Segregated Funds Working Group

Position Paper

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This document reflects the work of regulators who are members of the CCIR. The views expressed should not be considered as legal opinions.

This document does not necessarily represent the official position or views of any provincial, territorial or federal government or agency.

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1. INTRODUCTION

1.1 CCIR

The CCIR is an inter-jurisdictional association of provincial, territorial and federal insurance regulators. The provincial and territorial regulators are responsible for market conduct regulation and ensuring legislative compliance of insurers authorized in their province or territory. They may also have responsibility for the solvency of insurers incorporated in their jurisdictions.

The CCIR has developed a framework for cooperative market conduct supervision among its members. CCIR members have made a commitment to observing, where reasonable, the Insurance Core Principles (ICPs) of the International Association of Insurance Supervisors (IAIS). Of particular importance are ICP 18 and 19 which address the supervision of market conduct and intermediaries:

- ICP 18 *Intermediaries* – the supervisor sets and enforces requirements for the conduct of insurance intermediaries, to ensure that they conduct business in a professional and transparent manner.

- ICP 19 *Conduct of Business* – the supervisor sets requirements for the conduct of the business of insurance to ensure customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied.[1]

One of the major goals of the CCIR is to promote greater consistency of insurance regulation across Canada to benefit both consumers and the insurance industry through regulatory efficiencies, cost savings, and consistent fair treatment of customers. The CCIR also considered the regulatory regimes for other financial services and products. Individual jurisdictions may need to accommodate any local or regional requirements in implementation.

1.2 Introduction – Segregated Funds and Mutual Funds Markets

In 2016, Canadians had over $318 billion invested in segregated funds. . Total segregated fund assets grew at an average annual rate of 7.6% over the past decade.[2]

[1] Insurance Core Principles (ICPs) 18 and 19 "Intermediaries" and "Conduct of Business", International Association of Insurance Supervisors, http://iaisweb.org/page/supervisory-material/insurance-core-principles//file/58067/insurance-core-principles-updated-november-2015.

[2] Canadian Life and Health Insurance Facts: 2017 Edition, Canadian Life and Health Insurance Association

As of January 31, 2017, Canadian mutual funds had over $1.34 trillion in assets under management.[3]

Segregated funds resemble mutual funds. However, unlike mutual funds, segregated funds are purchased under life insurance contracts. The insurance elements included in a segregated fund contract offers certain protections, including:

- Guaranteed protection against some or all of the investment risk associated with the fund. This guarantee is a minimum of 75% of the contract holder's gross contributions at a specified maturity date (usually no less than 10 years from the date of the original investment) or at the death of the insured person. Some segregated funds cover 100% of the gross contributions.
- Guaranteed death benefits for beneficiaries of the contract, which are not subject to probate.
- Protection from creditors (in most cases).

Segregated fund contract holders are allocated notional units based on the amount contributed to the fund and the unit price at the time the investment is made. The insurer owns the segregated fund. The net asset value (NAV) of the notional segregated fund units fluctuates with the fair value of the fund's assets and liabilities, in the same way as mutual fund units.

Segregated funds have been available from Canadian life insurance companies for over 50 years. Traditionally, they have been managed and sold by insurance companies. The guarantees and other insurance benefits of segregated funds result in cost-management expense ratios (MERs) that are typically 50 to 150 basis points (e.g., +0.50% to 1.50%) higher than those for mutual funds.

The segregated funds and the mutual funds regulatory frameworks share the same desired outcome: fair treatment of the customer. As the two products fulfill similar investment objectives, segregated fund contract holders have the same need to measure how their investments meet their financial objectives. Differences in the frameworks exist to address the two products' respective and unique features.

While gathering research and input for this Position Paper, the CCIR has sought statistical evidence to demonstrate that regulatory arbitrage is occurring within the mutual fund/segregated fund sectors. Despite anecdotal statements from stakeholders and in the media, no such evidence has been found. However, in order to protect consumers, the CCIR seeks to proactively amend standards where appropriate to ensure that intermediaries have little incentive to prioritize their own interests over those of clients.

[3] https://www.ific.ca/en/info/stats-and-facts/

1.3 Segregated Funds Working Group

The CCIR established a Segregated Funds Working Group in 2015, with a mandate to:

- Review recent regulatory changes made in the mutual funds industry in relation to the regulatory framework for segregated funds and identify existing and potential gaps;
- Assess potential risk of regulatory arbitrage by dually-licensed (insurance and mutual funds) insurance intermediaries;
- Assess a harmonized approach to regulatory issues affecting segregated funds and mutual funds; and
- Use studies and research in behavioural economics to analyze investment behaviour to determine the impact of information disclosed to investors at and after point of sale, and implications for fair treatment of customers.

In May 2016 the CCIR released an Issues Paper on Segregated Funds ("Issues Paper").[4] This set out the CCIR's understanding of the comparative regulatory frameworks for segregated funds and mutual funds as of April 2016, including existing and potential gaps that may need to be addressed in order to protect consumers. Stakeholders were invited to provide feedback by July 15, 2016.

1.4 Purpose of this Position Paper

The objective of this Position Paper is to communicate back to stakeholders what we have learned from the consultation and to set out our recommendations regarding the issues discussed.

It is assumed that the reader has read and/or has access to the Issues Paper. Further background information on each area discussed below may be found in that document. Any consultations subsequent to the publication of the Issues Paper will be addressed in the following sections.

2. RESULTS OF CONSULTATION, NEW DEVELOPMENTS AND RECOMMENDATIONS

The Issues Paper was intended to gather several kinds of input from stakeholders with regard to:

[4] https://www.ccir-ccrra.org/en/init/Segregated_Funds/IVICs%20Issues%20Paper%20(ENG).pdf

- Whether the CCIR's understanding of the topics and issues as presented was accurate;
- Whether all significant gaps and issues had been identified;
- The extent of harmonization between segregated funds and mutual funds' regulatory regime that should be required; and conversely, if different regulatory treatment is appropriate for the products and for what reasons; and
- Options to ensure the consistent fair treatment of the customer under both regulatory regimes.

To this end, the Issues Paper requested specific feedback in several areas:

- Disclosure of fees/costs, account and product performance
- Soft dollar arrangements/sales incentives
- Risk classification of segregated funds
- Oversight of segregated fund sales
- Standard of care for segregated fund intermediaries

Sixteen submissions were received from stakeholders that included associations, other regulators, insurance companies, insurance intermediaries, financial planners and entities dealing in mutual funds. In addition, the Working Group met with several stakeholders to expand on and clarify their comments.

We wish to thank all of those who participated in the consultations: your input has been invaluable.

2.1 Disclosure

Disclosure is viewed as a means to ensure consumers may make informed decisions, but this is dependent on consumers being able to understand that disclosure, and to take into account conflicts of interest that may exist. Behavioural economics research has indicated that in some cases, more disclosure may not be better, and indeed might have the opposite effect – creating confusion for the consumer. Those studies have also shown that consumers tend to minimize, in their considerations, any potential conflicts of interest of their intermediary, and believe that although the intermediary is receiving compensation from fees, he or she is still acting in the best interest of the customer.

In July 2013, the Canadian Securities Administrators (CSA) introduced changes as part of an ongoing effort to provide mutual fund investors with more transparency and better disclosure around fees and performance in the securities industry. The Client Relationship Management model, Phase Two (CRM2) requires registrants to:

- Provide investors with clear, complete disclosure of all charges and compensation received by the dealer; and
- Provide meaningful reporting on how their investments are performing.

CRM2 has created a gap in the level and type of disclosure given for mutual funds and for segregated funds.

2.1.1. Disclosure of Fees and Other Compensation

In particular, the requirement under CRM2 to disclose fees received by the dealer, in dollar terms, has raised questions about whether comparable disclosure should be required for segregated funds. The Issues Paper asked:

- What enhanced disclosure of charges and other compensation for segregated funds would encourage intermediaries and consumers to examine more closely the products recommended and purchased?
- How else might better disclosure and transparency be achieved by the segregated funds industry?

Stakeholders were in general agreement that additional disclosure of fees is necessary for segregated funds. There was also consensus that the requirements of CRM2 could not be simply transferred to segregated funds, because of the many differences between the products and their distribution models. However, it would be important to try to achieve a consistent outcome in terms of transparency.

There was considerable support for going beyond CRM2 with respect to the actual charges that are disclosed. CRM2 mandates disclosure of compensation received by the dealer (distribution costs) rather than the overall cost of the investment product. Many stakeholders urged that all actual product costs be disclosed. A segregated fund's Management and Operating Expense Ratio (MER) consists not only of distribution costs and administrative expenses (as with mutual funds) but also of the insurance fees – the cost of the death benefit and maturity guarantees. Since this insurance cost increases a segregated fund's MER, stakeholders believed that the value of the insurance features that this buys should also be made clear.

The insurance industry raised concerns about the costs of imposing new disclosure requirements on products that are still in force but are no longer being sold; these often reside on older information technology systems. The long-term nature of life insurance, combined with mergers between insurers over the years, has given rise to many such "legacy" products. Insurers urged the CCIR to consider the costs that would eventually be passed on to consumers, versus the benefits of increased disclosure about these products.

The CCIR is developing a prototype client account statement that includes minimum full cost disclosure with respect to segregated funds fees and performance (see Appendix IV for the proposed minimum required content for full cost disclosures). The CCIR expects to engage in consumer-focus group testing before consulting further with the industry on the statement.

Recommendations

- The CCIR expect that insurers will follow the minimum required content for their statements for full cost disclosure (See Appendix IV).
- The management expense ratio must be broken out to explicitly show management fees, distribution costs and insurance costs. An explanation of what these costs include must be provided.
- The minimum required content is composed of key elements. Therefore, CCIR members would not expect the addition of many other items. However, insurers will have flexibility in statement formatting as well as to adapt the statement to their products and to adjust the wording according to the contract and other prescribed disclosure, such as the Fund Facts.

Reports must provide information on the guarantee and other benefits of segregated fund contracts, and how those impact costs, risk and performance.

2.1.2 Disclosure of Account Performance

CRM2 requires that annual report information for mutual funds be reported in a variety of ways, including through the use of tables and charts. The CRM2 annual performance report shows the annual change in market value of the mutual fund, and the investor's personal rate of return on 1-, 3-, 5-, and 10-year periods and since account inception; these rates are calculated using a dollar-weighted methodology.

Insurers must provide an annual statement to segregated fund contract holders within four months of each successive fiscal year-end of a segregated fund. This statement must report the value of:

- benefits under the segregated fund contract, related to the market value of the segregated fund at the end of the period covered by the statement;
- money allocated to the underlying segregated fund(s). The dollar amounts allocated to the notional units of the segregated fund(s) are used.

This annual statement must inform the segregated fund contract holder that information regarding the current management fee, management expense ratio and the overall rate of return of the fund (calculated on a net basis for the last 1, 3, 5 and 10-year periods, if applicable) are available upon request, and provide the contact information to obtain these.

These requirements are not equivalent to those of CRM2, as most required information pertains only to the fund(s) held under the segregated fund contract, not the account.

The Issues Paper asked:

- How should account performance reports for segregated fund contract holders be harmonized with those on the mutual fund side? What adjustments could be made to take into consideration segregated fund contracts' guaranteed protections?
- Are segregated funds generally considered to be held as a long-term investment compared to other types of investment products?
- To what extent should the enhanced investment performance data requirements be harmonized with mutual fund rules?
- What additional data would be of value to segregated fund contract holders?
- What differences could be made to take into account the guaranteed protections in a segregated fund contract?

Most stakeholders recommended the use of dollar-weighted methodology to calculate performance, because this is the method used for mutual funds. This would facilitate comparisons between the performances of the two types of funds. Some suggested including amounts in both dollars and percentages where appropriate.

However, as noted under cost disclosure (above), respondents emphasized the importance of discussing the impact of the insurance features on product or account performance. Applying CRM2 reporting standards to segregated funds is made even more complex because the insurance and investment aspects of the segregated fund product are interlinked, in terms of the value of the insurance guarantees on any given day.

As with disclosure of fees and compensation, the insurance industry raised concerns about the costs of imposing new disclosure requirements on legacy products and urged the CCIR to consider the costs versus the benefits of increased disclosure about these products.

With regard to fund performance, stakeholders overwhelmingly agreed that segregated funds are generally long term investments.[5] Therefore some questioned the appropriateness of including the short-term performance of segregated funds.

Recommendations

- The CCIR will expect that insurers will follow the minimum required content for their statement for performance disclosure (See Appendix IV).
- The minimum required content is composed of key elements. Therefore, CCIR members would not expect the addition of many other items. However, insurers will have flexibility in statement formatting as well as to adapt the statement to their products and to adjust the wording according to the contract and other prescribed disclosure, such as the Fund Facts.
- Performance must be shown using a dollar-weighted methodology.

[5] There are some cases where segregated funds might be also appropriate for short-term savings goals.

- Given the long term nature of segregated funds, short-term/three-month performance reporting should not be made mandatory for segregated funds.

2.1.3 Disclosure upon Subsequent Purchases

The Issues Paper asked:

- Are there any reasons why segregated fund investors should not receive updated Fund Facts upon subsequent investment in the same fund? Please explain.

Most stakeholders agreed that clients holding segregated funds should be provided with updated Fund Facts according to the requirements which govern mutual funds. However, many stakeholders felt that the disclosure should not have to be "sent" as this might overload consumers with too much information.

It was noted that although each mutual fund transaction is a separate purchase or sale of an asset, each segregated fund transaction is an exercise of a contractual right established when the client entered into the contract with the insurer. Any requirements must respect this contractual right of the contract holder.

Stakeholders questioned whether clients would actually want to receive this information and how they would use it in the context of a segregated fund. Insurers report that very few clients currently request or access Fund Facts for funds they already own, even though they are available. It was suggested that clients be notified when there were changes in Fund Facts and require that they be made available online. Additionally, intermediaries and insurers should/must (depending on the requirements of the jurisdiction(s) in which they operate) canvass their clients and document their preferences for receiving this type of information.

Recommendations

- Requirements for delivery of updated Fund Facts for segregated funds should align with mutual fund requirements.
- Clients should be reminded upon each subsequent purchase how they can access Fund Facts online or request a hard copy, in accordance with their preferences.

2.1.4 General Feedback on Disclosure

Several respondents urged the CCIR to use behavioural insights or behavioural economics research and consumer focus groups to ensure that any recommended

further/enhanced disclosure is of value to customers and to reduce any unintended effects (e.g., extra cost passed on to customers or customer confusion/disengagement).

The CCIR was also encouraged to maintain flexibility in any disclosure requirements to allow for technological improvements to disclosure, and to consider how current technologies could be better used.

Recommendations

- The goal of disclosure should be a consistent outcome – the fair treatment of customers – for both mutual funds and segregated funds.
- Information should be conveyed in plain language, use graphics where appropriate, and be in an accessible format. It should allow for ease of comparison between mutual funds and segregated funds.
- Regulators should incorporate the findings of behavioural economics research when determining requirements for disclosure; consider cost vs. value to consumers, using consumer focus groups where appropriate.
- Regulators should embrace technology-neutral practices and guidance in providing disclosure to consumers.

2.2 Soft Dollar Arrangements and Sales Incentives

The Issues Paper asked:

- What would be the most effective method of ensuring that segregated fund consumers were aware of soft dollar arrangements and other sales incentives?
- How should insurers make sure that soft dollar arrangements and other sales incentives do not create conflicts of interest for intermediaries?

Insurers confirmed that soft dollar arrangements would typically be between the insurer and the fund's portfolio manager and would be subject to requirements under securities legislation. For this reason, insurers that responded believed that the appropriateness of soft dollar arrangements should be assessed by the insurance company and that this would not be useful additional disclosure for segregated fund investors. However, two respondents recommended the same disclosure requirements for both mutual funds and segregated funds.

Of more concern to regulators in relation to conflicts of interest were sales incentives, such as those that occur when insurers pay for the travel and accommodation costs for conferences for intermediaries. The industry itself appears to be moving towards eliminating sales incentives or treating them as taxable benefits. Some respondents

believed these should be banned or limited, as some insurers have already done; others noted that there might be unintended consequences of such bans/restrictions.

Respondents also pointed out that the Canadian Life and Health Insurance Assocation (CLHIA) had provided its recommended best practices on this subject in its February 2016 paper, *Insurance Distribution in Canada: Promoting a Consumer-Based System*.[6] The CLHIA recommends following a similar model to that required in the mutual funds sector: where there might be a perception that the incentive will influence a product recommendation, advisors must pay their own travel and accommodation costs.

The CCIR acknowledges that "soft dollar" requirements under securities legislation apply *de facto* when a dealer acts for the fund; insurers are obligated to assess the appropriateness of such arrangements. We see no need to add further requirements at this point.

Recommendations

- In June 2006, the CCIR formally endorsed three principles for managing conflicts of interest in the insurance industry. Insurers should align with best practices for sales incentive programs as identified and/or endorsed by regulators.
- Sales incentives such as travel and accommodation must be disclosed to clients, with approximate or actual values.
- Conflicts of interests related to all sales and other incentives must be appropriately addressed by insurers and intermediaries, including meeting all statutory requirements where applicable.
- The CCIR will continue to monitor developments in the area of sales incentives, to further identify best practices.

2.3 Risk Classification Methodology

Historically, the segregated funds industry has used the same investment risk classification methodology that is used for mutual funds. Mutual fund managers could choose the methodology to be used for their funds, but this made it more difficult to compare the risks where different methodologies had been selected.

After consultation with the industry, in December 2016 the CSA published amendments prescribing a mandatory methodology to be used for conventional mutual funds and exchange-traded-funds (ETFs) for each filing of a Fund Facts or ETF Facts, and at least annually.[7] The funds must be located in one of five categories, based on the degree to

[6] http://clhia.uberflip.com/i/644367-insurance-distribution-in-canada

[7] *CSA Notice of Amendments to National Instrument 81-102 Investment Funds and Related Consequential Amendments*. Canadian Securities Administrators. December 8, 2016.

which returns varied over a 10-year period from the average return. The amendments are in force since September 1, 2017.

The Issues Paper asked:

- What risk classification methodology do you believe is most appropriate for segregated funds and how should this be disclosed?

Stakeholders agreed that the same risk classification methodology should be used for segregated funds as for mutual funds. However, many recommended a reminder about the special features of segregated fund contracts that would affect the investment risk.

Recommendations

- Risk classification for segregated funds should align with the CSA's prescribed methodology for risk classification of mutual funds.
- A note should be included with the risk classification of segregated funds, noting that segregated fund contracts have additional features that impact the risk of an investment.

2.4 Oversight of Segregated Fund Sales and Distribution

Unlike manufacturers of securities, life insurers are legally responsible for the conduct of intermediaries representing them in the sale of their products. The situation is a little different in Quebec where the distribution firm is responsible for the actions of its attached representatives.

In most provinces, life agents are required to have errors and omissions (E&O) insurance. Where there is no statutory requirement (i.e., the Atlantic provinces and the territories), many insurers contractually require that life agents representing them carry E&O insurance.

The Issues Paper asked:

- What should be the responsibilities of life insurance companies with respect to oversight of segregated fund sales and their distribution? What factors affect the ability of life insurance companies to oversee segregated fund sales?
- What should be the responsibilities of intermediaries with respect to segregated fund sales?
- What could the industry do to address issues with insurer and intermediary supervision of the distribution and suitability assessment of segregated funds?

There was a range of opinions on this topic. Some stakeholders were against the adoption of a compliance system similar to the mutual fund distribution model – pointing out that the distribution model for segregated funds is very different. They noted that the relationship between the intermediaries who personally sell segregated funds to clients and those who create and distribute segregated funds can in some cases be relatively remote. Advisors may sell the products of more than one company, may operate independently or be attached to a MGA, a national account, or a dealer.

Others (typically non-insurers) were in favour of instituting similar models in both sectors – for example, insurance regulators were encouraged to work with securities regulators to design an outcomes-based supervisory framework that would combine best practices from both sectors.

There was support for strengthening needs assessment practices. For example, it was suggested that advisors be required to consistently document needs analysis and recommendations, and introduce more standardization across provinces. To that end the life insurance industry recently updated the *Reference Document on IVIC Suitability Needs-Based Sales Practices.*[8]

The consensus was that insurers are responsible for oversight of sales and distribution. Stakeholders suggested that technology could be better utilized to assist in this oversight. Insurers generally suggested that on-site reviews of advisors by insurers could be expanded. In Québec, insurers are responsible at each stage of the life cycle of a product (which includes that insurers should ensure compliance process control upon the supply of products and services), and the distributor is responsible for overseeing compliance of its representatives with obligations that apply to them. CCIR has continually provided guidance to the industry on such matters, as an example its May 2012 Position Paper – "The Managing General Agencies (MGAs) Distribution Channel in the Life Insurance Industry". In addition to its Guideline G8 - *Advisor Suitability: Screening, Monitoring and Reporting* - the CLHIA has also published a Reference Document to assist insurers in meeting their obligations.[9]

There was strong support for mandatory Errors and Omissions insurance and Continuing Education for sales representatives. The CLHIA has made these points in its February 2016 paper, *Insurance Distribution in Canada: Promoting a Consumer-Based System.* A number of jurisdictions already have requirements in place with regard to these matters.

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[8]https://www.clhia.ca/domino/html/clhia/clhia_lp4w_lnd_webstation.nsf/resources/Guidelines/$file/IVIC+Suitability+ref+doc.pdf

[9] *Screening Agents for Suitability and Reporting Unsuitable Agents: CLHIA Standardized MGA Compliance Review Survey*

Recommendations

- The CCIR re-iterates that insurers have a legal responsibility for oversight of their intermediaries.
- Intermediaries should follow needs-based sales practices and should be required to document the process. Further, intermediaries should provide clients with copies of the documentation on needs analysis and product recommendations.
- Regulators should encourage the standardization of needs assessments practices, to facilitate supervision, as insurers will have similar requirements.
- Regulators should consider designing an outcomes-based supervisory framework inspired by the best practices of both the insurance and the securities sectors, to ensure that customers in both sectors are treated with an equivalent degree of fairness regardless of the distribution model.
- Regulators should support the use of technology to facilitate the oversight of intermediaries by insurers.
- Regulators should consider how technology can be used for the better oversight of both insurers and intermediaries.

2.5 Standard of Care for Intermediaries

As discussed in the Issues Paper, the regulatory standard for insurance licensees in most of Canada requires advisors to deal with their clients honestly, fairly and in good faith.[10] This requires an objective determination and imposes a less stringent standard than that of a client's "best interests". Québec is the only Canadian jurisdiction that requires an equivalent standard for securities dealers and insurance intermediaries.

This discrepancy has led to concerns about regulatory arbitrage. It is an area where there is considerable interest and debate among regulators, consumers and financial services professionals.

The Issues Paper asked:

- To what standard of care should individuals who advise on and sell segregated funds be held? Please explain.
- Should the "know your client" / "know your product" standards as used in the securities sector apply to the sale of segregated funds?
- What requirements for updating client information should apply to segregated funds intermediaries?

Standard of care

[10] See MFDA Rule #2 for mutual fund registrants and provincial Insurance Acts for insurance registrants.

Comments by stakeholders in response to this and other industry consultation papers demonstrate a great deal of concern about the possibility of introducing a best interest standard, particularly if such a standard were to be in legislation. These concerns include how such an interest would be defined, if hindsight would be used to evaluate past advice, and whether clients would understand the limits of such a standard.

Respondents from the life insurance industry expressed the view that the current standard of care for segregated funds is sufficient. They noted that this includes the duties of care enshrined in legislation as well as industry best practices and guidelines. One respondent suggested adding to the three principles to manage conflicts of interest developed by the CLHIA the requirement to perform services with the care, diligence and skill that a reasonably prudent person would exercise. This would provide a more complete description of an appropriate standard of care.

Another respondent commented on the concept of banning embedded commissions as a way to ensure that a client's best interests are paramount, and suggested that CCIR first consider the experience of other countries in response to measures that banned or limited this type of compensation if this measure were to be contemplated for the insurance sector.

The CCIR recognizes that duty of care standards are already in place in the insurance industry, through both legislation and guidelines, and that the vast majority of industry participants abide by these standards. We believe that consumers of different financial services or products should have consistent protection.

Moreover, regulators in certain jurisdictions may in fact be mandated to develop common standards. For example, the recent review of financial planning regulation in Ontario by an expert committee recommended that a universal statutory best interest duty be applied to all firms and individuals who provide financial planning or financial advisory services and/or financial product sales and advice.[11] That would include securities and insurance intermediaries.

Some jurisdictions that consulted on a proposed regulatory best interest standard for securities registrants decided not to conduct further work on the proposed standard. Some other jurisdictions decided to conduct further work, or to consider such a standard, provided substantial revisions are made to add clarity and predictability.[12]

[11] http://www.fin.gov.on.ca/en/consultations/fpfa/fpfa-final-report.html

[12] CSA Staff Notice 33-319 Status Report on CSA Consultation Paper 33-404 : Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients May 11, 2017

Due to these ongoing developments, the CCIR is not in a position at this time to propose changes to applicable standards for segregated funds and other insurance products.

Know-Your-Client

With respect to Know-Your-Client (KYC) requirements, most respondents noted that the concept of KYC is good, but as used in securities it is only part of the needs-based analysis required for insurance products – therefore it would not be appropriate to copy what is done for securities.

CCIR recognizes the importance of this concept while acknowledging that copying the same process and forms would not be appropriate for segregated funds. The principles of KYC are present in current needs-based practices for segregated funds and must incorporate the considerations specific to insurance that are necessary for such complex products.

Updating Client Records

Regarding the question of how often client records should be updated, there was difference of opinion. Some cited the long-term nature of insurance products, the fact that securities portfolios are far more likely to require frequent adjustments, and even the difference in the nature of the client relationship in insurance versus in securities as reasons not to require this. Others suggested that this be aligned with the requirements for mutual funds.

We heard concerns from insurers about clients not fulfilling their responsibilities in notifying insurers of changes in their circumstances, or not responding to agent attempts to contact them. Documenting attempts to contact the client for an annual check-in will help to prove that the agent is fulfilling his or her duty in this respect.[13]

Clients holding longer-term insurance products may not, at first glance, require annual updating of their records as do mutual fund investors. However, from the perspective of consumer protection, it is difficult to see a downside to introducing such a requirement. Clients may not inform their advisors of changes in their circumstances that might impact initial recommendations. Therefore, connecting once a year to review the policy would provide an opportunity to ensure that the segregated fund client is aware of policy features and may ask any questions about their annual statement.

[13] Some clients may no longer be assigned to an agent (so-called “orphan” clients). However, insurers have a responsibility to address this gap.

Know-Your-Product

Know-Your-Product obligations would apply equally in both sectors. Segregated funds are complex products and the standards for intermediaries' knowledge of the products they are dealing in cannot be too high. Although intermediaries who sell segregated funds may indeed know the products very well, KYP requirements are not currently mandated as specifically for segregated funds as they are for mutual funds.

Recommendations

- There should be an equivalent standard of care for those dealing in segregated funds and those dealing in mutual funds; this standard should not be lower than it is currently for either product. Insurance and securities regulators should collaborate to ensure that the standard is appropriate for both products and is not the source of confusion for consumers.
- Insurance regulators should consider harmonization with the securities sector on Know-Your-Product/due diligence requirements for intermediaries.
- Advisors should be required to perform needs-based analysis practices for segregated funds that are acceptable to regulators.
- Reasonable steps to update clients' records should be taken annually, or sooner if the advisor becomes aware of a material change in the client's personal circumstances and financial needs. In this respect, advisors must make their best efforts, in a way that is commensurate with the policy features of the segregated fund contract, to contact clients, and must document these attempts.
- Regulators' practices and guidelines should be technology-neutral with respect to fulfilling insurer and intermediary obligations to their clients.
- Insurers should have appropriate measures that allow them to meaningfully assess the product knowledge of those intermediaries distributing their products.

2.6 Additional Feedback

In addition to specific feedback, the Working Group wanted to capture any other factors that stakeholders thought were relevant to the consultation.

The Issues Paper asked:

- In addition to the potential gaps discussed above, do you believe that there are other areas in which segregated funds and mutual funds regulation may achieve a more harmonized outcome with respect to the fair treatment of customers? Please explain your response.
- Are there other disclosures or requirements that have not been considered in this Issues Paper that would help achieve such a harmonized outcome?

- Please provide any other information that you believe regulators should consider regarding segregated funds.

There was strong consensus among stakeholders that the Issues Paper had covered the regulatory gaps well. Stakeholders reiterated many of the points they had made previously, stressing the importance of accessible, simple, plain language disclosure, using behavioural insights and behavioural economics research and considering how to better use electronic technology to communicate with clients and avoid overburdening them with information.

The preference for harmonizing outcomes, not specific rules, between the securities and insurance sectors was re-stated as well as the importance of harmonizing requirements between jurisdictions.

Some submissions contained suggestions for refinement of POS disclosure documents (e.g., the Fund Facts and Key Facts documents). A coordinated approach between insurance and securities regulators would be required in order to maintain the comparability of the POS documents for segregated funds and mutual funds.

Stakeholders expressed the desire to be consulted prior to any reforms being made and reminded CCIR of the need to consider how any new requirements would apply to legacy products.

3. NEXT STEPS

Given insurer concerns about the cost versus benefit of disclosure for legacy products, the Working Group has been consulting with insurers to obtain information on the potential impact of new disclosure requirements on older products, through “legacy systems”. The Working Group and insurers have established a Task Force to address issues to ensure that these expectations and recommendations are effectively implemented.

The CCIR will continue its development of a prototype client account statement with respect to segregated funds and will consult with stakeholders before publication. Each CCIR member will review these recommendations against the existing insurance regulatory framework and supervisory practices in its own jurisdiction. It may be necessary for regulators to recommend to their governments that new regulatory requirements be introduced.

The CCIR will continue to monitor issues related to segregated funds and seek feedback from the industry and consumers on whether the recommendations in this Position Paper achieve the goal of fair treatment for customers.

The CCIR will collaborate with the CSA to review point-of-sale documents for mutual funds and segregated funds and implement any appropriate changes.

Appendix I

List of Recommendations

- The CCIR expect that insurers will follow the minimum required content for their statements for full cost disclosure (See Appendix IV).
- The management expense ratio must be broken out to explicitly show management fees, distribution costs and insurance costs. An explanation of what these costs include must be provided.
- The minimum required content is composed of key elements. Therefore, CCIR members would not expect the addition of many other items. However, insurers will have flexibility in statement formatting as well as to adapt the statement to their products and to adjust the wording according to the contract and other prescribed disclosure, such as the Fund Facts.
- The CCIR will expect that insurers will follow the minimum required content for their statement for performance disclosure (See Appendix IV).
- The minimum required content is composed of key elements. Therefore, CCIR members would not expect the addition of many other items. However, insurers will have flexibility in statement formatting as well as to adapt the statement to their products and to adjust the wording according to the contract and other prescribed disclosure, such as the Fund Facts.
- Performance must be shown using a dollar-weighted methodology.
- Given the long term nature of segregated funds, short-term/three-month performance reporting should not be made mandatory for segregated funds
- Requirements for delivery of updated Fund Facts for segregated funds should align with mutual fund requirements.
- Clients should be reminded upon each subsequent purchase how they can access Fund Facts online or request a hard copy, in accordance with their preferences.
- The goal of disclosure should be a consistent outcome – the fair treatment of customers – for both mutual funds and segregated funds.
- Information should be conveyed in plain language, use graphics where appropriate, and be in an accessible format. It should allow for ease of comparison between mutual funds and segregated funds.
- Regulators should incorporate the findings of behavioural economics research when determining requirements for disclosure; consider cost vs. value to consumers, using consumer focus groups where appropriate.
- Regulators should embrace technology-neutral practices and guidance in providing disclosure to consumers.
- In June 2006, the CCIR formally endorsed three principles for managing conflicts of interest in the insurance industry. Insurers should align with best practices for sales incentive programs as identified and/or endorsed by regulators.

- Sales incentives such as travel and accommodation must be disclosed to clients, with approximate or actual values.
- Conflicts of interests related to all sales and other incentives must be appropriately addressed by insurers and intermediaries, including meeting all statutory requirements where applicable.
- The CCIR will continue to monitor developments in the area of sales incentives, to further identify best practices.
- Risk classification for segregated funds should align with the CSA's prescribed methodology for risk classification of mutual funds.
- A note should be included with the risk classification of segregated funds, noting that segregated fund contracts have additional features that impact the risk of an investment.
- The CCIR re-iterates that insurers have a legal responsibility for oversight of their intermediaries.
- Intermediaries should follow needs-based sales practices and should be required to document the process. Further, intermediaries should provide clients with copies of the documentation on needs analysis and product recommendations.
- Regulators should encourage the standardization of needs assessments practices, to facilitate supervision, as insurers will have similar requirements.
- Regulators should consider designing an outcomes-based supervisory framework inspired by the best practices of both the insurance and the securities sectors, to ensure that customers in both sectors are treated with an equivalent degree of fairness regardless of the distribution model.
- Regulators should support the use of technology to facilitate the oversight of intermediaries by insurers.
- Regulators should consider how technology can be used for the better oversight of both insurers and intermediaries.
- There should be an equivalent standard of care for those dealing in segregated funds and those dealing in mutual funds; this standard should not be lower than it is currently for either product. Insurance and securities regulators should collaborate to ensure that the standard is appropriate for both products and is not the source of confusion for consumers.
- Insurance regulators should consider harmonization with the securities sector on Know-Your-Product/due diligence requirements for intermediaries.
- Advisors should be required to perform needs-based analysis practices for segregated funds that are acceptable to regulators.
- Reasonable steps to update clients' records should be taken annually, or sooner if the advisor becomes aware of a material change in the client's personal circumstances and financial needs. In this respect, advisors must make their best efforts, in a way that is commensurate with the policy features of the segregated fund contract, to contact clients, and must document these attempts.

- Regulators' practices and guidelines should be technology-neutral with respect to fulfilling insurer and intermediary obligations to their clients.
- Insurers should have appropriate measures that allow them to meaningfully assess the product knowledge of those intermediaries distributing their products.

Appendix II

List of Submissions Received in Response to Issues Paper

Brian Shumak Financial Services

The Canadian Advocacy Council for Canadian CFA Institute Societies

Canadian Association of Independent Life Brokerage Agencies

Canadian Life and Health Insurance Association

The Financial Advisors Association of Canada (Advocis)

Groupe Cloutier

Great-West Life Assurance Company/London Life/Canada Life

HUB Financial Inc.

Independent Financial Brokers of Canada

Investment Funds Institute of Canada

Investment Industry Regulatory Organization of Canada

InvestorCOM

Manulife Financial

Mérici Services Financiers Inc.

Mutual Fund Dealers Association of Canada

Wealth Dejavu/Life Dejavu

Appendix III

Definitions

Below, we have defined a few key terms for the purposes of this Position Paper in order to avoid confusion.

Individual Variable Insurance Contract ("IVIC") - an individual contract of life insurance, including an annuity, or an undertaking to provide an annuity, as defined by provincial and territorial insurance statutes and by the Civil Code of Québec, under which the liabilities vary in amount depending upon the market value of a specified group of assets in a segregated fund, and includes a provision in an individual contract of life insurance under which policy dividends are deposited in a segregated fund.[14]

Intermediary - an entity that facilitates between two parties in a financial transaction. This includes both individuals (e.g., dealer representatives, financial advisors, insurance intermediaries, etc.) and corporate entities (e.g., for the purpose of this Position Paper, investment dealers, mutual fund dealers, insurance brokers, as applicable.).

Investment Fund Manager - a person or a company that directs the business, operations or affairs of an investment fund. Investment fund managers must be registered in accordance with *National Instrument 31-103 – Registration requirements, Exemptions and Ongoing Registrant Obligations*.

Mutual Fund – a conventional mutual fund that distributes its securities under a simplified prospectus governed by *National Instrument 81-101 – Mutual Funds Disclosure Prospectus*. Typically, mutual funds are open-ended funds professionally managed on the basis of a stated investment policy, usually expressed in terms of investment objectives and strategies, and the money raised from security holders is invested in a portfolio of securities.

Regulatory Arbitrage – where loopholes in regulatory systems are used to circumvent unfavourable regulation.

Segregated Fund - a separate and distinct group of assets (fund) maintained by an insurer in respect of which the non-guaranteed benefits of a variable insurance contract are provided.[15]

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[14] Canadian Life and Health Insurance Association (CLHIA) Guideline G2 – *Individual Variable Insurance Contracts Relating to Segregated Funds;* Autorité des marchés financiers*, Guideline on Individual Variable Insurance Contracts relating to Segregated Funds,* January 2011.

[15] Ibid.

Appendix IV

Client Annual Statement – Proposed Minimum Required Content

- Date of statement
- Insurer's name, contact information, telephone no. website
- A notice to remind the client that the information contained in the statement will assist in understanding whether the investment is on track to meet the client's investment goals.
- A notice to invite the client to contact the representative or insurer if additional information is required.
- Contract name
- Contract tax status
- Contract no.
- Contract issue date
- Contract holder(s)
- Designated beneficiary or beneficiaries
- Representative name, telephone no. and email address

- For each fund held, as at DD-MM-YYYY:

    - Fund name
    - Number of units
    - Net asset value per unit
    - Net asset value (also show total)

- Redemption value (total only)

- Changes in the net asset value of the contract in dollar amount (as at DD-MM-YYYY) – by fund and total, since issue (e.g. change in value net of charges from book value to previous annual account statement) and since the previous annual account statement (e.g. premiums, redemptions, transfers, increase/loss in value, charges). In addition to the dollar amounts, for the variation since the previous annual account statement, present total increase/loss in value and charges in percentages.

- Details of charges for the year, in dollar amount, for each fund and in total, including:
    - Ongoing fund expenses (e.g., management fees (excluding insurance costs), operating fees and transaction costs).
    - Insurance costs
    - Charges under the contract (e.g., front-end sales charges, redemption fees, transfer fees)
    - A notice that fees billed by the intermediary, if applicable, are not included.
    - A notice that charges related to ongoing fund expenses lower the net asset value per unit.
    - A notice that charges related to changes under the contract are paid directly from premiums or fund units

- Total personal rate of return net of charges calculated using the money weighted method (%):
    - Last year
    - Last 3 years
    - Last 5 years
    - Last 10 years
    - Since issue
    - A notice to remind that this rate of return may be different than the rate of return realized by the underlying funds because it takes into account the time of its premiums and redemptions.

- Remuneration paid during the year for the provision of services in connection with the contract in dollar amount:
    - Name of person to whom remuneration was paid
    - Break out commissions by type (e.g., front-end, deferred, no-load, trailing, other) and provide total amount paid by the insurer. For insurers who do not pay commissions to a third party, they are allowed to report a fair and reasonable estimate of commissions that could have been paid
    - Other compensation paid – Details of all soft dollars arrangements – names of payees and nature
    - A notice to the effect that a third party may also have paid other compensation .
    - The commission types must be clearly explained, especially deferred sales charges for which clients may have a charge upon redemption

- Guarantees applicable to the contract, including:
    - Net asset value of its segregated funds
    - Maturity date of the guarantee
    - Value of guarantee at maturity and on death
    - Date of next automatic reset of guarantees
    - For products with guaranteed redemptions, the following information depending on the phase in which the contract is :
        - Accumulation phase
            - Protected value for the calculation of guaranteed redemptions
            - Bonus added to protected value since the previous annual account statement
            - Guaranteed redemption amount for the earliest age possible, at age 65 and at age 70, for every redemption option available (i.e. lifetime, limited pay, life annuity purchase, ...)
        - Redemptions phase
            - Guaranteed annual redemption amount
            - Annual redemption amount the client have chosen to receive
            - Redemption amount guaranteed for lifetime
            - RRIF/LIF/LRIF/RLIF minimum
            - LIF/LRIF/RLIF maximum
        - Benefit phase
            - Guaranteed annual redemption amount

        - A notice that the redemption amount is guaranteed for lifetime or for a limited duration. For the latest, give the date of the last guaranteed redemption amount.
    - A notice that guaranteed redemption amounts have been calculated assuming no bonus, no premium or redemption, no future return and no revaluation of guarantees between now and the start of annual periodic redemptions.
    - A notice to remind that any redemptions that exceed the guaranteed annual redemption amount will decrease future guaranteed redemption amounts except if required in respect of the RRIF/LIF/LRIF/RLIF minimum redemption amount.
    - A notice to remind that the guaranteed redemption amount is payable to the client even if the net asset value of his segregated funds is less than this amount.
- A notice to remind clients that they can make discretionary resets if applicable
- A notice to explain how guarantees are affected by redemptions