Discussion Paper on Upfront Compensation in Segregated Funds

This document reflects the work of regulators who are members of the CCIR and CISRO. The views expressed are not legal opinions.

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Table of Contents

Definitions 3
Introduction 4
CSA Findings 5
Customer Outcomes 6
  Outcomes of Advisor Chargeback 7
    Potential Customer Benefits 8
    Potential Customer Harms 9
Insurance Sector Considerations 10
  Conflicts of Interest and Fair Treatment of Customers 10
  Distribution 11
  Intermediaries' Product Offerings 12
  Compensation 12
Comment Process and Next steps 13
Questions 13
Appendix 1: Sales Charge Option Descriptions 15
Appendix 2: IVIC Product Features 16
Appendix 3: Bibliography .... **Error! Bookmark not defined.**

Definitions

For purposes of this paper, with the aim to reflect current practices,

"**Customer**" means an owner or prospective owner of an IVIC with whom an Insurer or an Intermediary interacts.

"**Embedded Commissions**", relating to securities, means the practice of paying dealers and their representatives for mutual fund sales through commissions, including sales and trailing commissions, paid by investment fund managers.[1] Segregated funds also have embedded commissions, but the focus in this paper is on Upfront Commission, as defined below.

"**Fee-Based Arrangement**" means an arrangement where a Customer agrees to pay an Intermediary money for selling or servicing an IVIC. The Customer may pay the money directly to the Intermediary, or the Insurer may facilitate payment (such as through a Front-End Load Sales Charge Option) by accepting money from a Customer and directing a portion of the money to the Intermediary.

"Individual Variable Insurance Contract (IVIC)" means an individual contract of life insurance under which the Insurer's liabilities vary in amount depending upon the market value of a specified group of assets in segregated funds. IVIC includes a provision in an individual contract of life insurance under which policy dividends are deposited in segregated funds.

"**Insurer**" means an insurer as defined under the laws of a Canadian jurisdiction.

"**Intermediary**" means a Licensed Individual authorized to sell and service IVICs under the laws of a Canadian jurisdiction, or a Licensed Business.

"**Licensed Business**" means any person licensed under the laws of a Canadian jurisdiction to sell and service IVICs, other than an Insurer or a Licensed Individual.

"**Licensed Individual**" means any of the following individuals:

- an insurance agent,
- an insurance broker, or
- an insurance representative authorized under the laws of a Canadian jurisdiction.

"**Sales Charge Options**" mean the ways a Customer can pay to invest in an IVIC. See Appendix 1 for common Sales Charge Options.

"**Segregated Fund**" means a specified and distinct group of assets the Insurer holds with respect to an IVIC, in which a Customer can invest by allocating monetary deposits to notional units of the segregated fund under an IVIC.

"**Upfront Commission**" means money an Insurer pays to an Intermediary immediately after a Customer invests in an IVIC, because of the investment. Insurers pay Upfront Commission for some Sales Charge Options at rates described in the Insurer's Information Folders and Fund Facts documents, usually for Deferred Sales Charge ("DSC") or Advisor Chargeback options.

"**Upfront Compensation**" means any compensation, including money, arrangement for financing a payment similar to upfront commission or anything else of value, an Insurer or Intermediary provides to another Intermediary immediately after a Customer invests in an IVIC, because of the investment.

[1] CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions, at pg. 3.

Introduction

On February 10, 2022, the Canadian Council of Insurance Regulators ("CCIR") and the Canadian Insurance Services Regulatory Organizations ("CISRO") (the "Insurance Regulators") released a statement on the use of DSC in segregated fund contract sales, and the Insurance Regulators' intention to consult on other Upfront Commissions in individual variable insurance contracts ("IVICs"). That statement followed significant work done by the Canadian Securities Administrators ("CSA") in relation to embedded commissions and, among other regulatory actions, the ban on upfront commission payments by fund organizations to dealers, which came into effect on June 1, 2022.

CCIR and CISRO are of the view that there is a high risk of poor Customer outcomes associated with DSCs in segregated fund sales, and that this form of sales charge is not consistent with treating Customers fairly. Further, Insurance Regulators urged Insurers to refrain from new DSC sales in segregated fund contracts in line with the June 1, 2022, ban in securities, and expect a transition to a cessation of such sales by June 1, 2023.

As stated in the Insurance Regulators' announcement of February 10, 2022, Upfront Commissions in segregated funds may present similar concerns to the sale of other financial products in terms of the potential for conflicts of interest and alignment in cost and services provided in situations where the Customer is relying on an advisor to sell them a suitable product and the advisor is being paid by the product manufacturer for the sale. The Insurance Regulators are committed to improving outcomes for segregated fund Customers and are contemplating what other changes may be needed in Upfront Commissions for segregated funds. As segregated fund contracts and mutual funds are investment products with some similar characteristics, Insurance Regulators are concerned about keeping the regulatory regimes for these products as harmonized as practical and appropriate, to avoid regulatory arbitrage in the sale of these products and to provide similar investor protection for both products.

Like the securities sector, segregated fund sales also use commission-based compensation. The Insurance Regulators see similar investor protection challenges and market inefficiency concerns in the insurance sector as those raised by the CSA. The purpose of this discussion paper is to fully understand:

- Compensation arrangements in segregated funds and IVICs, and what other changes to Upfront Compensation may be needed, including understanding the impacts of a complete ban of Upfront Commissions or other measures that could be taken to improve Customer outcomes;
- Potential impacts for Customers, Intermediaries, and Insurers, including whether compensation models can align the interests of Insurers, Intermediaries and Customers so Customers' insurance needs are met and the Customer receives the ongoing service they need throughout the life of the product; and
- What would be a reasonable period of time for the industry to adapt to any changes.

This discussion paper builds on a few other projects conducted by the Insurance Regulators related to segregated funds and fair treatment of Customers, including:

- 2016 Segregated Funds Working Group Issues Paper ("2016 Issues Paper")
- 2017 Segregated Fund Working Group Position Paper, 2018 Amended Appendix and 2018 Prototype Account Statement (collectively, the "2017/2018 Position Paper")
- 2018 Guidance: Conduct of Insurance Business and Fair Treatment of Customers ("FTC Guidance")
- 2022 Statement on Deferred Sales Charges and upfront commissions in segregated fund sales
- 2022 Proposed Incentive Management Guidance
- 2022 Proposed Individual Variable Insurance Contracts Ongoing Disclosure Guidance
- Upcoming Proposed Guidance on the design, distribution, issuance, sale, and administration of IVICs

The 2016 Issues Paper and the 2017/2018 Position Paper provide significant background information about segregated funds and mutual funds and set out CCIR's understanding of the comparative regulatory frameworks as of their respective publication dates. The Insurance Regulators recommend stakeholders read these documents, as these documents provide important context for topics raised in this discussion paper.

While all of the above projects are relevant to improving fair treatment of segregated fund Customers, the Proposed Incentive Management Guidance will set an important baseline for better aligning incentive arrangements paid for insurance products with FTC principles. Although the Proposed Incentive Management Guidance is not intended to ban certain practices in the insurance marketplace, the Insurance Regulators may ban practices using their respective legal powers. The Insurance Regulators are releasing this discussion paper to consider whether regulatory action beyond the Proposed Incentive Management Guidance is required for IVICs given the customer outcomes discussed later in this paper. Non-IVIC products are out of scope for this discussion paper.

CSA Findings

The CSA's consultations and research started in 2012 and included discussion and consultation papers, roundtable discussions with industry members and consumer advocates as well as independent research.[2] In January 2017, the CSA released Consultation Paper 81-408, Consultation on the Option of Discontinuing Embedded Commissions ("Embedded Commission Paper"). The CSA identified and discussed three key investor protection and market efficiency issues arising from embedded commission:

1. embedded commissions raise conflicts of interest that misalign the interests of investment fund managers and dealers and representatives with those of investors;
2. embedded commissions limit investor awareness, understanding and control of dealer compensation costs; and
3. embedded commissions paid generally do not align with the services provided to investors.[3]

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[2] CSA Discussion Paper and Request for Comment 81-407 – *Mutual Fund Fees*, December 2012; See transcript of Ontario Securities Commission roundtable held June 7, 2013. The British Columbia Securities Commission and Autorité des marchés financiers held discussion forums in the summer and fall of 2013; Brondesbury Group, "Mutual Fund Fees Research", Spring 2015; Douglas Cumming, Sofia Johan and Yelin Zhang, "A Dissection of Mutual Fund Fees and Performance" February 2016; CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions January 2017.

[3] CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions, at pg. 3.

The Embedded Commission Paper also presented research and other evidence demonstrating how embedded commissions give rise to investor protection and market efficiency issues, including how embedded commissions can:

1. incentivize investment fund managers to rely more on payments to dealers than on the generation of fund performance to gather and preserve assets under management, which in turn can lead to underperformance and drive-up retail prices for investment products;
2. incentivize dealers and their representatives to sell funds that compensate them the best or focus on only those funds that include an embedded commission rather than recommend a more suitable investment product;
3. due to their opacity and complexity, inhibit investors' ability to assess and manage the impact of dealer compensation costs on their investment returns; and
4. cause investors to pay, indirectly through fund management fees, dealer compensation that may not reflect the level of advice and service they actually receive.[4]

After evaluating the feedback received from the Embedded Commission Paper, the CSA changed policy direction from banning embedded commissions. The CSA instead focused on three policy actions to address the investor protection and market efficiency issues identified:

1. to implement enhanced conflict of interest mitigation rules and guidance for dealers and representatives requiring that all existing and reasonably foreseeable conflicts of interest, including conflicts arising from the payment of embedded commissions, either be addressed in the best interests of clients or avoided;
2. to prohibit all forms of the deferred sales charge option, including low-load options [ ] and their associated upfront commissions in respect of the purchase of securities of a prospectus qualified mutual fund; and
3. to prohibit the payment of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who do not make a suitability determination in connection with the distribution of prospectus qualified mutual fund securities.[5]

The CSA put each of these policy actions into effect, including prohibiting investment fund companies paying upfront sales commissions to dealers as of June 1, 2022. The CSA expects the ban to end DSC and any other form of upfront commissions in mutual funds. DSC purchases made before June 1, 2022, will continue to have potential redemption charges until their respective redemption schedules end. The CSA ban does not prevent investment fund managers from facilitating an investor's Front-End Load payments to a dealer. The CSA continues to permit investment fund managers to pay trailing commission to dealers who make a suitability determination with the distribution of mutual funds.

There is more to the CSA work than this summary. The Insurance Regulators encourage those unfamiliar with the CSA work to contact their securities administrative body.

Customer Outcomes

Insurance Regulators conducted significant background research prior to releasing the discussion paper and encourage stakeholders to review material in Appendix 2: Bibliography Insurance Regulators recognize a potential for regulatory arbitrage between Canadian securities and insurance sectors where the regulatory approaches to commission-based compensation differ significantly. Insurance Regulators are also aware that upfront compensation paid for other life insurance products, such as those with market-linked investment features, may be

[4] CSA Staff Notice 81-330 Status Report on Consultation on Embedded Commissions and Next Steps, at pg. 2.
[5] CSA Staff Notice 81-330 Status Report on Consultation on Embedded Commissions and Next Steps, at pgs. 1-2.

significantly higher than upfront compensation paid for segregated funds. The higher compensation increases the risk Intermediaries may recommend Customers purchase these other products over segregated funds. The Insurance Regulators will continue to monitor for the sale of unsuitable products but also anticipate the Proposed Incentive Management Guidance will help reduce the risk of unsuitable sales by aligning incentive arrangements paid for life insurance products with FTC principles.

When considering how to address Upfront Compensation for segregated funds, the Insurance Regulators' key driving outcome continues to be the fair treatment of Customers as described in the FTC Guidance. Insurance Regulators have identified a few considerations to help inform the discussion surrounding fair outcomes for Customers ("Targeted Customer Outcomes") relating to Upfront Compensation. Insurance Regulators are targeting a regulatory approach which:

1. Effectively addresses conflicts of interest created by Upfront Compensation, which can misalign the interests of Insurers, Intermediaries and Customers;
2. Enhances Customer awareness, understanding and control of Intermediary compensation;
3. Fosters alignment of any Upfront Compensation with the services provided to Customers at point of sale and ongoing;
4. Avoids Insurers and Intermediaries relying more on compensation than fund performance and IVIC features to sell their products;
5. Balances the need for quality advice and personal recommendations for IVICs while enabling access to affordable advice and ongoing service;
6. Reduces the risk of mis-selling of segregated funds and IVICs over securities products by dually licensed Intermediaries due to differing upfront compensation arrangements;
7. Manages the risk of mis-selling other life insurance products over segregated funds and IVICs; and
8. Enables innovation and encourages flexibility in way Customers can pay for advice.

Outcomes of Advisor Chargeback

Insurance Regulators understand two of the Sales Charge Options in Appendix 1: Sales Charge Option Descriptions pay Upfront Commission. These options are the DSC option, which Insurance Regulators are currently undertaking steps to prohibit, and the Advisor Chargeback option.

One of the key differences between the DSC and Advisor Chargeback options relates to who reimburses the Insurer for the cost of Intermediary compensation when the Customer redeems segregated fund units before the end of a fixed schedule. Under the DSC option, the Customer pays the Insurer a redemption fee based on how long the Customer has held the segregated fund units according to a pre-determined schedule. Under the Advisor Chargeback option, the Intermediary returns all or a portion of the commission it received from the sale of segregated funds back to the Insurer, again based on how long the Customer has held the segregated fund units according to a pre-determined schedule.[6]

[6] A DSC fee or chargeback is not triggered every time a Customer redeems segregated fund units. DSC and Advisor Chargeback models may allow a Customer to take out a specified amount each year without triggering a fee or a chargeback. Additionally, a Customer may switch to a different segregated fund within the same IVIC without triggering a fee or chargeback.

There are no criteria setting out what is permissible Upfront Commission for IVICs. Each Insurer sets their own commission rates. Similar to the securities sector, Insurers provide details on the range of rates of commission they pay to Intermediaries for different Sales Charge Options in their Information Folders and Fund Facts documents. Using this information, Customers can choose a Sales Charge Option when they deposit money in an IVIC. After the mutual fund ban of upfront commission payments from investment fund managers to dealers, Insurance Regulators note mutual fund and segregated fund Fund Facts documents include different information relating to upfront commission rates and may make it more difficult for investors to compare the products.[7]

Beyond Upfront Commission, Insurers may provide other payments or benefits to Intermediaries beyond the commission set out in the Information Folder and Fund Facts documents, such as bonuses based on previous sales placed with an Insurer. On top of an Insurer's compensation, Intermediaries can compensate Licensed Individuals for sales placed with an Insurer through the Intermediary. Insurers and Intermediaries are not required to disclose these other compensation arrangements to Customers. As such, Customers may not be aware of these arrangements nor how they may impact the Customer, such as where these arrangements increase the financial incentive for a Licensed Individual to sell specific IVICs.

Outside the Fund Facts and Information Folders, the Insurance Regulators understand IVIC Customers presently receive minimal ongoing disclosure about Intermediary compensation costs. Such disclosure could increase a Customer's awareness and understanding of how Intermediary compensation impacts them. While the *Proposed Individual Variable Insurance Contracts Ongoing Disclosure Guidance* seeks to enhance disclosure of ongoing costs, it does not expect disclosing the dollar amount of compensation paid to Intermediaries. In contrast, mutual fund dealers provide this information in their client statements. Without ongoing reminders of the compensation, a Customer might not recall or be fully aware of a potential conflict of interest between the Customer and the Intermediary, such as where a chargeback period continues to exist.

Potential Customer Benefits

Insurance Regulators understand, according to industry, Upfront Commission enables Insurers to incentivize an Intermediary to provide service and advice to Customers at point of sale. A Customer may not have the minimum assets required by Insurers or Intermediaries to use a fee-based Sales Charge Option (when offered). Industry stakeholders also report Upfront Commission may serve to support new Intermediaries entering the business. Given the complexity of IVICs and the importance of personal recommendations for these products, barriers to access to advice for IVICs might have downstream impacts by preventing potential Customers from access to IVICs.

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[7] See Framework 81-406 Point of Sale disclosure for mutual funds and segregated funds October 2008. The three key principles of the Framework are:
- providing investors with key information about a fund,
- providing the information in a simple, accessible and comparable format,
- providing the information before investors make their decision to buy.

Potential Customer Harms

Many of the features of an IVIC, described in Appendix 3: IVIC Product Features, promote using an IVIC for long-term planning. Once a Customer purchases an IVIC, they may make more deposits into the contract but the IVIC's benefits are often only realized after owning it for an extended period of time. A Customer's longer term need of an IVIC can conflict with the short-term financial benefit (Upfront Compensation) an Intermediary may receive for the sale of segregated funds. Upfront Compensation may incentivize an Intermediary to sell an IVIC even where a Customer does not have a need for an IVIC. This scenario could involve an Intermediary, also registered to sell mutual funds, selling a Customer an IVIC over a mutual fund when a Customer may be better served through a mutual fund strategy. In other cases, it may influence an Intermediary to recommend a Customer buy a new IVIC to replace a pre-existing IVIC which already satisfies the Customer's long-term needs. If a Customer replaces an existing IVIC, then there is risk of losing benefits under the existing IVIC for which the Customer has already paid.

While the DSC option may involve a direct cost to Customers upon redemption, Advisor Chargeback does not lead to the same direct Customer fee. However, there appears to be a risk of other potential Customer harm. When a Customer invests money on an Advisor Chargeback basis, it introduces a potential conflict of interest for the Intermediary. An Intermediary may benefit financially if the Customer stays invested to the end of the chargeback period, even if staying invested is not aligned with the Customer's interests. While this conflict of interest exists in other situations, such as encouraging a Customer to stay invested in an IVIC so the Intermediary might continue to earn trailing commission, the potential conflict of interest is greater in the context of Advisor Chargeback. The overall impact of the chargeback to an Intermediary will increase with an increase in the money paid upfront for the sale and the duration of the chargeback period.

If an Intermediary has to repay some or all of their compensation because a customer withdraws money from an IVIC, and the Intermediary does not have the money to repay this chargeback, then the Intermediary could owe money to an Insurer or managing general agency ("MGA"). If the Intermediary continues to sell insurance for the Insurer or MGA to whom the Intermediary owes money, the creditor could use compensation earned on the new sales to reduce the amount the Intermediary owes them, instead of paying it directly to the Intermediary. This means the Intermediary may be motivated to sell products available through other insurers or MGAs, even if the most suitable product for a Customer is one available through the creditor.

Lastly, the Insurance Regulators note, from publicly available Fund Facts and Information Folders, significant differences between Insurer's Advisor Chargeback models. Some Upfront Commission rates ranging from 3% up to 7% of a Customer's deposit into an IVIC. In some cases, the Fund Facts documents state the duration of the chargeback period and note trailing commission rates may vary because of the Upfront Commission paid, but this information is not always provided. Without this information, Customers may have a harder time knowing how the Advisor Chargeback model impacts them. Varying lower trailing commission rates may also create a risk of unserved Customers ("orphan clients"), where the trailing commission rate is so low as to disincentivize a new Intermediary to take over the servicing of Customer's IVIC. A new Intermediary may take over servicing a Customer's IVIC if a Customer is dissatisfied with their previous Intermediary or the previous Intermediary is no longer able to service the IVIC. Another potential disincentive for servicing may arise in a situation where a chargeback debt or potential chargeback transfers to a new Intermediary when they start servicing a Customer's IVIC.

In consideration of the Targeted Customer Outcomes, Insurance Regulators understand Upfront Commission under the Advisor Chargeback model:

- can enable access to affordable, quality advice and incentivize Intermediaries to provide policy service at point of sale to Customers;
- provides a way for Customers to pay, indirectly, for advice and service;
- maintains a potential compensation-based conflict of interest which can misalign the interests of Insurers, Intermediaries and Customers;
- provides little customer control over costs and may not align with the ongoing services expected to be provided to Customers;
- provides Customers with some information to enhance their awareness and understanding of Upfront Commission at point of sale, but does not provide details on other Upfront Compensation or ongoing disclosure of the remaining chargeback period;
- has the potential for Insurers to rely more on compensation over IVIC features and fund performance to generate sales; and
- may increase the incentive, and potential, for Licensed Individuals to mis-sell IVICs over mutual funds.

Insurance Sector Considerations

Insurance Regulators intend the regulatory regimes for mutual funds and segregated funds to be as harmonized as is practical and appropriate. While Insurance Regulators recognize segregated funds have some similar characteristics to mutual funds, we also understand there are differences between the sectors, including their respective regulatory regimes, products, distribution methods and markets.

This section of the discussion paper raises some of these differences which may be relevant to achieving the Targeted Customer Outcomes. This section reflects generalized approaches across Canadian jurisdictions and may not capture all nuances of the different jurisdictions.

Conflicts of Interest and Fair Treatment of Customers

The Insurance Regulators previously set expectations for fair treatment of Customers in the FTC Guidance. The FTC Guidance, based on the Insurance Core Principles of the International Association of Insurance Supervisors, identifies Insurers as the ultimate risk carriers for fair treatment of Customers throughout the life cycle of the insurance product. The Insurer's ultimate responsibility does not absolve Intermediaries of the responsibilities for which they are accountable.[8]

As part of the FTC Guidance, the Insurance Regulators expect Insurers and Intermediaries to properly manage or avoid any potential or actual conflicts of interest and take measures so the conflicts of interest do not affect the fair treatment of Customers. These conflicts of interest include situations arising from compensation. Further, Insurance Regulators expect Insurers and Intermediaries to place a Customer's interest ahead of their own interests. If the Insurer or Intermediary cannot satisfactorily manage a conflict of interest, the Insurer or Intermediary should decline to act.[9]

[8] FTC Guidance, at "Scope" at pg. 6 and s. "1. Conduct of Business" at pgs. 7-8.
[9] FTC Guidance, at s. "6.2 Conflicts of Interest" at pgs. 14-15.

The expectation that Insurers are ultimately responsible for FTC is a unique IVIC consideration from the perspective of a product manufacturer. Insurance Regulators expect Insurers to consider the interests of target Customer groups when developing products and "remain[] ultimately responsible for servicing policies throughout their life cycle."[10] In the securities sector, fund managers have a duty of care to act honestly and in good faith, and in the best interests of the investment fund, but do not have general or specific duties to the Customer.[11]

Mutual fund dealers and their representatives have requirements to address conflicts of interest. At a high level, both dealers and representatives need to identify material conflicts of interest between themselves and the client, address the material conflicts of interest in the best interest of the client, and avoid the material conflicts if the conflict is not or cannot be addressed in the best interest of the client. Those requirements cannot be satisfied solely by providing disclosure to the client.[12] Those requirements are in addition to extended internal controls and compliance systems rules discussed below.[13]

Distribution

There are many ways in which Insurers and Intermediaries distribute IVICs in Canada, with distribution methods differing depending on provincial regulatory requirements and the types of licensed activity within each jurisdiction. Insurers often use an Intermediary (e.g., an independent Licensed Business or a MGA) to assist with distributing the Insurer's products through a Licensed Individual. The duties of the Insurer and Intermediary in these arrangements may vary across the sector depending on the contract between the Insurer and Intermediary. However, in some jurisdictions, Insurers can manufacture and distribute their own products through Licensed Individuals without the use of another Intermediary.

In most jurisdictions, Licensed Individuals are not legally restricted to distributing products for a single Intermediary or a single Insurer, unlike the securities sector which ties representatives to a single dealer. This fact adds a layer of complexity for addressing conflicts of interest. The ability to contract with multiple Insurers and Intermediaries creates oversight difficulties for Insurers or, in some cases, Intermediaries responsible for supervising Licensed Individuals. The Insurer or Intermediary may only be able to review and address the conflicts of interest resulting from the compensation arrangements of some of the products a Licensed Individual can sell. This appears to leave a potential FTC gap, as Insurers and Intermediaries overseeing Licensed Individuals may not know what IVICs the Licensed Individual could have sold to the Customer at the time of sale nor whether a product's Upfront Compensation influenced the sale.

On the securities side, the oversight responsibility rests entirely on dealers, who must comply with extended internal control and compliance systems requirements, such as day to day

[10] FTC Guidance, at ss. "1. Conduct of Business" at pgs. 7-8 and "6.4 Design of Insurance Product" at pgs. 18-19.
[11] General notice: In the context of this discussion paper, Insurance Regulators choose to refer to CSA National Instruments, while recognizing that self-regulated organisations throughout Canada have also their own requirements. National Instrument 81-107: *Independent Review Committee for Investment Funds*, at s. "2.1 Manager standard of care". Even though they must register, Investment fund managers are exempted from Dealing with Clients requirements under National Instrument 31-103: *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, at s. 13.1.
[12] National Instrument 31-103: *Registration Requirements, Exemptions and Ongoing Registrant Obligations* at ss. 13.4 and 13.4.1. The companion policy to National Instrument 31-103 explains some ways in which compensation gives rise to conflicts of interest in reference to ss. 13.4 and 13.4.1.
[13] National Instrument 31-103: *Registration Requirements, Exemptions and Ongoing Registrant Obligations* Part 11. See also Companion Policy to NI 31-103.

monitoring and supervision, systemic monitoring, detailed policies and procedures, designation of an ultimate designated person as well as a chief compliance officer.[14]

Finally, it is the Insurance Regulators' current understanding that Insurers do not offer IVICs and segregated funds on an execution only basis without a suitability recommendation.

Intermediaries' Product Offerings

The products which an Intermediary can sell (the "product shelf") depend on the contracts it has with Insurers or other Intermediaries which have a contract with an Insurer. A diverse product shelf may drive positive Customer outcomes by increasing the number of products an Intermediary can offer to meet more Customer needs. But there could be potential for Customer harm if Intermediaries create product shelves with a focus on products which pay the highest compensation.

The lack of a restriction requiring Licensed Individuals to distribute products for a single Intermediary or a single Insurer adds a layer of complexity for addressing conflicts of interest introduced when creating a product shelf. The entity responsible for building a product shelf may be a Licensed Individual who has multiple distribution contracts with different Insurers or Intermediaries. On the securities side, mutual fund dealers are under strict requirements to approve securities made available to clients, after conducting due diligence on product shelves regarding the securities' structure, features, and risks, including conflict of interest risks arising from compensation structure ("Know-your-product" or "KYP").[15]

Compensation

The Insurance Regulators previously discussed Upfront Commission and Upfront Compensation above. One of the major differences between the regulatory regimes of mutual funds and IVICs relates to mutual fund restrictions on payments and benefits. Except under permitted exceptions, the CSA prohibits fund organizations from paying a dealer or representative, providing a non-monetary benefit to a dealer or representative, or paying or reimbursing a dealer or representative for a cost or expense the dealer or representative incurred.[16] There is a reciprocal restriction on dealers and representatives from accepting money, non-monetary benefits or reimbursements of costs from fund organizations.

Previously, upfront commission payments were one of the permitted exceptions, provided the payments met prescribed criteria.[17] To implement the ban on upfront commission payments from fund organizations to dealers, the CSA repealed that exception. Other permitted exceptions include trailing commission, facilitating fee-based arrangements between the dealer and client, and some marketing and educational practices.[18]

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[14] National Instrument 31-103: *Registration Requirements, Exemptions and Ongoing Registrant Obligations* Part 11. See also Companion Policy to NI 31-103.

[15] National Instrument 31-103: *Registration Requirements, Exemptions and Ongoing Registrant Obligations* at s. 13.2.1.

[16] National Instrument 81-105: *Mutual Fund Sales Practices* at Part 2 General.

[17] The prescribed criteria required the obligation to make the commission payment arose at the time of trade, the prospectus or simplified prospectus of a mutual fund to set out the range of rates of commissions and the method of calculating the rates, and the rate of commission did not increase based on either the amount or values of the mutual fund or its fund family sold, or did not increase for a period of time in a year where commission was paid or earned. See National Instrument 81-105: *Mutual Fund Sales Practices* at now repealed s. 3.1.

[18] National Instrument 81-105: *Mutual Fund Sales Practices* at s. 3.2, Part 5 Marketing and Educational Practices, and Companion Policy 81-105CP to National Instrument 81-105 *Mutual Fund Sales Practices* s. 4.1.1.

Comment Process and Next steps

The Insurance Regulators invite all interested parties to review and comment on this paper. The consultation period will start on September 8, 2022, and continue for 60 days, with a deadline for written submissions on November 7, 2022. Please send comments to the CCIR Secretariat at ccir-ccrra@fsrao.ca.

Please note CCIR may publish on its website all submissions received pursuant to this consultation process.

After this consultation, the Insurance Regulators intend to move forward swiftly with a policy position and guidance on Upfront Compensation in sales of segregated funds. The Insurance Regulators will publicly consult on the draft guidance on Upfront Compensation in sales of segregated funds. This guidance will eventually be part of a consolidated segregated fund guidance inclusive of Proposed Individual Variable Insurance Contracts Ongoing Disclosure Guidance, guidance resulting from this discussion paper, and other guidance setting out expectations for Insurers and Intermediaries for the design, distribution, issuance, sale, and administration of IVICs.

Questions

1. Please comment on whether the topics and details covered in this discussion paper accurately describe the current environment in which Customers are offered IVICs and segregated funds and provide any necessary factual corrections or additional information.
2. Should Insurance Regulators consider other Targeted Customer Outcomes?
3. For each Sales Charge Option in Appendix 1,
    a. How prevalent is the Sales Charge Option?
    b. Where a Sales Charge Option has a range of possible compensation rates, such as Front-End Load, how do Insurers or Intermediaries determine the amount to charge a Customer? Are there common rates charged?
    c. Please describe in detail how current Insurer and Intermediary processes and controls align with Targeted Customer Outcomes, including, but not limited to, outcomes 1 to 3. Are there different processes and controls for different Sales Charge Options, such as between the Advisor Chargeback and Front-End Load options?
    d. Please describe how Insurers and Intermediaries can encourage innovation and flexibility in ways Customers can pay for advice.
4. Please comment on the extent to which Insurers and Intermediaries provide payments or benefits for the sale of segregated funds or IVICs other than the commission rates set out in Information Folders and Fund Facts and how the payments or benefits align with the Targeted Customer Outcomes, including, but not limited to, outcomes 1 to 3.
5. If Insurance Regulators were to implement a regulatory ban on Upfront Commission or Upfront Compensation, what would be the insurance sector considerations to take into account for achieving the Targeted Customer Outcomes? Where possible, please provide data to support your position.

a. How could any ban for segregated funds be worded to achieve the Target Customer Outcomes?

b. What would be the minimum transition time needed to implement an applicable ban and arrange for the use of different compensation and fee structures?

c. What are the estimated qualitative and quantitative costs and benefits of a ban to Insurers and Intermediaries?

d. What are the estimated qualitative and quantitative costs and benefits of a ban to Customers?

6. If Insurance Regulators were to implement alternative or complementary regulatory measures to a ban, which regulatory measures would help achieve the Targeted Customer Outcomes? Throughout Insurance Regulators' discussions with industry, the following measures were proposed as examples to foster stakeholders reflections on this matter:
   - a cap on amount of Upfront Commission,
   - limits on the duration of chargeback schedules,
   - increased monitoring of Licensed Individuals with chargeback debt,
   - enhancing disclosure of potential costs or negative effects to the Customer of available Sales Charge Options, and
   - requiring Upfront Compensation paid to Intermediaries be reasonably proportionate to value of the product and amount of service provided to the Customer.

   Please provide supporting evidence in your response to explain:

   a. where such measures differ from the regulatory approach taken by the CSA, why such an approach would be reasonable for segregated funds even if the approach is not permitted for mutual funds,

   b. how such an approach aligns with Targeted Customer Outcomes,

   c. the estimated qualitative and quantitative costs and benefits of the applicable alternative regulatory measures to Insurers and Intermediaries,

   d. the estimated qualitative and quantitative costs and benefits of the applicable alternative regulatory measures to Customers, and

   e. the minimum transition time needed to implement such regulatory measures.

Appendix 1: Sales Charge Option Descriptions

Please note Insurers may describe Sales Charge Options differently. Insurance Regulators provided the list below as a common reference to enable better comparison of information received during the consultation. We believe we have captured the Sales Charge Options used in segregated funds but are interested in hearing of any we may have missed.

Sales Charge Options	Insurance Process
Deferred Sales Charge (Includes low load variant which has a shorter redemption schedule)	**To be banned:** • Customer invests money in segregated fund units without a charge applied at time of sale • **Insurer pays an Intermediary an Upfront Commission** • Insurer pays an Intermediary a trailing commission • Customer pays a redemption fee to withdraw funds if withdraw occurs before the redemption schedule ends (≈ 3 to 7 years) and is greater than the IVIC's annual fee-free redemption amount
Advisor Chargeback	• Customer invests money in segregated fund units without a charge applied at time of sale • **Insurer pays an Intermediary an Upfront Commission** • Insurer pays an Intermediary a trailing commission • If Customer removes money within chargeback period (≈ 2 to 5 years), the Intermediary returns part of commission to Insurer • Customer does not pay redemption fee similar to DSC
Front-End Load (FEL) *Some Insurers' FEL Sales Charge Options start at 0%. Please note we have included the 0% option under No-Load.*	• Customer invests money in segregated fund units, minus a negotiated portion taken from the Customer's initial investment to compensate an Intermediary at the time of sale (ranges from >0% to 5%) • Insurer may facilitate a Customer's payment to an Intermediary • Insurer pays an Intermediary a trailing commission • Customer does not pay redemption fee similar to DSC
Fee for Service	• Customer invests money in segregated fund units • Customer negotiates fee arrangement with the Intermediary, such as amount based on percentage of investment value • Insurer does not pay an Intermediary an upfront or trailing commission, though the Insurer may facilitate a Customer's payment to an Intermediary by withdrawing an amount from the IVIC to pay the negotiated payment • Customer does not pay redemption fee similar to DSC
No-Load (or FEL Zero)	• Customer invests money in segregated fund units without a charge applied at time of sale • Insurer does not pay an Intermediary an Upfront Commission • Insurer pays an Intermediary a trailing commission • Customer does not pay redemption fee similar to DSC

Appendix 2: Bibliography

Many international jurisdictions have continued to address compensation relating to the sale and service of financial products, including providing advice or recommendations, since the CSA finished revising National Instruments to address the investor protection and market efficiency issues they identified relating to embedded commissions. The Insurance Regulators reviewed documentation from a number of these jurisdictions prior to preparing this discussion paper. While these regulatory approaches provide further insight, they are also jurisdiction specific. In some cases, a regulator's approach to managing the conflicts of interest from compensation arrangements applied to advice across multiple sectors and products.

All hyperlinks were last accessed on August 8, 2022.

- Australian Government, Treasury,
  - "Future of Financial Advice" website.
  - "Quality of Advice Review – Issues Paper" (2022).
- Australian Securities & Investments Commission,
  - "Future of Financial Advice (FOFA) reforms" (2021) website.
  - "REP 407 Review of the financial advice industry's implementation of the FOFA reforms" (2014).
  - "REP 614 Financial advice: Mind the gap" (2019).
  - "REP 627 Financial advice: What consumers really think" (2019).
  - "CP 332 Promoting access to affordable advice for consumers" (2021).
- Canadian Securities Administrators,
  - "CSA Discussion Paper and Request for Comment 81-407 - Mutual Fund Fees" (2012).
  - "CSA Consultation Paper 81-408 - Consultation on the Option of Discontinuing Embedded Commissions" (2017).
  - "CSA Staff Notice 81-330 - Status Report on Consultation on Embedded Commissions and Next Steps" (2018).
  - "Proposed Amendments to National Instrument 81-105 Mutual Fund Sales Practices and Related Consequential Amendments" (2018).
  - "CSA Staff Notice 81-332 - Next Steps on Proposals to Prohibit Certain Investment Fund Embedded Commissions" (2019).
  - "Multilateral CSA Notice of Amendments to National Instrument 81-105 Mutual Fund Sales Practices Changes to Companion Policy 81-105CP to National Instrument 81-105 Mutual Fund Sales Practices and Changes to Companion Policy 81-101CP to National Instrument 81- 101 Mutual Fund Prospectus Disclosure relating to Prohibition of Deferred Sales Charges for Investment Funds" (2020).
- European Insurance and Occupational Pensions Authority, "Technical advice on Retail Investor Protection" (2022).
- Organisation for Economic Cooperation and Development, "Life Annuity Products and Their Guarantees" (2016) OECD Publishing, Paris.
- United States Securities and Exchange Commission, "Regulation Best Interest, Form CRS and Related Interpretations" website and associated documents.
- United Kingdom Financial Conduct Authority, "Financial Advice Market Review (FAMR)" (2020) website and associated reports.

Appendix 3: IVIC Product Features

IVICs are complex products. An IVIC has investment options and contains insurance aspects. To that end, a Customer may need advice on IVICs to ensure product feature selections and selected investment options align with the Customer's needs. The contractual benefits of an IVIC will vary contract to contract and are not the same for all IVICs. Yet the range of features an IVIC offers can meet different insurance needs. These features include:

- Guaranteed protection against some or all investment risk, ranging from 75% to 100% of the Customer's gross contributions to the IVIC, reduced for withdrawals, triggered on:
    - A specified future date (Maturity Guarantee); or
    - Death of the insured person (Death Benefit Guarantee);
- Death benefit payments to named beneficiaries do not form part of the estate of a deceased contract owner/ annuitant and are not subject to claims of the estate or estate administration costs, including probate fees;[19]
- Where an IVIC has a contingent owner, the ownership of the IVIC may pass to the new owner outside the estate of the deceased contract owner and is not subject to claims of the estate or estate administration costs, including probate fees;
- Guaranteed minimum benefit payments to provide a steady source of income for a defined period of time or during one or more lives; and
- Protection from creditors (in particular scenarios).

For a Customer to get the most out of these features, a Customer may need to spend time with an Intermediary to make sure an IVIC is structured properly, including choosing:

- the contract owner(s),
- contingent owner(s) if applicable,
- annuitant including any joint or successor annuitant(s),
- beneficiary designation(s) including primary and contingent beneficiaries, and
- measuring lives for income payments, if applicable.

After the initial setup, an Intermediary may have to continue planning with the Customer to ensure the IVIC continues to meet the Customer's needs and the Customer understands how the IVIC works. An example of this service includes explaining how guarantees or income benefits affect a Customer's recommended action in a time of market downturn. Customers may pay for an IVIC's insurance features and for the Intermediary's service for an IVIC.

The contractual nature of IVICs affects the Sales Charge Options a Customer can use when purchasing segregated funds. The Sales Charge Options generally stay in effect for the duration of the insurance contract unless the contract is changed. Even where the applicable contracts allow Insurers to change an IVIC's Sales Charge Options, Insurers need to comply with regulatory requirements such as solvency measures to project for long term product sustainability when developing IVICs. Compensation for the sale and servicing of IVICs can be one of the factors involved in calculating product sustainability. Making a change to compensation arrangements for segregated funds and IVICs may take time to ensure existing IVICs remain sustainable. Based on the above, the Insurance Regulators understand a change to any regulatory measures impacting compensation arrangements may have a different impact for IVICs issued prior to the effective date of such measures, when compared to IVICs issued after the effective date.

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[19] An annuitant is an individual who consents to be the life insured or "measuring life" for the death guarantee.