Navigating Conflicts of Interest in the Financial Services Industry

Announcer: Welcome to the Empowered Investor Podcast. Have you ever felt overwhelmed by the sheer volume of choices and voices telling you how to plan or invest for your future? With his straightforward approach, host Keith Matthews of Tulett, Matthews & Associates cuts through the noise to help you create a winning action plan for you and your family. The decision-making framework discussed in this show can transform you and your investment experiences and will increase your odds of becoming financially secure. Learn more and subscribe today at TMA-invest.com.

Keith: Welcome to The Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada for today's episode. Marcelo, how are you doing today?

Marcelo: I'm great. The weather's great. Everybody's getting their vaccines, summer's coming, barbecue season started, it's going to be a good summer. What about you?

Keith: Yeah, things are looking much more positive, and so that's encouraging and it's fun and it's great for our listeners. In today's show, Marcelo, we continue on our theme on next generation advice and today's topic of conversation will be conflicts of interest. So why is that important, Marcelo?

Marcelo: I feel like the last two episodes we did, actually the one before about family law in Ontario, I think it's on the same ballpark because I feel like it hits right home again. And this is because the drive to provide conflict-free advice is at the core of our firm. And a lot of people may think that this is the norm in financial institutions, that they're getting conflict-free advice, but this is not the case. And I remember back when I was looking to land the job that I have now at TMA, it was one of the things that I wanted to be involved in—a firm that really cares about this subject and really has the customer's best interest at its core. So that's why I feel this subject is important.

Keith: You've always come across as an extraordinarily mature young man, Marcelo, and kudos for that.

Marcelo: Now you're making me blush, Keith.

Keith: So in today's show, what we're going to cover, the four main themes of the show are: we're going to identify three main conflict of interest categories in the financial world; we're going to speak to the upcoming client-focused reforms that we expect in Canada for 2021; we're going to highlight the difference between suitability and fiduciary standards and responsibilities; and then finally, we're going to provide our listeners with a list of recommendations as to how best to navigate conflicts of interest. Marcelo, let's start with a kind of definition. What is a conflict of interest and how would you define that whole subject matter?

Marcelo: A conflict of interest pretty much occurs when an entity or an individual becomes unreliable because there is a clash between a personal self-serving interest and a professional duty or responsibility. So that can happen in a company, it can happen with a service provider, it can happen in a personal relationship. So there are many types of conflicts of interest. So it's not necessarily just proprietary to the financial services industry.

Keith: Yeah, many professions have to deal with conflicts of interest and financial services is one that is grappling with it and has to improve.

Marcelo: Correct. Just a general example: if you're selling a service and all of a sudden you get paid higher commissions to sell particular products, then you're going to be incentivized to sell those to the client even though it may not be in the client's best interest. So in general, that's what a conflict of interest looks like. Another example is if you're running a company and all of a sudden you need to hire a relative to do the job, then that may be a conflict of interest because you're not hiring the best person for the job. So in general terms, that's how a conflict of interest looks like. But the financial industry has a few ones that we want to cover today. So we've identified actually three of them, Keith. So let's go through each of them and then have fun with it.

Keith: So yeah, to me the number one conflict that we would identify would be this issue of underwriting and advice. So historically at a brokerage firm, they serve sort of two sets of clients. One client would be a corporation who is looking for financial expansion. So they come to the brokerage firm, they're looking to either issue more stock, more debt, and they rely on the brokerage firm's underwriting new issue department. That's a service that firm offers. At the same time, the brokerage firm might have 300, 500, a thousand advisors. So the conflict comes about when, on the one hand, they're trying to underwrite a firm and bring it to market. On the other hand, they're also turning to their sales force and saying, even though it may not be a great offer, they're then encouraging the salesforce to talk to their clients and put it in their portfolios. So this is something that was much more prevalent a few years ago, but it is still at the core issue of brokerage firms. It's something to worry about and to think about and at least be aware of.

Marcelo: Yeah, it makes total sense, right? If you're getting huge amounts of money from a company to underwrite your initial public offering, and then you have within the same roof people who are serving clients, investing in stocks, it only makes sense that if they want to maximize profits, they need to sell because it's also in their best interest that the price of that stock goes up, right?

Keith: Absolutely. That's a good one. The second major conflict of interest, and this is a little bit easier for individuals to identify and understand, is advisor compensation, how advisors are compensated. And this is something that's changed dramatically over the last 20 years, but there are still conflicts. I believe now we're at the zone where DSCs (Deferred Service Charges) will be banned in Canada. But this was a major conflict, and it influenced the way advisors would make recommendations. Whether it's DSCs, IPO commissions, trading commissions, or certain types of strategies that pay higher compensation to advisors. So therefore, you've got to kind of question, is that really in the best interest of the client when that recommendation comes through? And then lastly in this whole area, there's this whole area of wholesaler sale incentives. Marcel, you came from that world.

Marcelo: Yeah.

Keith: And it's cleaned up quite a bit now, and it's a lot more above board. But what did that world look like in the past?

Marcelo: Yeah, so I think a lot of the things that we've seen in that world where wholesalers were essentially buying business, that looked like very expensive gifts. One thing people have to understand is that an asset management firm, so an advisor, is essentially an intermediary between an asset management firm and the end client. So they have to promote sales in any way they can. Now, like you said, the industry has cleaned up a lot. There's limits on gifts and this type of thing. But in the past, people used to take advisors to expensive trips, expensive lunches, and get them expensive gifts. And it's never a "I'll give you this and you give me that," but it's almost like a wink-wink type of situation where they gave you the trip but it's also implied that you're going to give them business. Now, that's become better, but it's still the case that you can give some gifts even though there's limits. I think the limit is $100, which is okay. You still have wholesalers buying lunches and taking people to hockey games and to play golf, which are normal sales tactics. But it's, who are you going to pledge allegiance to, right? Are you going to be more likely to buy from the person taking you for lunch or really look into the products on their own and see which one is best for the client? So it is a murky situation in there.

Keith: Yeah, you're absolutely right. The whole advisor compensation and benefits that advisors get is at the core of this main conflict. The last conflict that we wanted to identify was a conflict within the asset management industry at large. A lot of large financial institutions are doing this where they have in-house products, and it's this whole idea of promoting your in-house, your built products that you build, and somehow incentivizing people to move the in-house products more than the open market products. So if you're a client and you go to an organization and they suggest a product, you want to know that it's the best for them, not necessarily that somehow somebody's been incentivized to sell more of that. Or if that's the case, then you better go in with your eyes wide open so that you can make the best judgment possible.

Marcelo: Correct. I think if you're dealing with, for example, an advisor at one of the major banks, they do have the freedom to choose whatever in the right setup because there's two levels. There's the branch level and then the advisor setup. So if you're dealing with an advisor, they have the freedom to choose whatever product they want, but they may get a higher commission or higher incentive if they sell the fund created by the bank they work for. And I think we've seen this case pretty widely in the industry.

Keith: Yeah, we've seen this pretty much across all banks. The banks were found to be paying bank staff more if they promote the bank services. And I think the last one to be found technically guilty was the Royal Bank. And that was three years ago where they were paying, I believe, 10 basis points of additional fees to individuals to make sure that they sold those products. Now, they were fined, and it was quite heavily noted in the journals. TD was fined. And essentially all of the banks have been fined between the periods of 2012 and 2017. Now, if we give them the benefit of the doubt and assume that they're getting better at doing this, I think that would be great for our end investors, but it is interesting. This is a very subtle and nuanced conflict, but it's interesting to see that they were in fact offside on this. So Marcelo, let's talk about Canadians at large. Do you think Canadians understand conflicts of interest?

Marcelo: Unfortunately, no, Keith. It's hard to get real statistics on this because there are none, but I think we get a good sample size for a few reasons. One, we work in the industry, so we talk to a lot of prospects that come through our door. And two, we have a lot of friends and family who generally tend to ask us questions when they have investment questions and that type of thing. So I always make sure to ask people, do you know how much you're paying? Like I try to get a feel of how transparent things are in a general sense. And the answers I get are not very promising.

Keith: Yeah, listen, I think for me, the best thing that I would point to would be in general, I think Canadians are a trustworthy group. Canadians trust people, and so the challenge that comes with that is that unfortunately, it leads to maybe not necessarily being 100% aware, having too much confidence in the organization and not really realizing what might be going on or asking the tough questions.

Marcelo: Yeah, and listen, you have, I think the best example of that is the first world and the third world. I remember when I studied political science, we had this teacher who introduced us to this book called *Why Nations Fail*, and it essentially said that the difference between the first world and the third world is that people have more trust in institutions in the first world. It's a good thing to have that when you have a government, but I think either too much trust or too much cynicism can be bad. And I think what we have with the Canadian banks is that we have this tremendous amount of trust in them, which is good for a lot of ways, but it could lead to a lot of abuse and sometimes taking things for granted. And maybe just a little bit of cynicism or skepticism will help us in a good way.

Keith: Yeah, you're absolutely right. I've always told individuals to invest in the banks because they pay great dividends and they pay great returns. Some of the bank services are sometimes high fee, low service, less than transparent offerings. Now, that said, Marcelo, five years ago the financial services industry came out with a new client-focused environment where they essentially mandated all firms, all advisors to do... what did they ask them to do to disclose?

Marcelo: They asked them to disclose fees and performance. So the way fees were disclosed before used to be almost a voluntary process. Now it became a mandatory thing. At the end of the year, we have to send a statement. Everybody has to send a statement detailing the fees that advisors are paying. And then the performance, they changed the way it was measured and reported to essentially just take more into account. There are two ways of measuring it, but the one that they oblige people to report now is a bit clearer in how money goes in and out of the portfolio. So it gives a better representation of the true performance of a portfolio.

Keith: You're absolutely right. Now that was something, Marcelo, you joined our firm. Now you're coming up on your fifth-year anniversary, I believe.

Marcelo: Right.

Keith: But that was something that as a firm, as a PM firm, we've been doing since inception. PM firms are obliged to show performance and have always been showing money management fees because it goes through the accounts. So the new regulation in essence, instead of just saying that to a client or to an investor, "You are being charged this percent," what you need to now say is "You are being charged this dollar amount through your portfolio." And the idea there was that investors were going to be able to judge, "Hey, I pay this amount for my services." And in turn, they should be able to judge what kind of services they receive. That was a major thrust, and part of this was to try to alleviate conflicts and try to start giving transparency. I think it was a big move on the transparency part, but I think there's still a lot more to be done on the conflict side.

Marcelo: Yeah, I think that's a good segue for number three, the other one. One of the things that I found out is that a lot of Canadians think that the services they're getting are free. Essentially you have two models, right? You have the fee-for-service where you're paying the advisor a fee, and then there's another layer added when the portfolio is added, right? So in that model, you'll see in your statement how much you pay your advisor every month. But in the other model, which is like when you're dealing with a branch, it's like you're buying a mutual fund that costs 2.5%. So the client is never seeing in their statement how much they're paying that institution to manage their money. If they see 3% in their statement of returns, the actual return was 5.5%. So it's 2.5% gone into fees, but a lot of people see that and they say, "Oh, my return is 3%. I actually paid zero." So it's very misleading into how it's reported. So a lot of people may get this impression that their fees are zero, but it's actually not.

Keith: Yeah, I don't know if I've heard clients or individual investors feeling they get it for free, but that said, they definitely don't know how much they're being charged and they don't know the compensation structures and the motivation levels, and whether that is a breeding ground for potential conflicts. It's a very nuanced world, and to the benefit of investors, the Canadian financial services industry doesn't necessarily make things easy. Marcel, we talked about this off-air before. We don't even have the right terms for what financial advisors are. There's so many misleading terms and titles and compensation structures.

Marcelo: It's crazy, actually.

Keith: Everybody positions themselves as a financial advisor, and often that means maybe some fees, maybe some commissions, but the end investor doesn't really know. It's hard. Now, Marcelo, this year there's going to be some big changes coming out. There are client-focused reforms coming. What are the big changes and what are they intended to do here?

Marcelo: So the CFR regulations will help in two ways. Clients will be aware of the conflicts of interest when dealing with an advisor. And now the second layer is now the advisor has to show proper research and documentation of how suitable a product is. So it essentially will change the way conflicts of interest are disclosed and the way advisors have to present information and prove that what they're choosing for a portfolio is actually suitable and properly selected.

Keith: Okay, cool. So hang on a second. Let's take one at a time here. So the first one you mentioned is conflicts of interest. So what that means, I think, is that individuals and organizations, especially if they're selling their own in-house products, they actually have to come out now and say there's a conflict. We are selling our own in-house products, we are building them, and they need to state that. And so an organization like ours, we will have to state to our clients. If there are any conflicts we can identify, we have to state those conflicts and present those to them. And I think for our benefit and for our listeners' benefit, we're really proud of the statement that we will be coming out with our disclosure statements, and there's very little conflict in our operating model. So that's wonderful news for our clients and friends, but this is a new component in the industry that has to happen. And what's the second component? Let's dive a little deeper into that one where the advisory firm has to do more work now.

Marcelo: Yeah, so let me go back to the other example that I gave you before about the advisory compensation. So if you have a fee-for-service advisor, that person will have to get paid by the client directly and then choose a product to go into the portfolio. The other model is where an advisor may have two identical products. So say I want to invest in a U.S. mutual fund. Now I can have two same products, but one of them pays a higher commission. So I will now need to prove, first of all, the first layer is I will have to prove that there's a conflict of interest because I'm choosing the one with higher commissions if that's the case. And second, I have to say why the product that I'm choosing is suitable and okay for that client for the level of risk and the client's situation and that type of thing. So there are more details going into the selection process, which before was very murky.

Keith: It's what's interesting. You're absolutely right. Sort of the world was murky and regulators are trying to force institutions to demystify that murky world. And I think some of the firms, I can think of these firms that offer high-fee strategies. The onus is going to be on them to say that their high-fee strategies where their returns are mediocre are in fact the best for the client. I actually don't know how they're going to do that.

Marcelo: No, me neither. I think there's going to be a lot of rationalization, and there's going to be a lot of use of past returns which we know are not indicative of future returns. And there's going to be a lot of narratives created around products and strategies to justify the use in client portfolios. So look, it's definitely a great step. I think the right intentions are there and clients will be more aware at least of the stuff that's going into their portfolios and different types of conflicts of interest. But yeah, I'm a bit skeptical of the whole execution, so I guess time will tell.

Keith: Yeah, you're absolutely right. Time will tell, and the pressure is definitely going to be on large financial institutions to really do their work or on institutions that don't have sort of fiduciary responsibilities and best interest responsibilities.

Marcelo: That's a huge one.

Keith: That's a segue, Marcelo. Let's go into the next topic here on advisor standards, if you will—suitability standard versus best interest standard. Let's just talk briefly. Why is that important and why does one lead to less conflict of interest than the other?

Marcelo: Yeah, that's a great question. I think it's the way it's set up. So when you have a suitability obligation to the client, you say your uncle becomes your client. Right now you only have to prove that the investment you're choosing for your uncle is suitable for him, but it doesn't mean that you have to act in the best interest. And I revert back to the example I just gave you. So if I want to give my uncle a mutual fund that gives him exposure to Canada or the U.S., I can choose one with a higher commission or a more expensive product as opposed to another one that gives me the same exposure but is cheaper. So I am allowed to go with the most expensive one, whereas on the best interest standard, the fiduciary duty, you have a legal framework where I would have to give my uncle the cheapest option or the option that's best for his interest, and I'm legally obliged to do this. So I think that's the big difference.

Keith: Yeah, and I don't think it's necessarily driven by the cheapest option. I think it's driven by value-based options. So obviously we know that fees are important in returns within the investment management business, but you have to put your best foot forward. Your general points are bang on for fiduciary and best practice. You have to put your very best foot forward for the client, and suitability, which for all intents and purposes is the main standard here in Canada, still unfortunately what it does is it allows high-fee solutions to be presented to clients and less than performance-oriented solutions to be presented to clients. Within the U.S., they have the RIA model, which we've spoken a lot about in the past, the Registered Investment Advisor, which is a fiduciary standard. No commissions are charged, open architecture, and it really drives the absolute best for the end user.

Marcelo: Like we said, it's so murky as to who is a fiduciary and who is not that if you're a client, just ask. I think the best thing is to ask your advisor upfront. Are you a fiduciary? Are you acting in my best interest? And they have to tell you.

Keith: Yep, yep, you're absolutely right. And traditionally, the fiduciary will end up being more in the PM model, portfolio management model, independent portfolio management model. You will find that activity exists within IIROC, but it will only exist within portfolio managers that don't use commission products.

And it is a bit murky. Jeez, I wish, Marcelo, that the Canadian regulators would come up with an RIA model here in Canada because that would be the best. It would be absolutely the best to compete and to push this best interest for clients. That's how we're registered. We want more of us registered like this in Canada, though.

Marcelo: Absolutely. That would be the best thing for Canadian investors, actually.

Keith: So Marcelo, as we wrap up the show, we want to come up with a list of recommendations for our listeners as to what kind of structure, what kind of environment would be best to reduce conflicts of interest and to give them a conflict-free environment. So give us your top recommendation. We'll go one by one here.

Marcelo: So number one is open architecture. You want your advisor to be able to choose from many different products and essentially not to have any allegiance to a brand, a product, or a company.

Keith: Perfect. That's amazing. And I would go as far as not many different open architecture means complete openness. There's not one single product that they cannot buy—product, stock, bond, fund, ETF, you name it. They have to have everything. Okay, perfect. That makes total sense. What's the second one, Marcelo?

Marcelo: So second, you want to be working with an advisor that has a similar setup as the RIA model you mentioned in the United States. So that's a fiduciary, is obliged to act in your best interest, and has that legal framework all set up. That's exactly what you need.

Keith: Perfect. And to be clear, that means they should be charging management fees, no commissions.

Marcelo: Yes.

Keith: And management fees, I'll tell you, I think the only way to do it properly is a management fee on the entire portfolio, not different management fees on different sections of the portfolio because that creates a conflict. For example, sometimes people say, I'll charge less on a fixed income and more on equity. That creates a conflict.

Marcelo: Yeah, because you're going to now put more people in equity funds where they may need more fixed income. And that could create a conflict where they may be taking more risks than they need to.

Keith: Absolutely. And another one that I think needs to really be frowned upon is performance fees. Now, I know that performance fees sound like an interesting model where the investor goes, I'll give the advisor more if they can generate more and I'll give them less. The problem with that strategy is it creates a home run hitting kind of environment. And the hedge funds use this all the time. They try to go for a home run, make massive returns. If they win, they get a massive profit. If they lose, they're out of business. They start another firm a month later. It's not a great model. So like you said, the fee-only model is the best service with a fiduciary responsibility. What's the third point, Marcelo?

Marcelo: The third one is you want to be in an environment that puts transparency and discloses everything at the core. We put a lot of effort into showcasing this transparency during our proposal meetings to show clients that we've been doing this for years, not because we're obliged by a regulator but because it's at the core of what we do. And I think that's what investors should be looking for in a relationship with an advisor or a firm.

Keith: I agree 100%. And the good news is that the regulations are encouraging this across the entire industry. So things are getting better and better across the industry. So Marcelo, your takeaway for today's show on conflicts of interest.

Marcelo: I actually have a simple one. So even though things are getting better and regulations are helping the end advisor, just be inquisitive. Ask questions. Don't be scared to ask in what environment and what type of fees are you paying. I think the few extra questions, even though they may be uncomfortable sometimes and may put people on the spot, could save you a lot of money and could put you in the right situation to prepare for retirement and have a proper portfolio. So that's my takeaway. Just be inquisitive.

Keith: That's an amazing takeaway, Marcelo. It's perfect. That would be mine as well. I echo almost the same thing. Become aware, learn about it, become aware, ask questions, and it'll serve you well. And challenge yourself when you're working with an advisory firm or an advisor or looking at anything like, where are the potential conflicts? And I think that will help all of our investors.

Absolutely. So thank you, Marcelo. This is a wonderful show on next-generation advisory services. Thank you so much for participating and joining me in today's show. And to our listeners, have a wonderful start to your summer.

Announcer: Thank you for tuning in. You've been listening to The Empowered Investor Podcast hosted by Keith Matthews. Please visit TMA-invest.com to subscribe to this podcast, learn more about how his firm helps Canadian investors, or to request a complimentary copy of *The Empowered Investor*. Investments and investing strategies should be evaluated based on your own objectives. Listeners of this podcast should use their best judgment and consult a financial expert prior to making any investment decisions based on the information found in this podcast.