POWER FINANCIAL
CORPORATION

HENRI-PAUL ROUSSEAU
VICE-CHAIRMAN

Financial Advice and New Products, New Technologies and New Regulations

SPEECH—*COLLOQUE RETRAITE, INVESTISSEMENT & FINANCES*
QUÉBEC, NOVEMBER 8, 2016

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HENRI-PAUL ROUSSEAU

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INTRODUCTION

The financial advice industry has been awaiting the consultation paper announced by the CSA[1] on the option of banning embedded commissions in favour of direct pay arrangements. This proposal will generate in-depth discussions regarding conflicts of interest in the client-advisor relationship, the true value of advice, access to this service and payment for it, and possible changes to business models in the industry. At the same time, companies operating in the financial sector are putting the final touches on preparations to meet the requirements of CRM2[2] and are getting ready for the round tables on the CSA consultation paper tabled in April 2016, which proposes new changes to advisors' obligations toward their clients.

My intention today is not to delve into the details of the authorities' proposals or the specific answers the industry could give. I intend instead to step back and try to place the discussion on another level. The basic premises I defend are the following:

1. Financial advice provides true value to the individual investor; and
2. It is crucial to maintain access to such a service for all Québec and Canadian households, regardless of their income or initial asset level.

This access could be negatively impacted by the regulatory changes proposed. We have to convince regulators, political decision makers and the public at large that a pause is in order so that the financial advice industry can finish improving what it is currently striving to improve and so that we, along with the regulators, have time to explore how to implement the principles that will protect our clients while preserving access to financial advice.

1. Canadian Securities Administrators (CSA)
2. Client Relationship Model (CRM)

PART ONE: THE TRUE VALUE OF FINANCIAL ADVICE

To take the discussion to another level, we have to start by better explaining the nature of the service we offer. This is essential, because there is a perception—exaggerated in our view but widespread nonetheless—that the individual investor gets a bad deal.

I would like to point out, and I am quite sure we all agree on this, that financial advice is not first and foremost a question of beating benchmark indices (the "alpha"); rather, it is advice on the choice of assets to place in a portfolio based on a specific risk tolerance profile (the "beta"). Most importantly, however, it is about providing support for clients in achieving their savings objectives as the circumstances of their lives and their concerns regarding market fluctuations evolve: the "gamma."

Defined and explained in this way, ongoing financial advice creates true value for the client.

The econometric studies carried out by CIRANO under the direction of Claude Montmarquette and Nathalie Viennot-Briot demonstrate and measure the intrinsic value of advice. The assets of households that receive support from a financial advisor see steadier growth than the assets of those that do not; over time, they will grow to more than double the value of the latter. What's more, this effect applies to both lower- and higher-income households. (Bear in mind that, for most households, the initial contact with a financial advisor takes place when financial assets are less than $50,000.[1])

And there is more: financial advice is not only good for the households that benefit from it, but it also has positive effects at the societal level, which in more technical (or economic) terms are referred to as positive externalities.

What are these positive effects or externalities?

- Households that have access to financial advice are better prepared for retirement. As we all know, individual savings play an important role in our Canadian retirement system, especially for the middle class. When more households are well prepared, it stabilizes and strengthens our retirement system, as fewer people are likely to require assistance from the government, freeing essential resources for other purposes.
- People in households that have access to financial advice are less worried about achieving their financial objectives and therefore enjoy better financial well-being, which has a positive impact on their work attendance, for example,[2] and on their health.

1. Pollara Research (2013): Over 70% of households have assets of less than $50,000 at the beginning of a relationship with a financial advisor.
2. Manulife white paper (March 2016): *Employee Financial Wellness and Its Impact on Canadian Businesses*

- The use of financial advice is tied to a higher national savings rate, which promotes investment, productivity, the growth of our economy,[1] and domestic control of our businesses.
- Finally, financial advice leads to more satisfactory results in the case of the intergenerational transfer of assets, a phenomenon that is poised to increase considerably in Canada over the coming years.

If you agree with the preceding, i.e., that financial advice provides true added value for both the households that receive it and our society in general, you will agree with me that it is essential that access to advice not be reduced as part of the set of changes the financial advice industry is facing.

As a matter of fact, these changes are considerable, and it seems to me that the financial advice industry is now facing a new world. Let's take a look at it together.

PART TWO: THE NEW WORLD OF FINANCIAL ADVICE

Three major developments have taken place in parallel over the last few years:

1. The perception that the individual investor is getting a bad deal
2. Technological advances in all aspects of the investment process
3. Regulators very determined to take wide-ranging action

First, as I mentioned earlier, there is a perception that the individual investor is getting a bad deal:

- Advisory services are said to be rather expensive and of varying quality, resulting in poor cost-effectiveness for clients.
- There is an alleged lack of transparency regarding the cost of services, the benefits received in return and the qualifications of advisors. Clients have a hard time making sense of the many different advisor titles and designations (portfolio managers, brokers, financial consultants, investment advisors, financial planners, etc.).
- There are conflicts of interest, real or perceived—for example, there is a perception that the trailing commissions paid to brokers and their sales staff by investment fund managers could unduly influence advisors to the detriment of individual investors' interests. More generally, there is a perception that the disclosure of a conflict of interest by advisors to clients is no longer sufficient to exempt advisors from doing everything to put the interests of clients above their own. This perception feeds the discussions regarding the imposition by regulators of a best interest standard.

1. See the Conference Board of Canada document dated September 2014: *Boosting Retirement Readiness and the Economy Through Financial Advice*.

Moreover, following the worldwide economic and financial crisis of 2008, there is also the macroeconomic context, with its low interest rates, slated to remain low for longer than envisioned, and low expected returns on all financial assets over the medium term. All this puts a spotlight on the level of fees for financial advice versus investment portfolio performance.

Lastly, there are the concerns and the confusion of the individual investor given an uncertain and constantly changing world:

- How much should I save for retirement?
- How can I achieve my financial objectives?
- Which investment strategies would be best for me: passive or active?
- What kind of portfolio should I build in terms of assets, their risks and their fees?
- Should I use a financial advisor, and if so, what type (automated, human/personalized), at what cost, and with what kind of payment arrangement (fees, commissions)?

The second element of this new world: technological advances, which have completely changed every aspect of the investment process, from products to portfolio building, analysis and even distribution.

- Let's look at a few examples of new products: exchange traded funds (ETFs), smart "beta" portfolios, and quantitative approaches.
- There are also technological management tools that, for example, give clients and their advisors a consolidated view of assets (Yodlee), or help advisors build and optimize portfolios (in Canada, Glidepath Professional Services, Wealthsimple for Advisors, Nest Wealth Pro).

In addition, technology increasingly plays a role in the distribution of financial products and services by promoting:

- Disintermediation, which gives individual investors direct access to products through platforms such as P2P lending, or to services such as automated advice;
- Ubiquitous connectivity, which enables clients to have access to their assets and portfolios from anywhere and at any time; and finally,
- The acquisition and onboarding of clients in a few clicks, possibly on a smartphone.

Technological advances offer financial advisors real benefits. At the same time, they raise a number of serious and costly issues relative to their technological positioning, computer systems and business model.

Finally, as the third and final element of this new world, Canadian regulators, like their colleagues elsewhere around the globe, feel the urgent need to take wide-ranging action in what they view as the best interest of the consumer, which means that we are now seeing an avalanche of reforms in support of the individual investor.

The genesis of this renewed regulatory activity can be traced back to the trauma caused by the 2008 economic and financial crisis:

Regulators were first faced with the urgency of saving the day by preventing the collapse of the financial system, and then stabilizing it on a longer-term basis. Subsequently, they—along with governments—wanted to ensure that such a situation would not recur, and they focused on the system's financial stability.

Naturally, this was followed by an emphasis on the regulation of incentives that can lead to excesses. Caps were placed on the compensation of managers and professionals in the financial sector. There was also a crackdown on the excesses of the past, such as those involving interest rate markets (Libor) and the mis-selling of financial products such as subprime loans.

In other words, the emphasis was placed on market conduct.

What we are now seeing is a new phase in regulatory activism, with a focus on supervising interactions between financial professionals—including financial advisors—and their clients, which is consistent with the perception, true or false, of a "bad deal" for consumers. This is what could be called "professional conduct."

As far as the financial advice industry is concerned, we have many examples of regulatory initiatives throughout the world:

- In the United Kingdom, the Financial Conduct Authority (FCA) carried out a comprehensive review of the rules governing the distribution of financial services and advice in January 2013. The two key elements of the reform were the abolition of embedded sales commissions on financial products, and the creation of two categories of financial advisors, determined on the basis of what they sell.
- In Australia, regulations banned pay structures—such as sales commissions, volume commissions or even services in kind—that could lead to any type of conflict of interest. The new regulations also imposed new fiduciary or quasi-fiduciary standards.
- In the United States, we saw the Department of Labor issue a regulation designed to eliminate, or at least minimize, conflicts of interest in advisory services in the area of retirement savings. The Securities and Exchange Commission (SEC) also announced that it intends to address this issue in order to update its own regulations on the fiduciary duty of financial advisors.

- In Europe, the European Union adopted the revised MiFID directive.[1] One of the components of this directive is to improve investor protection, in particular by strengthening the rules to prevent conflicts of interest. Independent advisors and portfolio managers will no longer be allowed to receive compensation from anyone but their clients. Limiting conflicts of interest also means that rules and oversight applicable to the compensation policies for the staff of investment services providers are strengthened.
- In Canada, regulators have not remained idle:
  > The client-advisor relationship was the subject of reforms starting in 2009 with the implementation of National Instrument 31-103 and subsequent modifications to the relevant MFDA[2] and IIROC[3] rules. The standard, initially called CRM ("Client Relationship Model") and later CRM1, specified, with an eye to transparency, the obligations of advisors regarding the disclosure of conflicts of interest and an assessment of the suitability of their clients' purchases.

  > At the same time, regulators required brokers and other sales staff to provide clients, directly at the point of sale, simplified information documents rather than a long, hard-to-read prospectus. The guideline was progressively tightened from 2010 to May 2016, to the point that the seller of a fund must now give the client a two-pager (double-sided) known as "Fund Facts" prior to concluding the transaction.

  > Phase 2 of the Client Relationship Model, or CRM2, progressively came into effect from 2013 to 2016 and is also intended to promote transparency by providing individual investors with timely, easy-to-understand information about the cost of advisory services and the returns on their portfolios.

  > Lastly, Canadian regulators continue to examine two related issues:

    > The first is the issue of trailing commissions paid by investment fund managers to brokers and other sellers of financial products (embedded commissions);

    > The second is the notion of the client's best interest, and whether to elevate this notion to a fundamental standard for advisors.

  > The dialogue between regulators and the financial advice industry continues on both fronts. Last April, the CSA issued a consultation paper[4] which proposes targeted reforms to National Instrument 31-103 regarding the obligations of advisors toward their clients, and which consults on a regulatory best interest standard against which client-related obligations would be interpreted.

1. MiFID governs the markets in financial instruments.
2. Mutual Fund Dealers Association of Canada (MFDA)
3. Investment Industry Regulatory Organization of Canada (IIROC)
4. Consultation paper 33-404 dated April 28, 2016, *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients*

> Finally, it has been announced that a consultation paper will be issued before the end of the year regarding a potential proposal from the CSA to ban embedded commissions and to move to direct pay arrangements that, it is believed, would better align the interests of clients and those of their advisors.

It is clear that the activism of Canadian regulators is part of a worldwide movement, attesting to the fact that such authorities observe, learn from and influence one another.

PART THREE: THE INDUSTRY'S RESPONSE

What should we, as an industry, do to promote access to financial advice in this new world marked by the perception that the client is at a disadvantage, by technological advances and by regulatory activism?

I believe we have to start by recognizing the existence of these three fundamental developments, accepting their validity, particularly in respect to the lack of transparency that has characterized us, at least at some levels, and then, we have to refocus on our mission through two initiatives:

1. Increase our client focus and accelerate the implementation of measures to place the client at the centre of our business model.
2. Request a pause in the implementation of new regulatory measures in order to complete our adaptation to this new world, and explore, along with regulators, political decision-makers and the public at large, how to implement the principles that will protect our clients while preserving access to financial advice.

The first priority is to increase our client focus and accelerate the implementation of measures to place the client at the centre of our business model.

- For that, let's change our business practices where they need to be changed, and let's use technology when it is useful. The goal is to improve the cost-benefit ratio for the client, particularly as concerns the cost of financial products and providing advisory services that are more uniform in quality. In the same vein, let's personalize advisory services so that they meet, in quality and in cost, the needs of the various market segments;
- Let's get rid of practices that are more difficult to justify these days, such as deferred sales charges;
- Lastly, let's improve the transparency of advisory costs and returns on assets—the implementation of CRM2 gives us an opportunity to do that.

But we must also:

- Properly police, in accordance with our collective responsibility, our industry, to ensure that all our members take to heart, first and foremost, the interest of the client;
- Be willing to carry out a critical inventory of our business practices that might stand in the way of an alignment between our interests and those of our clients;
- Clarify, as is already under way in Québec, the training requirements for our advisors, upgrading them where necessary and, to ensure the quality of the financial advice, make sure to clearly communicate to our clients what they are entitled to expect from each type of financial advisor; and
- Finally, defend our clients' rights to a range of choices and options in advisory services, including in terms of payment for such services.

The next priority is to ask for a moratorium on the implementation of new regulations, in order to give the financial advice industry time to adjust to technological changes and the new regulations, such as CRM2, and to counter the negative perception of the industry in certain circles.

This pause would also be used for the industry, regulators and political decision-makers to make sure that the proposed regulations, which impact our business processes and payment practices, take into account the importance of preserving—and even augmenting—access to financial advice.

As an industry, we subscribe to the principles put forward by the regulators, which are increasingly supported worldwide. These include greater transparency, aligned interests, a better cost-benefit ratio for the individual investor and better training for financial advisors.

We are concerned, however, about the unexpected negative consequences that abolishing embedded commissions could have on access to financial advice in Canada. The advisor pay structure is not without impact on the demand for this service. From the point of view of clients—especially those who are just starting to save—it is advantageous for the costs of the service (advice) and those of the product (such as a fund) to be combined in a trailing commission structure.[1] Over time, this approach gives clients the opportunity to realize the value of the service they receive. The interests of the client and the advisor are aligned, since the compensation of the advisor depends on the performance of the product. If, on the other hand, compensation for the service and payment for the product were forcibly separated, by requiring, for instance, that advice be paid for upon delivery, i.e., at the beginning of the relationship, it would discourage a great many small investors from taking advantage of it.

1. To this effect, see the document written by Pierre Lortie, published in April 2016 by the University of Calgary's School of Public Policy: *A Major Setback for Retirement Savings: Changing How Financial Advisers are Compensated Could Hurt Less-than-wealthy Investors Most.*

It is worth noting the recent experience of New Zealand where, last July, the government (not the regulators) tabled a bill on financial advice designed to simplify the regulatory framework, place the "quest for the client's best interest" at the centre of the client-advisor relationship, regulate the use of the title of financial advisor, upgrade quality standards, impose greater transparency, and facilitate the introduction in the New Zealand market of robo-advisors. Reflecting on the experiences of other countries, the government decided not to ban trailing commissions, explicitly voicing a concern that such a measure could reduce access to advisory services for the less wealthy. In fact, in 2015 in the United Kingdom, the FCA carried out a study, the Financial Advice Market Review (FAMR), to determine whether the abolition of trailing commissions, implemented two years earlier, had had a negative effect on access to financial advice.

The challenge, therefore, is to reconcile the principles we all subscribe to with the preservation of access to advice for Québec and Canadian households at every level of income and assets. We do not have all the answers, but we feel there must be acceptable, and quite possibly complementary, solutions in various areas:

- Payment arrangements for advisory services;
- Segmentation of the regulatory requirements (and therefore of the costs to service providers) based on client needs—for example, increased use of technology in certain segments; and
- Potential complementarity between advisory services in group savings vehicles and advisory services for the individual investor.

CONCLUSION

To sum up, we are deeply convinced of the value we bring to our clients. We believe that financial advice also has a positive societal impact. We are therefore looking to engage in an active dialogue with political decision-makers and regulators to ensure that the value of financial advice, together with the importance of preserving access to it for all Québec and Canadian households, regardless of their level of income or initial assets, is recognized.

We would like to explore, with all stakeholders, ways to reconcile the principles of investor protection with the preservation and increase of access to financial advice. And we would like a bit of time to do so. We think it would therefore be prudent to postpone the implementation of new regulations.