Segregated Funds Working Group

Issues Paper

May 2016

This document reflects the work of regulators who are members of the CCIR and is intended to generate discussion. 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.

Contents

1. Executive Summary

This Issues Paper outlines the preliminary understanding of the Canadian Council of Insurance Regulators (CCIR) with respect to the fair treatment of customers in the regulatory frameworks for segregated funds/Individual Variable Insurance Contracts (IVICs)[1] and mutual funds. IVICs are well-regulated in Canada, aligning with the recommendations of global regulatory bodies on insurance regulation and fair treatment of customers. However, it is important to continuously strive for disclosure that provides customers with the most meaningful information. It is no longer a matter of when the disclosure requirements will change but how these requirements will change. The CCIR must address the issue now and determine what changes to disclosure requirements must be implemented.

This Issues Paper reviews the current international focus on regulation of financial products and the fair treatment of customers, the regulatory frameworks for IVICs and mutual funds, recent changes to disclosure rules on the mutual fund side, the on-going and future Canadian Securities Administrators (CSA) consultations, and both existing and potential gaps in regulation that have been identified. Recent research report findings have been examined up to March 31, 2016. Preliminary options are presented because of the imperative to address current or potential issues going forward.

The issues discussed are also being considered within the context of the findings of behavioural economics research. Disclosure principles underpin insurance and securities regulation, but what also must be kept in mind is how consumers make use of the information provided; are clients more informed and better able to make decisions, or is too much information being provided that the client does not understand or find helpful? While there will be changes to disclosure in the insurance sector, it is important to ensure it is appropriate disclosure.

The CCIR has certain specific questions for stakeholders; these have been included in this Issues Paper. However, stakeholders are invited to provide any relevant feedback that will assist regulators in ensuring that the regulation of IVICs both protects consumers and ensures a competitive and efficient marketplace for the product.

2. Introduction

2.1 Canadian Council of Insurance Regulators

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:

[1] For clarity, this paper will refer to “IVICs” when discussing the insurance contract product, and “segregated funds” when discussing funds that may be included in IVICs.

- 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.[2]

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.

2.2 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 IVICs and identify existing and potential gaps;
- Assess potential risk of regulatory arbitrage by dually-licensed (insurance and mutual funds) insurance agents;
- Assess a harmonized approach to regulatory issues affecting IVICs 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.

2.3 Definitions

Below, we have defined a few key terms for the purposes of this Issues 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.[3]

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

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[2] 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.

[3] 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.

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.

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.[4]

2.4 Purpose of this Issues Paper

A core principle of insurance regulation is to be accountable and transparent in the exercise of regulatory functions and powers.[5] Providing the opportunity for meaningful public consultation on the development of policies, and in the establishment of new and amended rules and regulations, is a key element of transparency.

This Issues Paper sets out the CCIR's current understanding of the comparative regulatory frameworks for IVICs and mutual funds as of April 2016, including existing and potential gaps that may need to be addressed in order to protect consumers, and invites stakeholder comment. With greater international focus on the fair treatment of customers and the recognition that markets are interconnected across borders and sectors, in addition to recent and ongoing reports and consultations in the financial sector, the CCIR believes this is an opportune time for this Issues Paper. The goal is to stimulate discussion, launch a process of consultation, set expectations, and build a common understanding of the topic and issues for both regulators and stakeholders.

The findings from behavioural economics studies also inform the discussion. While disclosure of information to clients is designed to help investors make better decisions, there are indicators that investors do not know how to use the information provided to make decisions in their own self-interest. Clients also do not have a clear understanding of the duty of care owed to them by their intermediaries.

The existing insurance regulatory framework and supervisory practices may be amended or updated where it is considered necessary or appropriate.

2.4.1 Stakeholder Input Sought

Stakeholders are asked to provide input with respect to the following:

- Whether the CCIR's understanding of the topics and issues as presented is accurate;
- Whether all significant gaps and issues have been identified;
- The extent of harmonization between IVICs 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

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[4] Ibid.

[5] Insurance Core Principle (ICP) 2 "Supervisor", International Association of Insurance Supervisors, in *Ibid.*

- Options to ensure equivalent fair treatment of the customer under both regulatory regimes.

Stakeholder feedback will inform the direction of the CCIR's future work in this area.

3. Background

Ensuring fair treatment of the customer across financial sectors is a matter of both national and international interest. This section briefly reviews the broader context for this Issues Paper.

3.1 Global Context

The global financial crisis that became apparent in 2008 prompted regulatory bodies in various countries to consider risk in the context of a financial system where the rise of financial conglomerates and new technologies means that risks have spread beyond national borders or financial sectors.

The international Joint Forum is a group of regulators from the banking, securities and insurance sectors of 15 countries. It has issued two reports of particular relevance to the issues being considered in this Issues Paper. The first, published in 2010, looked at supervisory and regulatory standards for similar activities in different sectors. It concluded that having different standards for similar activities may pose risks to financial stability and create regulatory arbitrage opportunities, and recommended that similar rules and standards be applied to similar activities.[6]

The second report (2014) assessed differences and gaps specifically in regulatory approaches to point of sale disclosure in relation to investment or savings products in the insurance, banking and securities sectors.[7] This resulted in eight recommendations, all of which focused on providing consumers with clear, concise, fair, and consistent point of sale (POS) disclosure both before and at the time a purchase decision is made.

Current disclosure in the Canadian insurance sector aligns with these recommendations; disclosure on the mutual fund side will align as of May 2016, when new disclosure rules have been fully implemented.[8]

3.2 Current Regulatory Frameworks

Ultimately, the desired outcome of both the IVICs and mutual funds regulatory frameworks is fair treatment of the customer, but if one structure is perceived to be less onerous than the other there may be incentive for intermediaries to prefer to sell the products regulated under one regime over the other. Differences in the regulatory framework of similar products may exist to address their respective and unique features. The potential exists for individuals who are dually licensed to sell both mutual funds and life insurance products to let self-interest influence their product recommendations. This is contrary to providing fair treatment to the customer or acting in the client's interest.

Although the CCIR is not aware of any statistical evidence to demonstrate that regulatory arbitrage is occurring within the mutual fund/IVICs sectors, in order to protect consumers it seeks to proactively

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[6] *Review of the Differentiated Nature and Scope of Financial Regulation,* January 2010. The Joint Forum (Basel Committee on Banking Supervision, International Organization of Securities Commissions, International Association of Insurance Supervisors).
[7] *Point of Sale Disclosure in the Insurance, Banking and Securities Sectors*, April 2014. The Joint Forum (Basel Committee on Banking Supervision, International Organization of Securities Commissions, International Association of Insurance Supervisors).
[8] Required delivery of Fund Facts at point of sale (vs. within two days as prior to that date).

amend standards where appropriate to ensure that intermediaries have little incentive to prioritize their own interests over those of clients. [9]

3.2.1 IVICs

IVICs are life insurance contracts. Each IVIC has an annuitant who consents to be the life insured ("measuring life") for purposes of the death guarantee. The contract holder may name beneficiaries. In a registered IVIC, the annuitant must be the contract holder (this is not the case for non-registered IVICs). IVIC contract holders pay premiums to the life insurance company and are allocated notional units in the segregated funds of their choice. Notional units serve only to determine the value of the contractual benefits under the IVIC – the segregated fund itself is owned by the life insurance company.

The authority to issue IVICs is given to life insurance companies under their incorporating legislation, which could be under section 450 of the federal *Insurance Companies Act* (for the majority of life insurers) or provincial legislation. Most life insurance companies offering IVICs provide segregated funds as an investment option (some may offer other investment options under an IVIC, such as fixed term guaranteed rate or daily interest accounts).

Segregated funds must be maintained and accounted for separate and apart from the insurer's other assets. Depending on the jurisdiction in which an insurance company is incorporated (federal or provincial), its solvency and governance are regulated by the federal Office of the Superintendent of Financial Institutions (OSFI) or by a provincial regulator. Regulators require that adequate reserves be maintained by life insurance companies in respect of the guarantees provided under an IVIC.

The regulation of an IVIC as an insurance contract is governed by provincial insurance acts, which mandate the generally applicable elements of all life insurance contracts, as well as the marketing and disclosure to purchasers of IVICs and the segregated funds offered as investment options under them. Intermediaries who recommend and sell IVICs must be licenced under provincial insurance legislation and must satisfy certain proficiency requirements and be monitored by the life insurance companies whose IVICs they sell and, in Québec, by their dealers. Provincial insurance regulation also incorporates standards for the management of segregated fund assets.

In several provinces, certain regulatory functions have been delegated or assigned to self-regulatory insurance councils.[10] In most jurisdictions, IVICs cannot be sold to the public until an insurance contract, application and information folder are filed, in approved form, with the provincial insurance regulators.

Expectations of the provincial regulators are also contained in IVICs guidelines:

- The *Guideline on Individual Variable Insurance Contracts Relating to Segregated Funds* sets out the expectations of Québec's financial services regulator, the Autorité des marchés financiers (AMF). The guideline is largely harmonized with the G2 provisions described below.

- The Canadian Life and Health Insurance Association (CLHIA) Guideline G2: *Individual Variable Insurance Contracts related to Segregated Funds* (commonly referred to as the "G2") was endorsed by the CCIR in 1997 and sets out the expectations of regulators in the common-law

[9] *An Approach to Risk-based Market Conduct Regulation,* October 2008. Canadian Council of Insurance Regulators.
[10] British Columbia, Alberta, Saskatchewan, Manitoba and Québec.

jurisdictions.[11] The G2 provides a comprehensive code for, among other things, the conduct of the sponsoring life insurance company, management of the segregated funds, and product and financial disclosure, including advertising and distribution. The G2 has regulatory standing only in Ontario, but in practice the other common-law jurisdictions require compliance with the G2.

Most life insurance companies engage portfolio manager subsidiaries for investment management of their segregated funds; many appoint external, unrelated portfolio managers and some invest segregated fund assets directly in mutual funds managed by external portfolio managers. Administration of IVICs and segregated funds is done by the life insurer or a third party service provider with whom they have contracted.

3.2.2 Mutual Funds

Mutual funds are separate legal entities and issuers of securities. In contrast to segregated funds, which are owned by life insurers, a mutual fund's investors own shares or units of the fund. Each province and territory in Canada regulates the manufacturing and distribution of mutual funds and other securities in its jurisdiction under provincial securities legislation and through a government agency (usually a securities commission).

Through the CSA, efforts have been made to develop uniform and harmonized rules that are applicable to all investment funds (e.g. mutual funds, exchange-traded funds, non-redeemable investment funds, scholarship plans) offered for distribution in Canada.

Similarly, the CSA's regulation of investment fund managers is generally uniform. The main rules that govern mutual funds and investment fund managers are found in national instruments that are created by the CSA and adopted by each provincial and territorial securities regulatory authorities.[12] These rules cover the governance, disclosure, custody of assets, investment restrictions, calculation of net asset value and operations of an investment fund.

To act as representatives, individuals must be sponsored by a dealer and be registered with the securities regulatory authority in each jurisdiction in which they operate or wish to operate. They must meet proficiency requirements.

A dealer must be registered with the appropriate securities regulatory authorities and, depending on the jurisdiction and the types of securities the dealer is authorized to sell, it may have to be a member of the Mutual Fund Dealers Association (MFDA) or the Investment Industry Regulatory Organization of Canada (IIROC). The individuals sponsored by a dealer are also regulated by the MFDA or IIROC, except in Québec where some of them are regulated by the Chambre de la sécurité financière.

Some of the functions of an investment fund manager include establishing a distribution channel for the fund, overseeing the day-to-day administration of the fund, retaining and liaising with the portfolio manager, the custodian, the dealers and other service providers of the fund. Every firm that acts as an

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[11] In Ontario these Guidelines are referenced in Regulation 132/97 of the Insurance Act, R.S.O. 1990; Ontario is the only common-law province that references the G2 specifically in its regulations.

[12] See, among other things, National Instrument 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations; National Instrument 81-101 respecting Mutual Fund Prospectus Disclosure; National Instrument 81-102 respecting Investment Funds; National Instrument 81-105 respecting Mutual Fund Sales Practices; National Instrument 81-106 respecting Investment Fund Continuous Disclosure; and National Instrument 81-107 respecting Independent Review Committee for Investment Funds.

investment fund manager, along with its ultimate designated person and chief compliance officer; and every firm that acts as a portfolio manager, along with its ultimate designated person, chief compliance officer and representatives, must also be registered with the relevant securities regulatory authorities.

3.3 Regulatory Developments in Canada

3.3.1 CCIR-CSA and Joint Forum Reviews

Insurance and securities regulators share common goals in the regulation of asset accumulation products that fall under their jurisdictions. These goals include effective regulation that is responsive to consumer needs and industry trends, and, where appropriate, coordinating and harmonizing the treatment of similar products. Fair treatment of the customer is a primary concern for both sectors.

In 1999, the CCIR and the CSA worked together and with their respective industries to compare key features of IVICs and mutual funds regulation, based on 100 points of comparison. In a report published by the Canadian Joint Forum of Financial Market Regulators (Joint Forum),[13] the working group concluded that the key features of the regulation were essentially similar, but identified several areas in which further harmonization was recommended. The continued philosophy of the CCIR is reflected in this statement:

> "…the regulatory objectives for IVICs and mutual funds are similar, but because the products are based on fundamentally different legal principles, are satisfied in different ways…harmonization of *result*, rather than harmonization of rules should be the goal."[14]

Most of the recommendations were implemented through amendments to CLHIA's G2 in 2001.

Further collaborative work was undertaken in 2002, with a focus on disclosure under the two regulatory frameworks. In 2003 the Joint Forum released recommendations on point of sale disclosure. This led to extensive discussions with industry and other stakeholders. In 2009, the CCIR and the CSA worked together to complete the Point of Sale project, which included a fresh review of the regulatory frameworks for IVICs and mutual funds and consideration of issues related to the fair treatment of customers. The mandate was to:

- Develop a point of sale disclosure system that provided consumers with information to assist them in making an informed investment decision; and
- Harmonize, to the extent possible, the point of sale disclosure system for IVICs and mutual funds.

As a result of this project, the CLHIA amended G2 on January 1, 2011 while the AMF issued the first version of its guideline on the same date to require insurers to include in the information folder a Key Facts executive summary (describing the insurance features in the contract) and a Fund Facts document (describing each investment fund available through the contract). Insurers were required to make Fund

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[13] A voluntary organization of Canadian securities, insurance and pension regulators, not to be confused with the international Joint Forum mentioned in section 3.1.

[14] *Recommendations for Changes in the Regulation of Mutual Funds and Individual Variable Insurance Contracts.* Joint Forum of Financial Market Regulators, December 15, 1999. http://www.jointforum.ca/en/init/ivics_mutualfunds/15%20recommendations%20(december%201999).pdf.

Facts continuously available to contract holders on their websites and to provide printed copies upon request without charge.

Mutual funds are also required to provide a Funds Facts document to investors, however this requirement has been phased in since July 2011 and will be fully implemented as of May 30, 2016.

In 2009, the CCIR's Intermediary Regulation Working Group had examined the effectiveness of insurers' compliance monitoring systems with respect to the selling of IVICs by insurance intermediaries, specifically for client needs analysis. This review found that in general, insurance companies had adequate policies and procedures in place to oversee agents and monitor compliance, but that these were not applied in the same way to MGAs.[15]

The CCIR and the CSA continue to engage in an effort to achieve equivalent regulatory standards and fair treatment of customers.

3.3.2 CRM2

The most significant recent changes in the area of mutual funds regulation have been those collectively known as the Client Relationship Model – Phase 2 (CRM2). In July 2013, the CSA introduced changes as part of an ongoing effort to provide investors with more transparency and better disclosure around fees and performance in the securities industry.[16]

CRM2 notably requires registrants to:

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

CRM2 was adopted in July 2013 and is being phased in over three years. Since December 31, 2015 enhanced client statement requirements have been in force with regards to detailed position cost (book or original cost) information and market value using prescribed methodology. Summer 2016 is the final implementation step of this initiative as dealers will have to deliver annual reports to investors on charges and other compensation and an annual investment performance report of the client's portfolio for a period that includes July 15, 2016.

The focus of CRM2 is to provide disclosure of the charges and other compensation received by the dealer rather than the overall cost of the investment product. In particular, the requirement to disclose fees received in dollar terms has raised questions about whether comparable disclosure should be required for IVICs.

[15] *Final Report on Intermediary Regulation in the Securities and Insurance Sectors* (DRAFT). Joint Forum of Financial Market Regulators, March 4, 2011.
[16] http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130328_31-103_notice-amendments.htm.

3.3.3 CSA Consultations

The CSA has been consulting on several issues of particular relevance to this Issues Paper, including:

- The possibility of introducing a statutory "best interest" standard for securities registrants who provide advice to retail clients;[17]
- How to address the potential investor protection and market efficiency issues arising from Canada's current mutual fund fees structure[18], and
- Introducing a standard risk classification methodology in the Fund Facts for mutual funds and exchange traded funds (ETFs).[19]

The fact that these consultations are happening in the securities sector is one factor contributing to the timing of the CCIR's review of IVICs regulation. The CCIR will closely follow and assess the outcome of these consultations on the mutual funds side when determining next steps.

3.3.4 Cooperative Capital Markets Regulatory System

In 2014, the federal government and five provinces (British Columbia, New Brunswick, Ontario, Prince Edward Island and Saskatchewan) agreed to work together to implement the Cooperative Capital Markets Regulatory System (CCMRS). Yukon joined the agreement in 2015. A uniform Capital Markets Act (CMA) would be adopted by each participating provincial or territorial jurisdiction, and a federal Capital Markets Stability Act (CMSA) would be enacted by Parliament.

Of concern to the IVICs sector is that the CMSA as drafted defines a security as including "any contract, instrument or unit commonly known as a security" but does not include an explicit exemption for contracts of insurance issued by licensed insurance companies (as does current provincial securities legislation in the participating jurisdictions). The draft CMA allows for an exemption for certain products "unless otherwise provided by the regulations" - which raises the possibility that a participating jurisdiction could choose to regulate IVICs as securities. This could lead to unnecessary duplication of regulation, as many stakeholders have noted, and would increase confusion amongst consumers.[20]

3.4 Comparison of IVIC and Mutual Fund Key Features

This section gives a brief overview of the key features that distinguish segregated funds and mutual funds.

Segregated funds resemble mutual funds. However, there are some differences that justify why one is considered a securities product and the other an insurance product, and regulated as such. The defining factor is the existence of the life insurance contract under which the contract holder invests in segregated funds. This insurance contract (the IVIC) offers certain protections, including:

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[17] *CSA Consultation Paper 33-403: The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients*. Canadian Securities Administrators. October 25, 2012.

[18] *CSA Discussion Paper and Request for Comment 81-407: Mutual Fund Fees*. Canadian Securities Administrators. December 13, 2012.

[19] *CSA Notice and Request for Comment: Proposed Amendments to National Instrument 81-102 Investment Funds and Related Consequential Amendments*. Canadian Securities Administrators. December 10, 2015.

[20] http://ccmr-ocrmc.ca/wp-content/uploads/CMSA-English-revised.pdf.

- 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 IVICs 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).

IVICs are expressly exempt from provincial securities legislation if they provide the minimum 75% premium guarantee.

Another key difference is that while mutual fund investors own securities of a fund, IVIC 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. As with mutual funds, the net asset value (NAV) of the notional units fluctuates with the fair value of the fund's assets and liabilities.

Segregated funds have been available from Canadian life insurance companies for over 50 years. Traditionally, they have been managed and sold by insurance companies. Some mutual funds also incorporate guarantee features. These funds are referred to as Guaranteed Income Funds (GIFs). Typically, GIFs will guarantee the principal investments if some conditions are met. The guarantee is provided by a financial institution and an insurer.

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.

4. Regulatory Gaps Identified

The CCIR has identified several areas in which there are gaps in regulation between mutual funds and IVICs.

When referring to harmonization between mutual funds and IVIC regulatory frameworks, the focus is on harmonized outcomes. This Issues Paper examines in detail outcomes such as the fair treatment of customers and other aspects of disclosure, in addition to standard of care and sales oversight for intermediaries.

4.1 Disclosure

Disclosure is an underlying principle of insurance and securities regulation. It is generally assumed that if consumers are provided with sufficient information, they are more likely to understand the implications of their purchase decisions and choose more wisely. Ensuring that consumers are given complete and accurate disclosure, particularly of actual or potential conflicts of interest, is an increasing priority for financial services regulators. Regulators also take into account the implications of behavioural economics on how consumers use the disclosure information provided.

4.1.1 Fees and Compensation

Internationally, financial services regulators are paying more attention to the way fees are charged and the compensation received for the provision of financial advice. The compensation intermediaries receive and the nature of the disclosures they provide regarding compensation has been a key interest of the CCIR. There is also significant interest among securities regulators surrounding the current mutual funds fee structure and potential investor protection and market efficiency issues, as evidenced by the CSA's 2012 consultation paper on mutual fund fees and two other independent pieces of research the CSA commissioned in 2014.[21] Of particular interest is how embedded intermediary compensation and other forms of tied compensation could give rise to actual or perceived conflicts of interests at the manufacturers' and intermediaries' levels.

In 2015 the CSA published its two commissioned reports on mutual fund fees.[22] These reports were commissioned to (i) evaluate the extent, if any, to which sales and trailing commissions influence mutual fund sales, and (ii) conduct a literature review to evaluate whether the use of fee-based vs. commission-based compensation changes the nature of advice and investment outcomes over the long term.

The research conducted by the Brondesbury Group found that:

- There is conclusive evidence that commission-based compensation creates problems for investors.
- While commission-based compensation is problematic, there are other factors affecting the client-intermediary relationship and influencing sales that would persist under a fee-base model (e.g. advancement, recognition, affiliation between the investment fund manager and a dealer firm).
- There is not enough literature on fee-based compensation compared to commission-based compensation to determine its impact on investors.

The research conducted by a team led by Professor Douglas Cumming found that conflicts of interest, specifically sales commissions and trailing commissions paid by manufacturers (embedded compensation), dealer affiliation and the use of deferred sales charge arrangements materially affect intermediary/dealer behaviour to the detriment of investor outcomes and market efficiency.

Although the studies did not include segregated funds, the results might be extrapolated to sales of IVICs.

The CSA is expected to release a policy direction on mutual fund fees structure in the first half of 2016. Options proposed in *CSA Discussion Paper and Request for Comment 81-407: Mutual Fund Fees* published in December 2012 included:

- Specifying and providing services in exchange for trailing commissions;
- Creating a standard class for DIY investors with no or reduced trailing commission;
- Unbundling trailing commissions from management fees (as separate asset-based fees);
- Creating a separate series or class of funds for each purchase option;
- Capping commissions;
- Implementing a best interest statutory duty; and

[21] *CSA Discussion Paper and Request for Comment 81-407: Mutual Fund Fees*. December 13, 2012; *Mutual Fund Fee Research*. Brondesbury Group, Spring 2015; *Dissection of Mutual Fund Fees, Flows, and Performance* Douglas J. Cumming, Sofia Johan and Yelin Zhang. October 19, 2015.

[22] *Mutual Fund Fee Research*. Brondesbury Group, Spring 2015; *Dissection of Mutual Fund Fees, Flows, and Performance*. Douglas J. Cumming, Sofia Johan and Yelin Zhang. October 19, 2015.

- Banning embedded commissions altogether.[23]

This concern about managing conflicts of interest with respect to embedded commissions is not confined to the insurance and securities sectors. For example, British Columbia's Financial Institutions Commission (FICOM) is proposing enhancements to conflict of interest disclosure requirements of mortgage brokers. Under FICOM's proposal, mortgage brokers would be required to disclose to consumers in dollar amounts the commission and volume bonuses, plus other compensation and remuneration that a broker and their brokerage receive from a lender.[24] This has led to a great deal of discussion among mortgage sector participants, both in favour and against.

The CCIR will review the CSA policy direction and consider stakeholder feedback on whether enhanced disclosure of dealer compensation, or other proposed methods of mitigating conflicts of interest associated with embedded commissions, would be appropriate and advisable for IVICs.

4.1.1.1 Restricting/Banning Embedded Commissions

One proposed option to address the problems associated with mutual fund fees is to ban embedded commissions paid to intermediaries by manufacturers, as is being considered by the CSA and has been done in the United Kingdom and Australia.

Australia's Future of Financial Advice (FOFA) reforms became effective in July 2013. These included a ban on "conflicted remuneration" which includes any monetary or non-monetary benefit given to a registrant that could reasonably be expected to influence his/her personal financial advice to clients.[25] Advisors must also act in the client's best interests at all times.

In 2006, the UK's Financial Services Authority (FSA) – since replaced by the Financial Conduct Authority (FCA) - launched its Retail Distribution Review (RDR). The RDR resulted in a set of regulatory changes aimed at improving standards of financial advice, and consumers' understanding of the cost of investing. Most significantly, these reforms introduced a ban on advisor remuneration that might result in conflict of interest, a requirement to distinguish "restricted" vs. "independent" advice, and higher standards for proficiency and professionalism.[26] As of January 2013 UK financial advisors must provide their clients with a clear charging structure and clear information on their charges rather than accept sales commissions from product providers. Examples of charging methods include hourly rates, a fixed fee, percentage charges or a combination of these. The charge must be clear to the consumer. Ongoing charges may only be taken if an ongoing service is provided.[27]

4.1.1.2 Effects of regulatory reforms related to embedded compensation

Some have expressed concern that a ban on "conflicted remuneration" would result in a higher cost for full service advice and more use of simplified advice (e.g. "robo-advisors") for lower income and lower wealth investors; increased use of technology-assisted brokerage services; and an increased rate of retirement among older advisors resulting in a shortage of advisors. [28]

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[23] http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_2012123_81-407_rfc-mutual-fund-fees.pdf.
[24] http://www.fic.gov.bc.ca/pdf/mortgagebrokers/consultationletter.pdf
[25] http://download.asic.gov.au/media/1247141/rg246.pdf
[26] *FSA Discussion Paper 07/01*: A Review of Retail Supervision, June 2007.
[27] https://www.the-fca.org.uk/adviser-charging-rules Financial Adviser - Adviser charging rules, (published January 11, 2016).
[28] *Mutual Fund Fee Research*. Brondesbury Group, Spring 2015.

The Australian Securities and Investment Commission (ASIC) found in 2014 that there had not been an "exodus" of financial advisors from the industry since the FOFA reforms had been implemented in July 2013, and that although there had been an increase overall in fixed fees for advice, the increase was generally small.[29]

The FCA reported in December 2014 that they had observed no significant reduction in the availability of individuals providing advice, commissions were no longer a driving factor in advisors' recommendations and advisors were providing an increasingly professional service tailored to their clients' individual needs. [30]

The UK's Financial Advice Market Review (FAMR) was launched in August 2015 to analyze the post-reforms effectiveness of the regulatory and legal framework governing the provision of financial advice and guidance to consumers. The final report of the FAMR was published in March 2016. It sets out 28 recommendations, which focus on three key areas: affordability, accessibility and liabilities/consumer redress, including a proposal that the FCA should set up a dedicated team to help firms developing large-scale automated advice models so these can be brought to market more quickly.[31]

The next phase of the FCA's post-implementation review will be published in 2017 followed by a subsequent third phase of the review which will consider the longer-term implications.[32]

4.1.2 Charges and Compensation Reports

The implementation of CRM2 for mutual funds will result in less similarity with IVICs compensation disclosure. This difference may result in investors not fully understanding the fees that are being charged for the two types of product, what the fees represent, and the impact on their investment returns.

Under CRM2, dealers will have to provide an annual report on charges paid as well as compensation received.   This includes:

- Operating charges, such as service charges, administration fees, safekeeping fees, management fees, transfer fees, account closing fees, and annual registered plan fees paid to the firm including sales taxes paid on those amounts;
- Transaction charges, such as commissions, transaction fees, switch or change fees, performance fees, short-term trading fees, and sales charges or redemption fees that are paid to the firm including sales taxes paid on those amounts;
- Total dollar amount of trailing commissions received by the registered dealer in connection with securities owned by the client, accompanied by a statement advising the client that the trailing commission is paid by investment fund managers, its amount varies depending on the purchase

[29] *Review of the financial advice industry's implementation of the FOFA reforms.* Report 407, Australian Securities and Investment Commission, September 2014. http://download.asic.gov.au/media/1845586/rep407-published-17-september-2014.pdf.
[30] https://www.fca.org.uk/news/early-indications-that-reforms-of-financial-advice-are-working (published December 16, 2014).
[31] *Financial Advice Market Review: Final Report*. Financial Conduct Authority and HM Treasury, March 2016. https://www.fca.org.uk/your-fca/documents/financial-advice-market-review-final-report.
[32] https://www.fca.org.uk/news/post-implementation-review-of-the-rdr.

options selected, and that these fees impact the customer because they reduce the amount of the fund's returns[33]

Disclosure of these fees is not required for investments in the same accounts that are not securities, such as Guaranteed Investment Certificates or IVICs, however the CSA and the MFDA encourage dealers to voluntarily disclose them.[34]

Management and operating expenses are paid each year by segregated funds and include such elements as fund manager's fees, legal and accounting fees, custodial fees and bookkeeping costs. Under the IVIC Guidelines the management expense ratio (MER) of a segregated fund must be disclosed. The MER is the percentage these expenses represent of the fund's average net assets.

Some insurers currently provide clients with the actual dollar amounts and breakdown of fees for IVICs. A requirement for more detailed information on how the MER is calculated would assist consumers in understanding why these are typically higher for segregated fund products than for mutual funds. To align with CRM2, all fees paid by the insurance account holder should be disclosed by the insurance company.

Questions

1. What enhanced disclosure of charges and other compensation for IVICs would encourage intermediaries and consumers to examine more closely the products recommended and purchased? Please explain.
2. How else might better disclosure and transparency be achieved by the IVICs industry?

4.1.3 Brokerage Arrangements ("Soft Dollars")

Soft dollar arrangements arise where benefits are exchanged instead of actual cash. Typically, investment dealers provide fund or portfolio managers with proprietary in-house research (or credits to purchase independent research, in the case of discount brokers) in exchange for an agreement to send the dealer trades, for which the dealer will earn commission. The soft dollar arrangements may not be clearly itemized, so in effect may be considered "hidden" to investors. Additionally, these arrangements can be perceived as promoting conflicts of interest for portfolio managers when they direct a trade to dealers in return for the provisions of any good or service. In the interest of transparency and to ensure that investors have an informed understanding of total costs, it is important to value soft dollar transactions.

The United States Securities and Exchange Commission has proposed banning soft dollar arrangements altogether.[35] However, it has been argued that in most cases these arrangements are preferable for investors to having the fund managers pay for research; that in fact, soft dollars may limit conflicts of

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[33] *CSA Notice of Amendments to National Instrument 31-103*: *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and to Companion Policy 31-103CP. March 28, 2013. http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130328_31-103_notice-amendments.htm.

[34] *CSA Staff Notice 31-337*: *Cost Disclosure, Performance Reporting and Client Statements* - Frequently Asked Questions and Additional Guidance as of February 27, 2014 http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20140227_31-337_faqs-guidance-31-103_2.htm http://www.mfda.ca/regulation/bulletins15/Bulletin0657-C.pdf.

[35] https://www.sec.gov/rules/interp/34-52635.pdf.

interest by aligning the interests of fund managers and their executing brokers to increase returns on the portfolio.[36] What seems clear is that investors should be made aware of such arrangements.

In 2009 the CSA published rules to clarify when intermediaries (e.g., investment fund managers, portfolio managers or investment managers with discretionary authority) are permitted to exchange client brokerage commissions with securities dealers for goods and services.[37] Intermediaries are required to provide disclosure to a client before opening a client account or entering into a management contract or similar agreement which includes:

- Description of the process and factors considered in selecting a dealer;
- Description of the nature of potential soft dollar arrangements;
- List of each type of research good or service that might be provided; and
- Description of the method by which the intermediary makes a good faith determination that the client receives reasonable benefit from a soft dollar arrangement.

Intermediaries will also have to provide annual disclosure of these requirements to their clients.

Mutual funds are required to provide similar detailed disclosure in their annual information form about brokerage arrangements. Among other things, this disclosure includes the process and other factors considered in selecting the dealer to effect securities transactions for the mutual fund, the nature of the arrangement and each type of good or service, other than order execution, that might be provided.[38]

Similar requirements do not exist for IVICs. To address this gap, such measures on the IVICs side should be implemented, keeping in mind any differences in distribution models that might preclude imposing exactly the same requirements.

Questions

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

4.1.4 Account Performance

Existing gaps in performance disclosure between mutual funds and segregated funds will be increased after the full entering in force of CRM2 requirements for dealers to provide an annual account report of performance in dollar terms and for various time periods. Notably, the annual performance report must include:

- Deposits into, and withdrawals from, the client's account;
- The change in value of the account;

[36] *The SEC's 2006 Soft Dollar Guidance: Law and Economics.* D. Bruce Johnsen. George Mason Law & Economics Research Paper No. 08-25, 1551, April 2008.
[37] *Canadian Securities Administrators*, NI 23-102 – Use of Client Brokerage Commissions, http://www.osc.gov.on.ca/documents/en/Securities-Category2/rule_20150601_23-102_brokerage-commissions.pdf.
[38] Section 10.4 of *Form 81-101F2 – Contents of Annual Information Form, National Instrument 81-101 – Mutual Fund Prospectus Disclosure*.

- Annualized total percentage return using a dollar-weighted methodology for a 1, 3, 5 and 10 year period, as well as since inception.[39]

The MFDA requires its members to include GIC and segregated funds in the account performance report.[40]

Question
5. How should account performance reports for IVIC contract holders be harmonized with those on the mutual fund side? What adjustments could be made to take into consideration IVICs' guaranteed protections?

4.1.5 Product Performance

For IVICs, past performance must be reported, at a minimum, on a 1, 3, 5 and 10 year basis. Under current guidelines, IVIC Fund Facts documents must include reporting of year-by-year return information and 10 year average return information. [41]

For mutual funds, performance disclosure at the fund level is provided in the Fund Facts and in the Annual and Interim Management Report of Fund Performance (MRFP). Past performance data included in sales communications should not be more than three months old.

Among other things, the CSA has modified disclosure in Fund Facts for mutual funds to include the best and worst three months performance. IVICs are often used as longer-term financial and estate planning tools. Therefore, when considering whether enhanced performance reporting should be introduced for IVICs, it is necessary to consider what information IVIC contract holders need to receive on an annual basis to make informed decisions about rights they can exercise under their contracts. Performance information for IVICs must also consider their unique features, such as guarantees.

In addition, under existing rules, mutual funds include in their MRFPs a brief analysis of the fund's performance, financial highlights and ratios, a breakdown of the management fees, past performance and a summary of the fund's investment portfolio. The management reports complement and supplement the fund's financial statements.

A similar report is not required for segregated funds. Although most of the information is made available in other documents prepared for segregated funds, a similar report would be a means to achieve comparable disclosure for mutual fund and IVIC fund performance and provide this information to the investor in one document.

[39] *CSA Notice of Amendments to National Instrument 31-103*: *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and to Companion Policy 31-103CP. March 28, 2013.
[40] *Implementation of Requirements under CRM2 Phase 2 Amendments to National Instrument 31-103* – Frequently Asked Questions (FAQs) – Revised as at September 1, 2015. http://www.mfda.ca/regulation/bulletins15/Bulletin0654-P.pdf CRM2 Implementation Guide and Tips http://www.mfda.ca/regulation/bulletins15/Bulletin0657-C.pdf.
[41] IVIC Guidelines, Form 1, Part H, Item 4.

Questions

6. Are IVICs generally considered to be held as a long-term investment compared to other types of investment products?
7. To what extent should the enhanced investment performance data requirements be harmonized with mutual fund rules?
8. What additional data would be of value to IVIC contract holders?
9. What differences could be made to take into account the guaranteed protections in an IVIC?

4.1.6 Disclosure upon Subsequent Fund Purchases

When consumers invest additional funds in a mutual fund or IVIC after the initial investment, the disclosure requirements differ for each product. For mutual funds, if the Fund Facts has been revised since the initial purchase, in most cases, the revised version must be provided to the investor upon subsequent purchases of units in the same fund. However, the same requirement is not explicitly stated for segregated funds. With the possibility of electronic distribution, it would make sense to have similar proactive requirements.

Question

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

4.1.7 Risk Classification Methodology

Currently mutual fund and segregated fund managers can select the classification method used to indicate the level of risk of the particular mutual fund or IVIC product. This presents fund manufacturers with opportunities to choose a method that may present a more favourable risk level than another method might indicate.

The Fund Facts document requires a mutual fund to provide its investment risk level based on a risk classification methodology which is chosen by the fund manager. The CSA has proposed a standardized risk classification methodology in an effort to provide enhanced transparency and consistency to allow investors to more easily compare investment risk levels in different mutual funds and exchange-traded funds (ETFs).[42] The risk level would be grouped in one of five categories based on the degree to which returns varied over a 10-year period from the average return. The risk level is to be determined at least annually. The proposed amendments, if approved, are expected to be in force early 2017.

The CCIR is considering whether this new risk classification methodology would be appropriate for IVIC point of sale disclosure documents and whether it should be adopted by the insurance regulators. Because of the guarantee in an IVIC, risk exposure can be substantially different than that of a comparable mutual fund.

[42] *CSA Notice and Request for Comment: Proposed Amendments to National Instrument 81-102: Investment Funds and Related Consequential Amendments*. Canadian Securities Administrators. December 10, 2015.

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

4.2 Behavioural Economics Studies

Investor outcomes are influenced by behavioural economic factors. The effectiveness of regulatory disclosure requirements may be considered in the context of the research findings of behavioural economic studies. This area of study examines the effects of psychological, social, cognitive and emotional factors on the economic decisions made by individuals and institutions. Behavioural economists have demonstrated that behavioural biases can cause individuals to act irrationally and even contrary to their self-interest at times. In fact, even with perfect knowledge and information, individuals may act in a manner that is contrary to their best interests because they are subject to systemic psychological and emotional influences such as biases, overconfidence, social pressure and anxiety.[43]

While there is a growing emphasis on regulatory disclosure, studies have found that mutual fund investors do not always discount the value of advice received from an intermediary even when a conflict of interest is disclosed. This may not be surprising, as other factors certainly are involved in transactions. What is worrisome is the possibility that disclosure requirements have been found, in some cases, to actually *increase* the bias in advice. Once the necessary disclosure has been made, intermediaries may feel that they have licence to exaggerate their advice even further, because the client can be considered well-informed of the potential conflicts of interest. In such cases, enhanced disclosure requirements could not only fail to resolve issues of conflicts of interest, but might aggravate them. [44]

A study on the disclosure of mortgage broker compensation in the United States found that detailed disclosure caused some consumers to make worse, not better choices, by leading them to focus on the fees disclosed and disregard other relevant factors in determining the cost of a mortgage. Investors may also simply be overwhelmed by information to the point where additional disclosure may compromise the usefulness of disclosure generally.[45]

Overall, such studies suggest that for disclosure to be effective, investors must know what to do with the information that has been disclosed; they must understand how the conflict of interest has influenced the intermediary and be able to correct for that biasing influence.[46] In addition, disclosure has been shown to be more effective if:

- The disclosure is provided by an external source rather than from the intermediary;

[43] Douglas C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioural Economics about Stockbrokers and Sophisticated Customers,* 84 California Law Review (1996) 627 at 670-672: http://scholarship.law.berkeley.edu/californialawreview/vol84/iss3/2/,Kristine Erta, Stefan Hunt, Zanna Iscenko, Will Brambley, *Appying behavioral economics at the Financial Conduct Authority,* Occasional Paper No.1, April 2013, at https://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-1.pdf.

[44] Daylian M. Cain, George Loewenstein and Don Moore*, The Dirt On Coming Clean: Perverse Effects Of Disclosing Conflicts Of Interes*t.; The Journal of Legal Studies (Impact Factor: 1.35). 02/2005; 34(1):1-25. (https://www.researchgate.net/publication/24101611_The_Dirt_On_Coming_Clean_Perverse_Effects_Of_Disclosing_Conflicts_Of_Interest [accessed Feb 16, 2016].

[45] Thomas A. Dirkin and Gregory Elliehausen*, Truth in Lending, New York*, Oxford University Press, 2011, p. 305.

[46] Bailey et al, *Behavioral Biases of Mutual Fund Investors*, 2010, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108163.

- The disclosure is not common knowledge between the intermediary and client;
- The client has an opportunity to change his/her mind later; or
- The client is able to make the investment decision in private.[47]

The disclosure of relevant information is a cornerstone of regulation in the financial services sector because it is believed that better-informed consumers will make better decisions. Thus disclosure plays a central role in consumer protection strategies formulated by regulators. However, the assumption that consumer protection is enhanced by increasing the amount of information provided has been challenged in recent years by behavioural economists. Their research indicates that simple information requirements may have resulted in improved transparency for consumers and better market outcomes, but complex information is not easily processed by the average consumer. Complex information may be ignored or misinterpreted by consumers.[48]

Given the complex nature of intermediary and investor behaviour around disclosure, it is worth considering whether more fair and effective treatment of the customer could be achieved by going beyond the requirement to disclose specific information. Requiring intermediaries to put themselves in the place of their clients when giving advice, and to recommend products that they themselves would purchase if they were the client, might help to mitigate the "checklist" approach to disclosures. This relates to the discussion below on standard of care for intermediaries and sales oversight by IVICs manufacturers.

4.3 Sales Oversight and Standard of Care

It might be appropriate to require a higher standard of care, product knowledge and sales oversight for segregated fund transactions in all provinces. Complaint and enforcement data indicate that some life insurers may not be monitoring the product knowledge and sales practices of those selling their products as well as is being done on the mutual fund side.

4.3.1 Sales Oversight, Internal Control Structure and Product Review

4.3.1.1 Mutual Funds

Mutual funds are generally sold through intermediaries who are registered with the securities commissions as dealers. Dealers hire individuals to distribute mutual funds. The relationship between a dealer and its salespeople can be employer-employee or principal-agent (where the dealer supervises and remains responsible for the conduct of the agent). Regardless of the type of business relationship, securities legislation obliges a dealer firm to properly supervise its salesforce.

A dealer is required to have a Chief Compliance Officer (CCO) - a designated person who has specified minimum education and experience. The CCO's responsibilities include establishing and updating compliance policies and procedures, monitoring and assessing the conduct of the dealer and its representatives, notifying the ultimate designated person of possible misconduct and reporting to the board of directors. Day to day monitoring and supervision activities include approving new accounts and reviewing transactions. Dealers are also required to approve the products they intend to sell and

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[47] Sunita Sah, Daylian M. Cain and George Loewenstein*, The Burden of Disclosure: Increased Compliance with Distrusted Advice,* Journal of Personality and Social Psychology, 2013 Vol. 104, No. 2, 289–304 https://www.cmu.edu/dietrich/sds/docs/loewenstein/BurdenDisclosure.pdf.

[48] Omri Ben-Shahar and Carl E. Schneider, *The Failure of Mandated Disclosure,* 59 University of Pennsylvania Law Review (2011), 647- 651.

provide product training to salespeople. Life insurance companies are not required to approve or provide training on their products.

4.3.1.2 IVICs

Life insurance companies retain varying degrees of statutory responsibility for distribution of their products across jurisdictions, including the sales conduct of licensed intermediaries who sell their products. Life insurance intermediaries may sell the products of more than one company, and if not tied to a single company may operate independently or be attached to a Managing General Agency (MGA), a national account, or a dealer.

For life insurance in general, the CLHIA's Guideline G8 (Advisor Suitability) and related reference documents describe factors related to advisor suitability and give examples of compliance monitoring practices. Guideline G18 (Insurer-MGA Relationships) provides advice for the MGA distribution channel. Insurers monitor intermediaries according to perceived risk to consumers.

Provincial insurance legislation contains comprehensive provisions governing the sales activities of intermediaries, including prohibiting unfair and deceptive acts and practices, false and misleading statements, incomplete comparisons between products, etc. In Québec, there are also provisions under a few guidelines, notably the Sound Commercial Practices Guideline and the Outsourcing Risk Management Guideline that applies to insurers in this respect.[49]

In principle, the supervision requirements of insurers and dealers are similar, but complaint and examination files surveyed by the CCIR indicate that in some cases life insurers have not accepted responsibility for the sales conduct of licensed intermediaries selling their products.

Questions

12. What should be the responsibilities of life insurance companies with respect to oversight of IVIC sales and their distribution? What factors affect the ability of life insurance companies to oversee IVIC sales?
13. What should be the responsibilities of intermediaries with respect to IVIC sales?
14. What could the industry do to address issues with insurer and intermediary supervision of the distribution and suitability assessment of IVICs?

4.3.2 Standard of Care for Life Insurance Intermediaries

Research has shown that most investors assume financial intermediaries already have a legislative duty to act in their best interests.[50] This is not always the case.

In Québec, the standard of care of the intermediary is equivalent in securities and in insurance. In other provinces the standard of care is arguably higher on the mutual fund side. Life insurance intermediaries must ensure that products they recommend or sell to clients are appropriate for the needs of the client,

[49] https://www.lautorite.qc.ca/files/pdf/reglementation/lignes-directrices-assurance/g_scp_2013.pdf; https://www.lautorite.qc.ca/files/pdf/reglementation/lignes-directrices-assurance/LD_Impartition_MAJ_ang_2010-12-03_CQ.pdf.

[50] For example, *Investor behaviour and beliefs: Advisor relationships and investor decision-making study*. Report by the Brondesbury Group for the OSC Investor Education Fund, 2012.

as determined by a needs-based assessment done by the intermediary and/or identified by the client, to the extent to which the client has provided accurate financial and personal information.

The CSA launched a consultation in late 2012 on the possibility of introducing a statutory obligation for securities registrants to act in the best interest of the client.[51] The CSA proposal for a statutory "best interest" standard is expected in spring 2016.

In general, acting in the client's best interest means an intermediary must ensure that:

- Client interests are paramount;
- Conflicts of interest are avoided;
- Clients are not exploited;
- Clients are provided with full disclosure of any material information related to the service being provided; and
- Services are performed reasonably prudently with the degree of care, diligence and skill a reasonably prudent person would exercise in the circumstances.[52]

Regulation in both sectors obliges intermediaries to know their clients' needs and assess product suitability. Securities legislation requires intermediaries to follow "know your client" (KYC) and "know your product" (KYP) rules. The basic KYC obligation for securities requires registrants to know the client's investment needs and objectives, financial circumstances and risk tolerance. The KYP rule requires the registrant to conduct product due diligence and be able to explain to clients the security's risk, key features, initial and ongoing costs and fees. For the life insurance sector, the CLHIA has developed reference documents describing "needs-based" sales practices related to IVICs in particular.[53] In Québec, intermediaries must prepare a written needs analysis, and the AMF has produced regulation and guidance on applying this specifically to IVICs transactions.[54] The CLHIA and AMF guidelines incorporate general principles on managing conflicts of interest that were established for life insurance agents by the CCIR.

Client needs may change over time, and products that were once suitable may no longer be appropriate. This principle is well understood in the insurance sector. Mutual fund regulation is more explicit in requiring registrants to take reasonable steps to update information about their clients. A similar explicit requirement may be of value for IVIC contract holders.

The above-mentioned review of complaints about IVIC transactions showed that over 80% are related to agent sales practices, specifically around suitability of the product. Consumers typically complained that they had not understood features such as the lock-in period for guarantees or how fees/charges were calculated. Often, these clients had signed all required disclosure documentation, but this suggests that

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[51] *CSA Consultation Paper* 33-403: *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients*. October 25, 2012.

[52] Ibid.

[53] *Reference Document: IVIC Suitability Needs-based Sales Practices*. Canadian Life and Health Insurance Association Inc., February 2013. https://www.clhia.ca/domino/html/clhia/CLHIA_LP4W_LND_Webstation.nsf/resources/Guidelines/$file/Needs_Based+Sales+Practices.pdf.

[54] *Sound Commercial Practices Guideline*. Autorité des marchés financiers. June 2013. http://www.lautorite.qc.ca/files/pdf/reglementation/lignes-directrices-assurance/g_scp_2013.pdf.

many do not read/understand them and perhaps would benefit from more proactive disclosure from the agents who sold them the products.

Questions

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

5. Conclusion

The purpose of this Issues Paper has been to outline the regulatory frameworks for IVICs and mutual funds, and to identify gaps that exist in the regulation of these products. Regulation on the insurance side is principled based, while securities regulation is more rules based. The objective of harmonization of regulation for these sectors is not that the frameworks be identical, but that the regulatory outcomes be harmonized. Harmonization of the outcomes may be achieved by different approaches. The desired outcome of the regulation is that customers be treated fairly.

Regulation in the insurance and securities sectors is constantly evolving as it responds to changes in the financial services marketplace. The regulators survey the financial markets, commission independent research studies, engage in consultations with stakeholders and keep apprised of trends in the marketplace, both national and international. Behavioural economics is an area of study that enriches the process of considering ways to improve regulatory outcomes for the financial consumer. Disclosure of information is one aspect of behavioural economics.

This Issues Paper has summarized the findings of significant research studies as of March 31, 2016. Other research studies and reports are currently being conducted but are not yet complete. Their findings will no doubt add valuable information to the discussion.

Both industry and the regulators have a role to play in achieving fair treatment for the customer and addressing issues identified that present barriers to this outcome. The CCIR's current understanding of the comparative regulatory frameworks for IVICs and mutual funds has been presented. This Issues Paper reviewed recent regulatory changes made in the mutual funds industry in relation to the regulatory framework for IVICs and identified some gaps. Regulatory developments in both the national and international contexts have been considered. Of particular interest are the new disclosure requirements of CRM2 and how enhanced disclosure will be implemented for IVICs. Disclosure of information to the client is a fundamental principle of both insurance and securities regulation.

Disclosure is viewed as a means to ensure the investor may make informed decisions, but this is dependent on the investor being able to understand that disclosure, and to take into account conflicts of interest that exist. Behavioural economic studies have shown the investors tend to minimize any potential conflicts of interest of their intermediary, and believe that although the intermediary is receiving compensation from fees, the intermediary is acting in the best interest of the customer.

Specific issues identified in this Issues Paper are disclosure gaps concerning fees and compensation, charges and compensation reports, account performance, product performance and disclosure upon subsequent fund purchases. It is recognized that disclosure of information to the client is essential to ensuring fair treatment of the client. An important part of the process is the standard of care that must be provided, along with effective oversight of the intermediary.

Canadian insurance regulators have been proactive to ensure fair treatment of customers with respect to IVICs. For this Issues Paper, the CCIR has focused on those regulatory gaps it believes are most critical. CCIR standards do align currently with international principles for insurance regulation and fair treatment of the customer, but it is a good time to consider what can be done to enhance this process even further.

Questions

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

6. Consultation Details

This Issues Paper is intended for stakeholder consultation and specific questions have been included to generate discussion and thought. The consultation period will be for 60 days, and findings will be presented to the CCIR at its Fall 2016 meeting. The CCIR is expected to report back to stakeholders in the winter of 2016/2017. This could be in the form of a position paper.

All comments should be submitted by **July 15, 2016**. Electronic submissions are preferred and should be forwarded to **ccir-ccrra@fsco.gov.on.ca**. Written submissions should be forwarded to:

CCIR Secretariat
5160 Yonge Street, Box 85
17th Floor
Toronto, Ontario M2N 6L9

CCIR intends to make the submissions received publicly available. If you indicate that you do not want your submission or specific parts of your submission to be made public, we will treat the submission, or the designated parts, as confidential to the limited extent permitted by law.