CCIR

Canadian
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REFERRAL ARRANGEMENTS

A Discussion Paper prepared by the
License Considerations Committee of the
Canadian Council of Insurance Regulators (CCIR)

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This Canadian Council of insurance Regulators (CCIR) welcomes the comments, suggestions and ideas of insurance industry stakeholders regarding the issues described in this paper. This document can be found on the CCIR's website at www.ccir-ccrra.org. We look forward to receiving your submissions by Friday, March 5, 2004.

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Electronic copies of submissions would be preferred. As it is the intention of CCIR to publicly release the submissions received in this consultation process, please indicate if you do not want your submission to be made public.

Technical questions pertaining to the paper can also be addressed to the License Considerations Committee by contacting:

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Please note that the proposed directions in this paper should not be construed as the official position of any provincial, territorial or federal government or agency.

REFERRAL ARRANGEMENTS
DISCUSSION PAPER

I ISSUE

At the spring 2003 meeting of the Canadian Council of Insurance Regulators (CCIR), CCIR directed the Licence Considerations Committee to explore options that would permit referral fees on a broader payment arrangement basis, with appropriate consumer protection measures. This paper has been prepared to present referral fee and consumer protection options and elicit input from stakeholders on these regulatory measures.

II BACKGROUND

Referral Fees

The term referral fee is meant to describe an amount (or the equivalent in goods and services) that an insurance agent or an insurer pays to another person for the referral of a potential client to the agent or insurer. It also includes amounts (or the equivalent in goods and services) that the agent receives from another person for the referral of a potential client or customer by the agent to the other person. The amount paid by an agent to an association for referring members to the agent would be considered a referral fee.

A referral fee arrangement consists of the terms and conditions under which referral fees are paid. (A referral fee arrangement might exist where the person making the referral has had no business relationship with the person being referred or it might exist where there is a business relationship, particularly one where the person referred is a client of the person making the referral.)

Fees Paid By Licensed Agent or an Insurer

The prohibition against the payment of referral fees by an agent or insurer is essentially an issue of whether the persons making the referrals and receiving the fees have engaged in activities that would require them to be licensed as an insurance agent. Consequently, referral fees paid by a licensed insurance agent to another licensed insurance agent are not prohibited.

Where a person who is not insurance licensed has made the referral, one of the factors examined to determine whether the person has been engaging in activities requiring a licence is how the amount of the fee is calculated. For example, if the fee were to be paid on the basis of a percentage of the commissions generated from the referrals (commission splitting), almost all

jurisdictions would consider the referral activity to be part of the process of soliciting the purchased insurance and thus be prohibited. Quebec is one jurisdiction that permits commission splitting. Jurisdictions also treat other fee arrangements differently, some not permitting them and others permitting them. The variation in the treatment of the referral arrangements is based on the wording of each jurisdiction's legislation and related regulations that define licensed agent and prohibit insurers and agents from paying unlicensed agents. The variation is also based on each jurisdiction's interpretation of these.

The exploration of referral fees by the CCIR is primarily an investigation of what type of referral fee arrangements should be adopted as permissible in all Canadian jurisdictions and what types of consumer protection measures should exist for these arrangements.

Fees Paid to Licensed Agents

All jurisdictions permit referral fees to be paid to licensed agents. The payment of referral fees to licensed agents is a secondary issue that relates primarily to protection of privacy where part of the process of sending a referral is to release personal information. This applies even when the referral is to another licensed agent. If the referral is to another licensed agent, there is also an issue of whether referral fee arrangements should be disclosed at point of referral.

Agreement to Explore Permitting Broader Payment Arrangements

There have been several factors that have motivated CCIR to reach its decision earlier this year to explore options that would permit referral fees on a much broader payment arrangement basis.

1. Some individuals who are dually licensed, for example for the distribution of life insurance products and another financial services product, hold the life agent licence for the sole purpose of making insurance referrals. Their active business is providing a financial service other than life insurance. These individuals have argued that there is no consumer protection problem arising from straightforward referrals and have questioned why they need to have a life agent licence. The introduction of the Life Licence Qualification Program (LLQP) creates a more rigorous qualification standard than the previous one. Consequently, if licensing actually is unnecessary for straightforward referrals, requiring qualification under the new standard makes it even more unfair to those who wish to make such referrals.

2. As noted above, the regulatory treatment of referral fees is not uniform across Canada. One of the major goals of CCIR is to bring as much harmonization to insurance regulation across Canada as possible. The regulatory proposal that will come out of this exercise is meant to be a model for all jurisdictions using the LLQP standard and therefore will advance harmonization.

3. Securities regulators have been reviewing the regulation of referral fees in their industry and are attempting to move towards regulatory harmonization in regard to permitting referral fees.

4. Networking has become more important in the marketing of products and services. Referral arrangements can be an important aspect of some networking arrangements. If referral fees can be permitted with safeguards to consumers, CCIR questions why the insurance industry should be denied this means of reaching consumers.

III DISCUSSION

Introduction

Before discussing the consumer protection measures that could be adopted in regard to referral fees, it is useful to describe the referral fee arrangement option, to examine in more detail what the consumer protection concerns are and to introduce options to protect consumers.

Fee Arrangements

CCIR has reviewed various referral fee payment arrangements possible regarding licensed agents paying persons who are not insurance licensed. As noted in the background, most jurisdictions prohibit the payment of referral fees on a commission splitting basis. Permitting commission splitting would be the broadest approach to referral fee payment arrangements. CCIR is considering this as an approach to referral fee arrangements for adoption by all jurisdictions.

If the person making the referral has only directed someone to a licensed agent and not engaged in any other activity, that individual has not engaged in an activity for which an insurance licence is required and need not be licensed. The Mutual Fund Dealers Association permits such arrangements where the referral is between a mutual fund firm and a regulated financial services sector entity, including insurance agents.

Consumer Protection Concerns About Referral Fees

There are at least three reasons why consumer protection is an issue in regard to referral fees. Note that the first concern relates only to unlicensed persons, the second primarily to unlicensed persons and the third to any person giving a referral, whether or not a licensed agent.

1. There is a risk that an unlicensed person making the referral may have been soliciting insurance or have given insurance advice to the person being referred. Without being licensed, the person would not have been subject to any review as to proficiency in insurance or suitability for engaging in insurance activity.

2. The second concern is that the potential customer who is referred will likely not be informed that the referral was made to the specific agent or insurer because of the referral fee arrangement. The person referred should be aware that the person making the referral has a financial interest in doing so and thus may have a conflict of interest. Furthermore, the amount of the fee payment might influence the consumer's decision to do business with the insurance agent or insurer.

3. The person making the reference could release personal information without permission.

Potential Measures for Consumer Protection

The following is a list of the broad categories of measures considered by the CCIR to protect consumers in regard to referral arrangements.

- Parties to the fee arrangement restricted to regulated financial service providers
- Disclosure
- Restriction on fee levels
- Record keeping regarding the referral arrangement

Measures to protect personal information were considered. Information such as name and address could be passed on in a referral. However, legislation of general application protecting privacy is now in place in all jurisdictions in Canada as of January 1, 2004. This will apply to the insurance industry for the protection of the type of personal information that needs to be released in a referral.

IV DESCRIPTION OF OPTIONS

Parties to Referral Arrangement

A regulatory option is to restrict referral arrangements to parties who are regulated financial service providers. There would likely be more pressure on a financial service provider licensed by another regulator to adhere to insurance referral rules than there would be on a person who is not in a regulated occupation. This is because the licensed financial service provider could not only be penalized by the insurance regulator (assuming that the violation is acting as an insurance agent when unlicensed) but also could be disciplined by his or her own financial services provider regulator.

In addition to the possibility of closer adherence to referral fee rules, restricting referral fees to financial service providers would mean better monitoring for compliance. There would be a smaller group involved in referral fee arrangements and record keeping in regard to referral fees would likely be better. The Mutual Fund Dealers Association restricts those to whom its members can pay referral fees, as does the Bureau des services financiers, in regard to those it regulates (insurance intermediaries and financial planners).

A negative aspect of confining referral arrangements to licensed financial service providers is the restriction it places on an agent's ability to use creativity to find new sources of referral and reach potential clients who might benefit from insurance but not otherwise be approached. With no such restriction, this creativity could be exercised. If with a no-restriction option, there proved to be an identifiable tendency for those not licensed as financial service providers to abuse referral fee arrangements significantly more than licensed financial service providers, restrictions could be introduced.

Except for Quebec, jurisdictions that currently permit referral fees do not restrict to whom these fees can be paid. Also, the Investment Dealers Association of Canada has no rule restricting referrals to regulated entities.

The CCIR seeks comments on the two options:

1. Restrict referrals to regulated financial service providers only
2. No restriction on who can make referrals

Disclosure

Disclosure is a major consumer protection measure in regard to referral fees. As noted earlier, the referral arrangement can create for the referring person, a conflict of interest. The CCIR proposes that disclosure of the referral arrangement be mandatory. The customer can then decide whether to proceed with the transaction. British Columbia is the only Canadian jurisdiction that requires disclosure.

There are options as to who, when, how and what to disclose.

Who and When to Disclose

The requirement to disclose would apply to licensed agents and brokers and to insurers. These entities are currently regulated. The requirement would, at a minimum, apply where they pay a referral fee. Those agents or insurers who have paid a referral fee would need to disclose prior to the transaction or the delivery of service. There would be little if any purpose in having disclosure after the transaction. British Columbia requires that disclosure be prior to the transaction. The Mutual Fund Dealers Association rules also require disclosure prior to a transaction.

In addition to requiring disclosure where agents and insurers pay a referral fee, there is the option to make them also disclose the referral arrangement where they will receive a referral fee. Protection of privacy legislation of general application that is now in place in all jurisdictions as of January 1, 2004, requires individuals to authorize the release of personal information such as their name and address for specific purposes before the holder of such information can release it. However, precisely what must be disclosed under the new privacy legislation may not completely meet the needs of disclosure of a referral arrangement. The advantage of also requiring disclosure of a referral fee arrangement at this stage is that the consumer may not even wish to have the referral made. The consumer's approval would be gained at the same time as approval is gained to release the personal information under the protection of privacy legislation.

The Mutual Fund Dealers Association and the Registered Insurance Brokers of Ontario require disclosure of the receipt or potential receipt of a referral fee by their members.

The options being considered are:

1. Disclosure to the customer only by those who have paid a referral fee, disclosure being prior to the transaction or delivery of service
2. Option 1 and in addition, disclosure by those who those who receive referral fees

How to Disclose

Disclosure in writing would provide clear evidence of what was disclosed if questions arise as to the contents of the disclosure. Disclosure in writing also should avoid, at the time of disclosure, any misinterpretation of what is being disclosed.

Disclosure in writing may be difficult where the contact is being made by telephone. Verbal disclosure may be more suitable, although it is possible to delay a transaction for a period of time until written disclosure has been received. If verbal disclosure is used, then some type of tape evidence of the disclosure might be required.

British Columbia requires disclosure in writing.

The options in regard to how to disclose are:

1. Written disclosure only
2. Written disclosure except for telephone meetings. Verbal disclosure in this case would need audio recorded evidence

What Information to Disclose

The consumer must have sufficient information in order to decide whether or not to proceed with doing business with the person to whom he or she has been referred. The Mutual Fund Dealers Association requires the following to be disclosed:

- The reason for the payment or potential payment
- The name of the parties receiving and paying the fee

CCIR considers the following as the main options as to what to disclose:

1. Reason for payment or potential payment and name of the parties receiving and paying the fee

2. Option 1 and in addition, the amount of the fee or how to calculate it

Whether option two is selected depends on whether disclosure of the fact that there is a benefit being received for the referral is believed to be sufficient for a person to make a decision on whether to proceed with a transaction or whether it is necessary to take into consideration the amount of the referral fee. Although British Columbia does not require the amount of the fee to be disclosed or how to calculate it, the Mutual Fund Dealers Association does require this level of disclosure.

Restriction on Fee Levels

If percentage referral fees are permitted, there is the option of establishing a cap on the percentage or amount of the referral fee. A high fee or high percentage could suggest that the person doing the referral is engaged in some activity that should only be done by a licensed agent.

It is argued that a cap on the amount of the referral fee can be an effective regulatory approach to ensure that the person making the referral is only doing the very limited activity of referring. However, placing a cap on the amount of the referral fee or commission percentage interferes with the business judgment of the parties as to what is appropriate based on the facts of the business environment and the bargaining strengths of the parties.

Comment is sought on the following options:

1. Permit percentage fees and other payment based on the sale of a policy
2. Option 2 but with cap on fee percentage and fee amount

Record Keeping

There are options in regard to record keeping. Licensed agents and brokers and insurers could be required to enter into a written agreement prior to the operation of the referral arrangement and keep a record of such agreement. This should provide information to regulators concerning whether referral fees were paid to unlicensed persons and whether the referral activity was actually confined to making a referral. However, this would impose a requirement on agents and insurers that may not be necessary and would require additional monitoring of compliance with the requirement by the regulator. The investigation of any questionable referral activity will need to focus on exactly what was done. The actual referral activity might vary from what is in the agreement.

The Mutual Fund Dealers Association requires that a written agreement exist prior to operation of the referral arrangement. No insurance regulator currently has such a requirement.

Licensed agents and insurers could also be required to keep financial records in a way which would permit the regulator to identify the transactions for which referral fees were paid, the amount of the fees and the amount of fees going to or coming from each person who has been paid or paid referral fees. This could help regulators in any investigation as to whether the referral fees were paid to unlicensed individuals and whether disclosure was provided to customers. The negative to this option is that agents and insurers may need to change their accounts, while the financial information as found in the records may be critical in only a very limited number of cases.

The Mutual Fund Dealers Association has a requirement that all fees be recorded in the books and records of its members while the Bureau des services financier has a requirement that all commission sharing must be separately identified in the accounts of those that it regulates. British Columbia does not have any requirements relating to record keeping for referral fees.

The options regarding record keeping are:

1. Require that a written agreement be made and kept on file
2. Require that accounts be kept identifying the amount of the referral fee related to a transaction
3. Options one and two
4. No record keeping requirements