IIACACCVM
INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

Vol. 135

The coming battleground for retail distribution

HIGHLIGHTS:

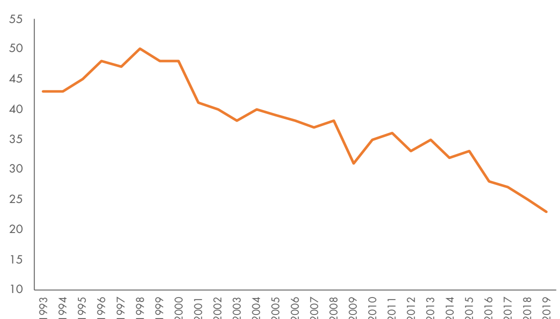
Several waves of disruption have transformed the Canadian investment industry in recent years: a widening spectrum of financial products and services in response to changing investor needs and behaviour; the impact of comprehensive regulatory reform; the consolidation of small dealers from collapsing margins and earnings from higher operating costs and weaker business economics; the expanding financial technology and digitalization to improve front and back-office efficiencies and client convenience; and the recent paced expansion in new small retail dealers, i.e. modest fragmentation in the industry.

Factors contributing to the recent renaissance in small boutique dealers include: the recent startup of dedicated third-party entities to support the operations of small dealers through sophisticated and tech-based carrying broker services; the ongoing structural adjustments to the existing retail business infrastructure which have unleashed existing advisors seeking new opportunities at firms; and the recent and planned regulatory proposals which are expected to enhance efficiencies, lower the cost burden, streamline structure, and improve the economics of small dealers.

The most common refrain among industry observers is the unprecedented transformation in the retail business. They would not be wrong, judged by the extensive and varied change in the industry in recent years, manifest in several and distinct waves of disruption.

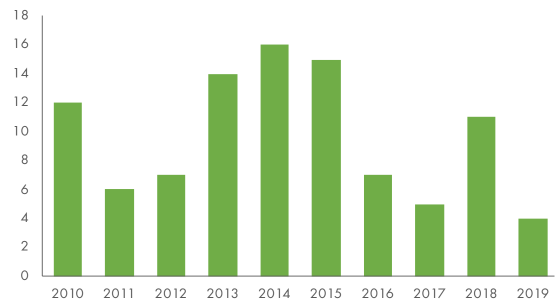
The first wave in the modern-day industry was the introduction of a wide spectrum of products and services on the dealer shelf, reflecting the changing needs, attitudes and behaviours of investors. Perhaps the most notable disruption has been the rise in exchange-traded funds (ETFs) since their introduction in the early 1990s. Popular with both institutional and individual investors, ETFs forced advisors to define their business model and value proposition more clearly. They shifted away from individual stock picking toward offering broader wealth-management services, such as financial planning, retirement planning, and tax and estate planning, and away from commissions to fee-based discretionary portfolio advice. Commissions are a share of total securities industry revenue fell from 43 percent in 1993 to 23 percent in 2019.

Securities Industry Commission Revenue as a Share of Total Revenue (%)



The second wave to pummel the industry was stepped-up regulation, focused on know-your-client (KYC), know-your-product (KYP) and suitability obligations, conflicts of interest and greater transparency. These reforms had a transformative impact on the retail business, driving up compliance costs, squeezing margins, and forcing greater reliance on financial technology. This, in turn, accelerated restructuring and cost reduction initiatives as well as industry consolidation. Nearly 100 dealers closed, amalgamated, or were suspended or terminated by the Investment Industry Regulatory Organization (IIROC) in the past decade.

Number of IIROC Resignations, Amalgamations, Suspensions or Terminations



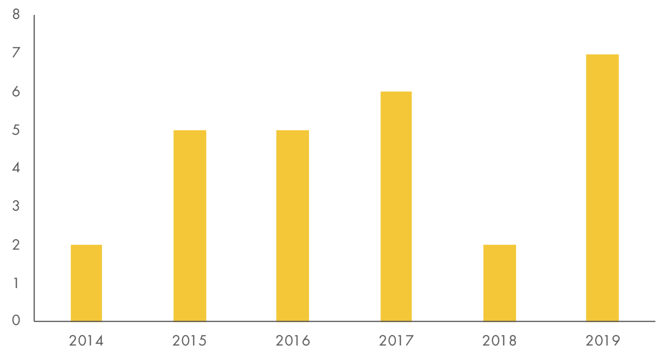
The third wave to hit the industry is the rise of FinTech and digital tools. Big Data, Artificial Intelligence, robo-advisors, robotic process automation and blockchain are at the forefront of the transformation taking place across the wealth management ecosystem and changing the basis of competition. Predictive analytics technology provides insights into client behaviour and needs, enabling firms to improve their products and services and attract new clients, while robo-advisors have transformed the way financial advisors interact with and provide services to their clients. Through investment in game-changing technology, firms can generate efficiencies in their front, middle and back offices and differentiate themselves from their competition.

The Canadian investment industry is now on the verge of another wave–the fragmentation of the wealth industry into new small and mid-sized dealers–not to reverse the trend of consolidation from rising costs and stiff competition, but to mitigate it. Until now, the Canadian wealth industry had not mirrored the structural evolution of the U.S. industry, with its dramatic disaggregation of the large integrated national-based dealers (the wirehouses) into small and mid-sized advisor firms following the financial crisis as many investors soured on the big Wall Street firms. Independent advisors set out to build their own brands from scratch, increasingly turning to the Registered Investment Advisor (RIA) channel which gave them the flexibility and autonomy to choose the platform and services that fit their firms' unique needs. According to Cerulli Associates, the U.S. wealth management industry remains very fragmentated with 66 percent of the market managing less than $100 million. Similarly, in Australia, there has been a proliferation of new, small boutiques–the number of Australian Financial Services

Licences granted by the regulator surged 55 percent between 2015 and 2019. In 2015, 60 percent of advisers in Australia worked for major financial institutions; today about 40 percent do so. Investors flocked to these smaller firms after the Hayne Royal Commission uncovered serious underlying problems in the wealth divisions of Australian banks.

The recent uptick in new IIROC-member firms reflects not the aftermath of a major financial crisis or financial mistrust, but the conflation of several factors in the Canadian wealth business.

New IIROC Dealer Firms



First, several third-party entities or agents, typically affiliates of an independent IIROC dealer with carrying broker services, have appeared, for the first time, with a dedicated business model to incubate new introducer firms and provide ongoing business support. These third-party entities provide advice and guidance for the set-up of the independent franchise and make available more sophisticated tools and technology for portfolio shelf and selection, client documentation, compliance support and clearing/custodial services. Further, the third-party facilitators have profile and infrastructure in the marketplace to attract advisors to build critical mass of client assets, scaling up to lower unit costs. More recently, several independent asset managers have recognized the role of the dealer support mechanism to build and support a network of independent dealers to widen the distribution channel for managed fund investments. Aside from increased distribution potential, the wider demand for product may ease downward pressures on fees on managed product as well as source alternative revenues through part-ownership of the small dealer network. Further, the larger independent IIROC dealers can similarly build a network of affiliate Type 2 introducing brokers as a more cost-effective alternative to build existing infrastructure, given significant broker recruitment costs, etc.

Second, structural adjustments to existing retail business models and related cost-saving initiatives, have prompted advisors to look for new opportunities in new dealer start-ups. For example, the larger dealers have been driving down compensation through reduced pay-out schedules and minimum revenue requirements, to jettison poor performing brokers to boost productivity and earnings. Further, these larger dealers have also restructured wealth operations to achieve greater efficiencies, segmenting high net worth clients between private banking geared to high net worth clients offering discretionary management and sophisticated financial services, and the client mass-market segment focused on financial advice and planning. As a result, conventional brokerage operations are sliced back, with less profile in the new retail paradigm.

Third, a wide range of analytical tools and broad spectrum of sophisticated managed products offered through third-party entities may attract existing Portfolio Manager (PM) registrants to a new platform. PM registrants would be attracted to the shelf of investment products and related technology, complementing the option of internal discretionary management, giving more scope for client relationships, and potential cost savings through asset aggregation as additional PM registrants attracted to the platform. A major business challenge, both for the PM and IIROC registrants, is to eliminate or mitigate the regulatory and technology barriers that complicate and obstruct the shift of client assets across different regulatory platforms.

Finally, impending regulatory changes aimed at improving competitiveness of the small and mid-sized dealers have attracted new firm entrants. In particular, the Ontario Capital Markets Modernization Taskforce recommendations, the Ontario Securities Commission (OSC) Burden Reduction recommendations, and the Canadian Securities Administrators (CSA) proposals for SRO consolidation have the potential to lower the regulatory burden and reform the structure of the self-regulatory system. For example, the IIROC proposals would permit IIROC and Mutual Fund Dealers Association of Canada (MFDA) advisors to operate on a consolidated SRO platform, given small Type 2 introducers to build client assets from mixed registrants on the platform, and give the flexibility of MFDA Type 2 introducer firms to bolt onto an IIROC carrying broker. Further, it would be a helpful step for IIROC to permit advisor incorporation, set under existing Canada Revenue Agency (CRA) tax precedents, to improve the economics and efficiencies of the Type 2 dealer, neutralizing the advantage of incorporated PMs shifting to a non-SRO introducer platform.

Regulators have put forward proposals to streamline the regulatory system to achieve greater operating efficiencies and cost savings for all investment firms, and encourage the start-up and expansion of small and mid-sized dealers, vital to capital formation and broader access to retail services for the investing public. A close focus on the recent structural trends underway in the investment industry may suggest direction for further reforms to improve efficiencies of the wealth business.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
September 2020