed a proposal to ban embedded commissions. It is now working with various industry participants to determine the feasibility of such a plan. There is no consensus on the matter.

In the U.S., investment advisors selling products under ERISA would do so under a fee-based model. However, the investment advisor must contractually commit to receiving no more than reasonable compensation[14]. There would be an exemption allowing investment advisors to continue receiving commissions. But to qualify for the exemption, the advisor and financial institution must contractually acknowledge fiduciary status and commit to certain conditions[15].

OUR OPINION

A BEST-INTEREST STANDARD IS POSITIVE FOR THE INDUSTRY, ESPECIALLY INVESTORS. BUT THERE WILL BE SOME CHALLENGES GETTING THERE.

CRM2 demonstrates that these regulations work

Today, there is heightened scrutiny regarding fees – specifically, the value investors receive for the fees they pay. In Canada, Client Relationship Model – Phase 2 ("CRM2") incorporated fee transparency into regulations, ensuring advisors inform clients of the full amount dealers receive. Despite the administrative and technological issues that popped up during its development, CRM2 was a needed change.

CRM2 has made it much easier for investors to determine if the value they're receiving from their advisor is proportionate to the fees they are paying. For advisors, full disclosure is a gateway to productive conversations about the value of their advice, which is often measurable.

The transition will be complex and potentially prohibitive for independents

New regulations demand new compliance needs. And new compliance needs lead to more costs, which will dramatically affect the bottom line of smaller, independent dealers. While we believe a best-interest standard is positive, we don't want to see more barriers to entry into the financial industry.

Further transparency often leads to reduced fees, which can shrink dealer revenue. Compressed margins from higher costs and lower revenues will likely make dealers rethink how – and with whom – they do business. This means smaller investors may end up with fewer options. The evolution of technology in the financial industry – for example, robo-advisors – will temper this shift. At the very least, it will force dealers to find creative ways to be nimbler and develop alternatives to best meet their clients' needs.

If a best-interest and/or fiduciary model is ever implemented in the U.S. and Canada, it may mean:

1. More litigation
2. Product consolidation
3. Fewer advisors overall
4. Downward pressure on fees
5. Younger, but more qualified advisors
6. Increased collaboration between advisors[16]

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