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**Response to the Central Bank of Ireland's Discussion Paper on the Payment of Commission to Intermediaries (the "Discussion Paper")**

**To be submitted via email to consumerprotectionpolicy@centralbank.ie**

**Date: 3 November 2016**

## 1. Introduction

We very much appreciate the opportunity to provide the Central Bank of Ireland (the "**CBI**") with our views on the Discussion Paper.

We strongly support the CBI's decision to review the practice of product providers paying intermediaries commission[1] for arranging the sale of their products, and the effect that this may have on investors. We fully support the CBI's proposal that the scope of the review will apply to all intermediaries. It is our policy not to pay third parties commission for arranging the sale of Vanguard funds. Instead, we work with fee based investment professionals who appreciate Vanguard's low cost, quality diversified fund range. We are a vocal proponent of banning the receipt and retention of commission by intermediaries, on the basis that such prohibitions:

- reduce the risk of intermediary conflicts of interest affecting the products that are purchased by/for end investors;
- increase product access and competition, meaning a wider variety of products are available for investors to purchase; and
- increase cost transparency.

[1] For the purposes of this response, when referring to "commission" we are employing the terminology as defined on page 3 of the Discussion Paper (i.e. "*a sum of money …for arranging the sale. This commission can take the form of a single once-off payment at the point of sale or an initial payment at the point of sale followed by further payments ('trail commission') at intervals during the period of time that the product is held by the consumer. Commission arrangements can also include other benefits such as access to software or other facilities to assist the business ('soft commissions') and other non-financial rewards such as entertainment or marketing budgets*.") However, at the same time, we would encourage the CBI to acknowledge the validity and value of intermediaries continuing to receive: (a) payment from product providers for genuine valuable services (unrelated to the sale of products) that an intermediary may provide to the product provider; and (b) appropriate, proportionate and reasonable non-monetary benefits from product providers from time to time (eg training or product marketing materials).

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## 2. Background on Vanguard

The Vanguard Group, Inc. ("**VGI**") began operations in the USA in 1975 and is headquartered in Valley Forge, Pennsylvania, USA. Today VGI (together with its affiliates, as appropriate "**Vanguard**") operates in Europe, Asia, Australia and Canada. In Europe, Vanguard Group (Ireland) Limited ("**VGIL**") (a wholly owned subsidiary of VGI) is the management company for Vanguard's Irish domiciled fund range. In addition, Vanguard Asset Management Limited ("**VAM**") (a wholly owned subsidiary of VGI) is based in London and has branch offices in Amsterdam and Paris, as well as a sister office in Zurich, Switzerland. As at 30 September 2016, Vanguard collectively managed approximately $3.8 trillion in assets under management ("**AuM**") of which €97.5 billion was in Irish and UK UCITS funds marketed in the European Union ("**EU**").

VGI is owned by Vanguard's US domiciled mutual funds, which in turn are owned by the investors in those funds. This means that Vanguard's US-domiciled mutual funds are managed with an at cost philosophy, which keeps expenses low, maximising investor returns. VGIL and VAM operate with the same intention and focus, which is reflected in our philosophy, policies and practices.

Vanguard's mission is to take a stand for all investors, to treat them fairly and to give them the best chance of investment success. It is our belief that investment success is based on four key principles, being: (a) clear and appropriate investment goals; (b) suitable asset allocation using broadly diversified funds; (c) minimising costs; and (d) maintaining perspective and long-term discipline. As such, Vanguard aims to offer investors the highest value investment products and services available and has an unwavering focus on investor value and costs.

## 3. Vanguard's support for a ban on intermediaries receiving and retaining commission payments

We welcome the CBI's decision to open a discussion with the industry in relation to the practice of product providers paying commission to intermediaries for the sale of their products, and the effect this may have on the consumer. As you are aware, there has been an increasing global trend to ensure greater transparency for costs associated with investing (ex: the United Kingdom, The Netherlands and Australia).

In accordance with Vanguard's mission to ensure that all investors have the best chance of investment success, we believe in minimizing investor costs as much as possible. Vanguard, as a product provider, does not pay intermediaries commission for distributing funds, a model which allows investors to benefit from lower ongoing charges. While we note that transparency in respect of commission sharing arrangements can mitigate the detrimental impact of product providers paying commissions to intermediaries we believe that the associated conflicts can only truly be addressed where the payment of commission by product providers to intermediaries is banned completely as has been done in the United Kingdom and The Netherlands.

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We strongly believe that the fund market operates in the best interests of investors where:

- providers compete on the price and quality of their products to secure distribution; and
- intermediaries are not inappropriately influenced by the payment of commission by product providers when providing advice or distributing funds to their customers.

We support the prohibition on product providers paying intermediaries a commission to sell their products and intermediaries retaining this payment on the basis that such a ban would:

- reduce the risk of intermediary conflicts of interest affecting the products that are purchased by/for end investors;
- increase product access and competition, meaning a wider variety of products are available for investors to purchase; and
- increase cost transparency.

The Discussion Paper provides a comprehensive description of the risks that are involved to investors in respect of the payment of commission to intermediaries. We consider the following to be good examples of the risks involved:

1. Where commission is paid to an intermediary by a product provider, there is a real risk that, rather than acting in the best fiduciary interest for their client, an intermediary will favour those product providers who remunerate the intermediary through the commission payment. Studies have shown a constant swing in the flow of business to those companies paying the highest commission to intermediaries[2]. Indeed, many "independent" advisers aren't independent at all. In fact, they are very "dependent" on commission payments from providers.

   - The payment of commission to intermediaries can cause product bias with evidence pointing to the fact that bias exists for those products paying higher commission and away from those paying less, or no, commission. Evidence in the United Kingdom, for example, saw a significant shift towards the sale of no-load products when the playing field was levelled by the Retail Distribution Review ("**RDR**"), as highlighted in the charts below:

[2] FCA Retail Distribution Review - Post Implementation Review - December 2014;
Europe Economics Retail Distribution Review - Post Implementation Review - December 2014

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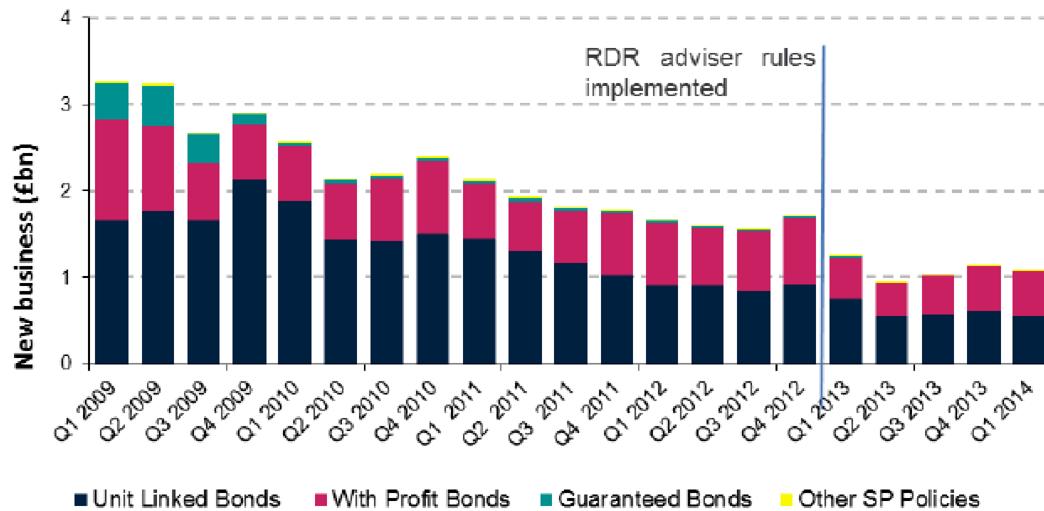
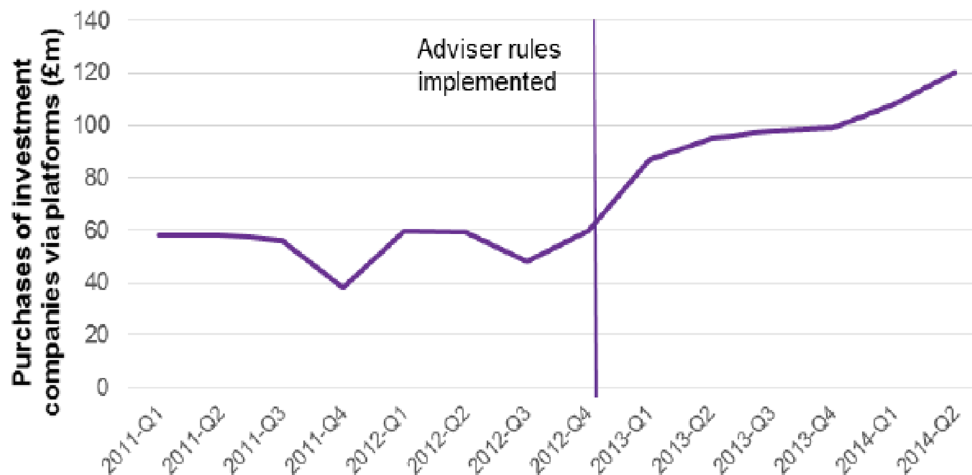
- Decline in sale of investment bonds (high commission paying product) – page 75 Europe Economics Retail Distribution Review - Post Implementation Review - December 2014




Source: Association of British Insurers (2014). Note data refer to ABI members only.

- Increase in purchase of investment trust products ("no load" product) through platforms – page 76 Europe Economics Retail Distribution Review - Post Implementation Review - December 2014




Source: AIC (2014) 'Demand for Investment Companies via Platforms Q4-13'.

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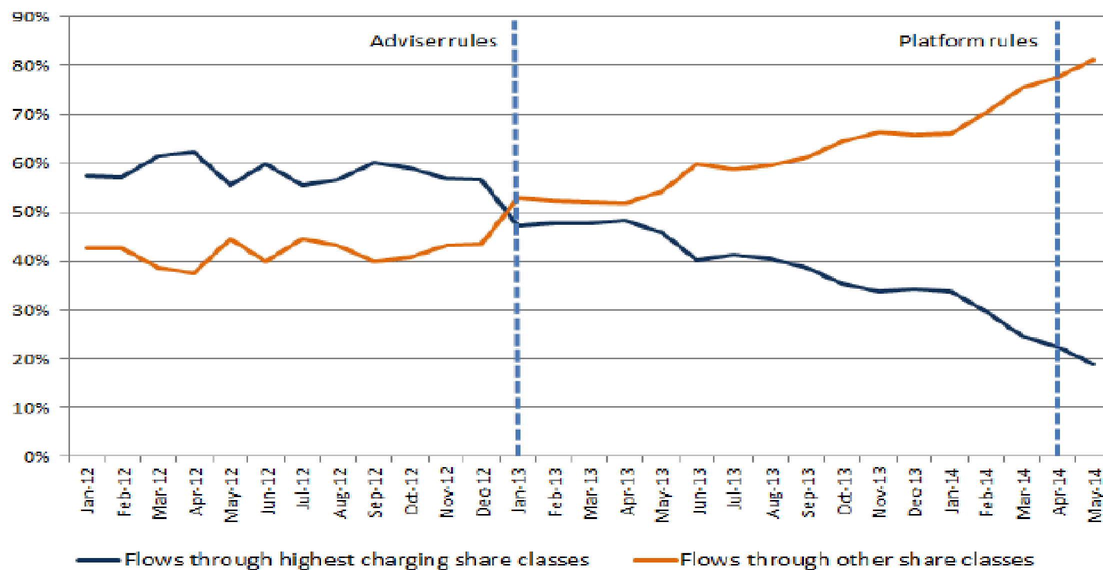
- Gross retail flows through highest-charging class shares and other shares – page 74 Europe Economics Retail Distribution Review - Post Implementation Review - December 2014




Source: IMA (2014), "Asset management in the UK 2013 – 2014".

2. In addition, as highlighted by the CBI, the focus by intermediaries on selling investment products to earn commission can mean an adviser will feel they have to recommend a product even if it is not in the investor's best interests. There is also a risk of an intermediary being discouraged from selling a commission generating product in an investor's portfolio, which is continuing to generate ongoing commission to the intermediary.

3. Finally, commission payments by product providers to intermediaries can exist with investors unaware of how, and how much, the intermediary is being paid. Moreover, the commission may ultimately increase the cost to the consumer of acquiring that product.

All of these risks work against the CBI's goal to protect the customers' interests by ensuring responsible business conduct, fair treatment of investors and avoiding conflicts of interest.

It is worth the CBI noting that the sort of regulatory change that prohibits intermediaries receiving commission from product providers has often been accompanied (or even preceded) by a consumer education programme which seeks to inform investors about the regulatory change and what costs they incur (and have always incurred) in purchasing an investment. Indeed, whilst it is apparent that many intermediaries worry that their clients won't be prepared to pay a transparent service fee, this is only a legitimate concern if clients really think they have been getting a service for "free". However, many

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consumers will already understand that nothing comes for free and that the product fees they have been paying have contributed to the payment of intermediary services. An accompanying (or preceding) consumer education programme can help to (further) educate in this regard. In the event of such awareness the question then becomes: if the client is unwilling to pay the required fee for the intermediary service in question, is it because the intermediary's value proposition is not proved?

***3.1 Reduced Risk of Conflicts of Interest***

Under the current Irish regime, intermediary firms can earn different amounts of money from product providers depending on which particular provider's product they select. Investor awareness of the commission being paid to intermediaries does not effectively mitigate the risk of remuneration bias that impacts the selection of products by intermediaries. Indeed, it is our view that many investors fail to appreciate that commission payments increase underlying product cost and, therefore, have the potential to act as a drag on their investment potential. Currently the risk remains that intermediaries are incentivised to select fund shares that generate high levels of commission from product providers, rather than being motivated by the best interests of the end investor. This is both potentially detrimental to end investors and serves to undermine trust in the financial services industry.

The replacement of payment through product provider commission by intermediary services paid directly by the investor reduces the incentive for intermediary firms to select potentially less suitable products generating high commission payments over products with lower or no commission. As such, we would expect that a prohibition on product provider commission, or at least a prohibition on intermediaries retaining such commission, should help to remove product provider bias displayed by intermediaries, thereby putting the needs and interests of investors ahead of the interests of intermediary firms.

***3.2 Increased Product Competition***

To the extent that product provider bias is reduced, we believe that more healthy competition will flourish between investment products based on their price and quality. As such, the prohibition of the receipt by intermediaries of commission would allow competitive forces to work in favour of end investors, improving the extent and quality of investment products available.

Our view is that current intermediary remuneration arrangements involving commission being paid by product providers may have an adverse impact on the range of investment products available to investors. Vanguard's own experience supports this conclusion. Whilst our range of low cost funds in Europe is available to all intermediaries, we have been most successful with fee-based intermediaries that value Vanguard's cost-focussed approach. We have thus far generally been less successful in persuading commission based intermediaries to carry our funds on a commission free basis. Clients who use commission based intermediaries may be unaware and not appreciate that certain products (ex: Vanguard funds) are effectively not available to them. It seems to us that this outcome cannot be in the best interests of investors in Ireland. We consider that the imposition of the prohibition on intermediaries

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receiving commission from product providers, or at least a prohibition on intermediaries retaining such commission, would be a decisive factor in resolving these access problems.
Product price and intermediary charging competition could also result in better value for money for investors. Our experience in the United Kingdom has been that fund product charges have reduced by approximately 75 basis points since implementation of the RDR. Even if the aggregate cost of intermediary and product charges following implementation of such a ban equates with current product charges, the increase in cost transparency will be in investors' best interests.

### *3.3 Increased Transparency*

We believe that investors should be able to discern the cost of the services they are paying for, including: intermediary services; the cost of the product; and any administration costs. Where product charges are kept at a level that allows a commission to be routinely paid to an intermediary, the true price of both the product and the intermediary service is obscured. We believe that it is important that intermediary charges are not "disguised" as product charges. A ban on the payment of commission by product providers or on the retention of any payment of commission by intermediaries would help achieve this objective. In addition, we would expect that the ban would aid investor led price competition.

We also note that post RDR it is not necessarily the case that the ultimate cost to the investor may actually be lower, however, the fact that all investment advisers must develop an upfront fee structure and disclose it to investors does at least ensure that investors have full costs transparency to make an informed investment decision.

## 4. Vanguard's Support for Retail Distribution Review

### *4.1 Summary*

Vanguard was a strong advocate of the RDR in the United Kingdom, which was introduced on 31 December 2012. The RDR was designed to make retail investment markets work better for consumers by raising the levels of retail adviser qualifications, improving transparency of retail adviser charging and services and realigning retail adviser and platform service provider incentives with those of consumers' by removing the commission received by retail advisers and platforms from providers. The most significant change introduced by the RDR was that retail financial advisers and platform service providers are no longer permitted to receive commission from fund companies in return for selling or recommending their investment products. Instead, retail investors now have to agree to pay specific fees to advisers and platform service providers.

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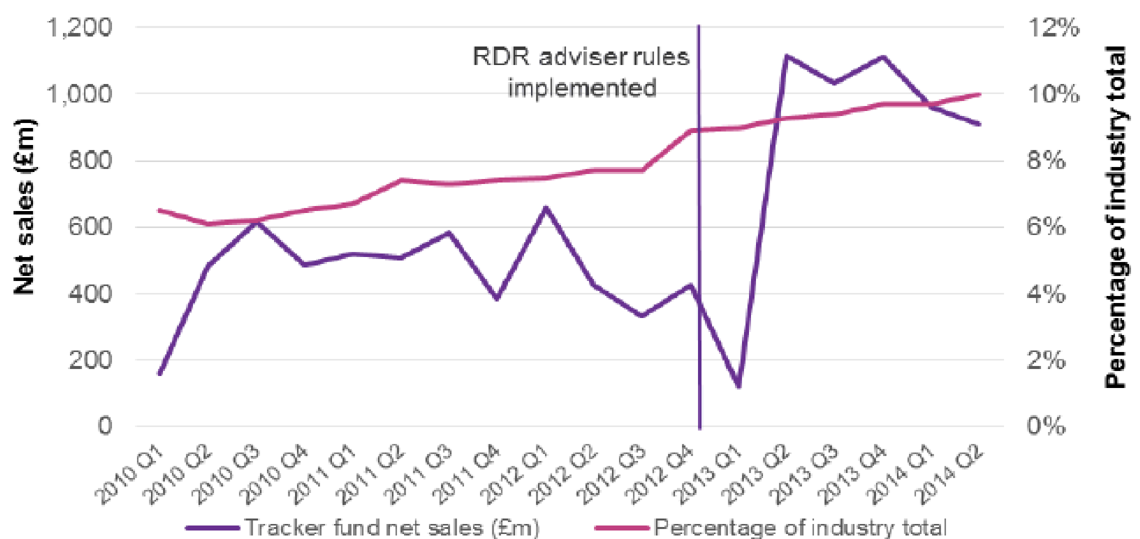
### *4.2 Positive changes since the introduction of the RDR*

There have been a number of positive changes highlighted since the introduction of the RDR and the ban on the payment by product providers and receipt by retail advisers and platform service providers of commission in respect of "retail investment products" in the United Kingdom.

Evidence suggests that there has been a significant shift towards the sale of "no load" products since the payment of commission to retail advisers and platform service providers was banned and a level playing field created (as set out in the charts in section 3 above). This has served to reduce product bias, increase investor choice and allow increased access to low cost investment products. Whilst the trend toward lower-cost index funds was already in evidence before RDR, it has been accelerated by RDR as a result of improved clarity on what investors are paying and a desire on the part of advisers to tie their value proposition to things they can control (e.g. product costs). The removal of commission, and perceived or real bias in the system, means that all products can be considered on an equal footing, eliminating the potential for biased advice. Ultimately this results in a greater focus on fees as investors focus on value for money from retail advisers and platform service providers, and these intermediaries focus on offering more cost-effective solutions to clients.

There is also evidence that the removal of commission payments by product providers has enabled investors to compare prices better across platforms (see chart below) and that product prices have fallen by at least the amounts paid in commission pre-RDR.

- Tracker fund net sales and percentage of total funds under management – page 75 Europe Economics Retail Distribution Review - Post Implementation Review - December 2014




Source: IMA.

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### *4.3 Potential Challenges and lessons learned from the RDR*

We acknowledge that some challenges have arisen as a result of the introduction of RDR in the United Kingdom. We note that there can be significant minimum costs per customer associated with supplying face to face advice. There has been some evidence that advisers revealing the true cost of advice has led to some investors to consider the extent to which the advice they receive represents value for money, and in some cases conclude that it is not. Further, it has been argued post RDR that a number of advisers have turned away clients due to affordability and that they have focused their efforts on clients with a larger amount to invest. This potentially results in investors with lower amounts to invest not being properly serviced[3].

In implementing any ban on commission payments by product providers or on the receipt and retention of commission payments by intermediaries, the CBI should learn from the experience in the United Kingdom and consider whether any of the policy recommendations proposed by the Financial Advice Market Review should be implemented at the same time (ex: facilitation of low cost technology-enabled advice to address any "advice gap").

Moreover, as in the case of the United Kingdom, were the CBI to prohibit the ongoing receipt of commissions by intermediaries from product providers, to ensure long-term compliance by firms (and therefore achievement of the CBI's objectives) the CBI would need to carry out ongoing supervisory follow-up work. Future breaches of any rules and spirit of the rules implemented as a result of the review by product providers and intermediaries should be forcibly acted upon. Indeed, by way of example, the objectives of this review would risk being significantly undermined in the event that a prohibition on intermediaries receiving commissions was accompanied by intermediary firms soliciting unreasonable and non-commensurate non-monetary benefits from product providers to encourage them to channel business to the provider in question.

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[3] The report from the Financial Advice Market Review on RDR post implementation included responses from a number of respondents that stated that firms focused their efforts on clients with a certain amount to invest or on pension pot size. This is supported by some quantitative evidence – a survey of advice firms suggested that, over the last two years, the proportion of firms who ask for a minimum portfolio of more than £100,000 has more than doubled, from around 13% in 2013 to 32% in 2010. The FCA's recent survey of advisers also supports this, suggesting that 45% of firms very rarely advise customers on retirement income options, if those customers have small funds (i.e. less than £30,000) to invest (page 19 https://www.fca.org.uk/publication/corporate/famr-final-report.pdf).

The report also states that HSBC research found that across all of their customers, between 30% to 50% of consumers wanted advice but were deterred by price. Citizens Advice Bureau found that only 8% of consumers would be willing to pay over £500 for advice on making an investment, whereas 14% would be willing to pay £200 to £500. It also found that people without significant wealth would be willing to pay on average £258 for advice on investing an inheritance of £60,000. Responses to the Call for Input supported this, with a number of respondents noting both the perception and the reality of clients being unable or unwilling to pay their fees (page 21 https://www.fca.org.uk/publication/corporate/famr-final-report.pdf).

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The CBI could also look to ensure that competitive forces are working in favour of the client, for example in the form of better pricing and/or more product choice. As a minimum, the CBI would need to ensure that increased fee transparency is allowing investors to make better informed choices which, in itself, will drive competition over time.

While there have been some challenges associated with the introduction of RDR in the United Kingdom (as summarized above), we strongly believe that the investor benefits of removing conflicts of interest, increasing transparency and increasing product competition with more suitable products available for potential investors far outweigh the possible challenges the CBI may face.

**5. Global Trend**

As the CBI's review recognises itself, it is clear that there is a global trend towards enhancing transparency of fund fees, reducing conflicts of interest and removing the bias associated with the payment of commission by product providers to intermediaries. Given our global footprint, we would be happy to discuss in further detail our impression of these initiatives and their implementation during a follow-up meeting with the CBI.

In addition to the jurisdictions cited in the review, the Canadian Securities Administrators ("**CSA**") (an umbrella group that coordinates policy among the country's provincial and territorial securities regulators) has recently announced that it will circulate a consultation paper that will seek comment on a policy that will include "discontinuing" embedded commissions. The CSA have stated that that "the prevailing practice of remunerating dealers and their representatives for mutual fund sales through commissions, including sales and trailing commissions, paid by investment fund managers (embedded commissions) raises a number of investor protection and market efficiency issues that suggest a need to consider change". The consultation paper is due to review several issues, such as the impact a commission ban might have on the fund industry in Canada, the extent to which a "direct pay" or an up-front fee system might protect investors, and the means by which the industry could switch to a direct pay system from the current commission-based system.

**6. Conclusion**

Regulators across Europe, and beyond, increasingly are seeing commission payments from product providers to intermediaries as non-transparent and are taking measures to either ban this practice outright or significantly increase transparency in respect of the practice. Based on the reasons set out above, we believe that Ireland should either (i) ban intermediaries from receiving and retaining commission; or (ii) follow the approach taken by the United Kingdom and The Netherlands and implement a complete ban on commission payments by product providers to intermediaries. The benefits of such a ban being to:

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- reduce the risk of intermediary conflicts of interest affecting the products that are purchased by/for end investors;
- increase product access and competition, meaning a wider variety of products are available for investors to purchase; and
- increase cost transparency.

Thank you for the opportunity to comment on the Discussion Paper. For further information in respect of our responses, please contact Rebecca Cotter, Legal Counsel at Rebecca.cotter@vanguard.co.uk or Richard Withers, Head of Government Relations, Europe at richard.withers@vanguard.co.uk. In the meantime, we will also seek to arrange a meeting with you to further discuss this response and our global experience in respect of regulatory initiatives to prohibit the receipt by intermediaries of product provider commission payments (such as in the United Kingdom, The Netherlands, Australia and Canada).