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CCIR Secretariat
25 Sheppard St. W., Suite 100
Toronto ON M2N 6S6

Submitted by email: ccir-ccrra@fsrao.ca

Dear Sirs/Mesdames:

Subject: Discussion Paper on Upfront Compensation in Segregated Funds

Independent Financial Brokers of Canada (IFB) appreciates the opportunity to comment on the *CCIR/CISRO Discussion Paper on Upfront Compensation in Segregated Funds* (Discussion paper).

About IFB

IFB is a national, not for profit association representing approximately 3,000+ licensed professionals across Canada. IFB members must agree to adhere to IFB's Code of Ethics and Standards of Professional Conduct[1], as an ongoing condition of membership.

IFB advocates for the value of professional, tailored financial advice from independent practitioners, that we believe should be accessible to consumers of all financial means. In support of these goals, IFB regularly engages with legislators, regulators, industry stakeholders and other interested stakeholders.

IFB members are self-employed individuals who typically own small to medium-sized financial practices in communities across Canada. Many have acquired additional licenses or accreditations to address the broader financial needs of today's client. These can include securities/investments (IIROC), mortgages, P&C insurance, deposit instruments, estate/tax services, and financial planning.

IFB members have typically spent 20+ years as an independent advisor. They tend to establish long-term relationships with clients (whether individuals, families, or businesses) spanning many years – even generations. Indeed, they often advocate on behalf of their clients to ensure the promises made by product manufacturers are fulfilled over the many years a client may own or be invested in a life insurance product. These local professionals offer an important, community-based alternative to the advisory services provided by larger retail financial institutions, and firms which are restricted to offering proprietary products.

General comments

Since 2016, IFB has actively participated in the various consultations regarding the distribution of segregated funds undertaken by the CCIR/CISRO and its Segregated Funds Working Group. We commend the CCIR/CISRO for its comprehensive review of the issues related to the distribution of IVICs and segregated funds to retail customers, as well as its ongoing discussions with various industry and consumer groups that have led to the development of this Discussion Paper.

[1] Independent Financial Brokers of Canada: https://ifbc.ca/code-ethics/

IFB was also actively involved in the consultations and discussion papers issued by the CSA, dating back to 2012, on the issue of discontinuing embedded commissions for mutual fund sales. In our responses then, as in this response, IFB seeks to balance the potential consumer protection issues, with the need to ensure that proposed regulatory changes do not inadvertently undermine choice or competition in the marketplace. Such a result is not a desirable outcome for consumers or for those who provide services to these consumers.

In our view, the overarching goal of this review by the CCIR/CISRO should be to consider what, if any, action is needed to align the desired consumer protection outcomes related to upfront compensation paid for sales of segregated funds and mutual funds, while recognizing that they are different investment products. In other words, is there a higher level of consumer protection afforded to consumers investing in mutual funds, as opposed to segregated funds.

Comments on the Discussion Paper

Research: In the development of this Discussion Paper, the CCIR/CISRO states that it conducted significant background research and provides links to this research in Appendix 2. IFB appreciates the depth of its review and the insights it provided. However, we note that much of the research has been conducted in international jurisdictions, some of which have implemented regulatory approaches that differ from Canada's.

The Canadian research cited in the Discussion Paper relies heavily on that conducted by the CSA in relation to mutual fund products. While there may be parallels at a high level, we wish to point to some fundamental market differences, the most of important of which is that the investment industry is dominated by bank-owned dealers, and proprietary mutual fund products.

Ontario's Task Force on Securities Modernization estimated that 80% of investment products are distributed through bank-owned shelf distributors. The Task Force indicated its concern that this limits investor choice largely to incentivized proprietary products and restricts access to independent product manufacturers. This was supported by the MFDA Client Research Report which found: *the majority of the distribution of investment products to investors is through bank-owned shelf distribution channels. Bank-owned shelf distribution channels are generally sold by deposit-takers and approximately 95 per cent of deposit-takers' mutual fund assets under administration are comprised of proprietary mutual funds.*

Conversely, the life insurance industry is characterized by independent sales distribution, which provides consumers with access to a wider choice of products (and providers), in a competitive environment.

IFB encourages the CCIR/CISRO to conduct empirical research specific to the sale of segregated funds to retail consumers, so it can be confident that any policy decisions support the reasons for aligning with mutual funds.

As you read through our response, you will find references to data we collected from IFB members on some of the questions posed in this Paper. While it represents only a small sample of views, we hope it will encourage insurance regulators to undertake broader research into the validity of some of the observations posited in this Paper.

Other guidance: Life insurance regulators have issued numerous policy positions, guidance documents and Principles, since 2016. Some have been adopted by various jurisdictions, while others are still in draft form. While IFB appreciates that the approach of these documents has been principles and risk based, we suggest that it may be opportune time for regulators to consider the impact of these proposals, before introducing more in the short time frame, the Paper is suggesting (page 13 – Comment Process and Next Steps).

As an example, we agree with the Discussion Paper's observation that it expects the *Proposed Incentive Management Guidance* will set an important baseline for aligning insurance incentives with FTC principles. This Guidance has not yet been implemented, and IFB looks forward to reviewing the final guidance when available. This along with the discontinuance of the DSC sales option may well address many of the issues raised in the Discussion Paper. There have also been significant changes in the oversight of distribution of life insurance products in recent years, stemming from the FTC guidance, and focused on promoting equivalent consumer outcomes. Consumers of securities and life insurance investment products should expect to receive an equivalent standard of care, and we believe these policy documents have better aligned the securities industry's Client Focused Reforms (CFRs), with those in the life insurance industry. **However, as these are new requirements, some of which are in transition periods, IFB suggests regulators should permit these to take hold.**

As a separate consideration, IFB encourages regulators to consider this in both the time provided to stakeholders to respond to these important consultations, and to those in the life insurance business, who must be informed, trained, and understand the changing expectations on them and their client relationships.

<u>Targeted Outcomes</u>
IFB generally supports the 7 Targeted Outcomes set out in the Paper. As mentioned at the outset of this response, IFB is concerned about any regulatory action which may create an unintended consequence, such as reducing access to advice for consumers. We suggest adding an Outcome that a regulatory approach:
Should not impose barriers to providing access to advice and products for consumers of different demographics, including less affluent or rural consumers.

<u>Current environment: Various factors of influence</u>

Fintech: The "current" environment is constantly evolving. Fintech, and its rising influence on the insurance industry is one example, as are changing consumer behaviours which demand more immediate access to products and their advisors. Developing policies which are principles-based and risk-based will be better positioned to adapt to these changes.

Better disclosure for segregated fund policyholders: The move to Total Cost Disclosure for investment funds and segregated funds will provide important information for clients and better equip them to evaluate the cost-benefits of their investments, at point of purchase and as an ongoing investment. By disclosing the embedded fees, as well as new cost and performance reporting, clients of both mutual funds and segregated funds should receive equivalent disclosures. As well, the *Proposed IVIC Contracts Ongoing Disclosure Guidance* is aimed at improving clients' understanding of the guarantees and how their actions might affect these guarantees.

Sales process for mutual funds and segregated funds: The sales recommendation process is different for mutual funds and segregated funds. One major difference is that mutual funds can be sold without advice, through order execution only brokers and direct with the mutual fund company. These options make them more accessible to consumers, including first-time or DIY investors, and arguably, in some cases, cheaper. Segregated funds cannot be sold without the advice of a licensed life insurance agent or the insurance company, has certain guarantees and a cost for advice and servicing built in.

> ***IFB member****: Segregated funds are complex products, completely unlike mutual funds. Seg funds require a level of technical knowledge and greater explanation, which makes them more complicated to explain to clients. Also, most segregated funds do not have the option to de-couple the trailer fee from the product, so these advisors cannot charge their higher "fee-for-service" without double-dipping on the seg fund trailer and their blanket fee.*
>
> *Most mutual funds have a fee option where the trailer fee is set to zero. These advisors build their client portfolios using these funds under a "nominee account" and then charge a "fee-for-service" fee on the whole account (charged at the dealer level) with the result usually being that they charge 1.25%-1.50%, instead of just getting the traditional 1.00% trailer fee. It is my understanding that only one or two segregated fund companies have this as an option. Since the MF advisor cannot deposit any other segregated funds into nominee accounts, they cannot extract their higher fee so they simply do not offer these products, even to the detriment of the client. Since some of the segregated funds have fees which are on-par and, in a few cases, lower than underlying mutual funds, the old argument of "I don't offer them because they are expensive" is really just an excuse for "I don't offer them because I don't understand them, and I cannot get paid as much on them."*

The cost of advice: As a life insurance product, there are also differences in the time it takes to assess the suitability of the segregated fund for the client, requiring agents to spend more time with a prospective client, upfront to assess their needs and conduct a risk analysis. Purchasing a segregated fund requires more detailed needs and risk assessments, regarding options that are not available to mutual fund investors, such as assessing the need for estate planning, beneficiary designation, creditor protection, capital preservation, etc.

IFB asked members to provide us with insight into the time they spend with a prospective segregated fund client. Note that we used an average time. Some advisors suggested much higher time frames.

Advisor perspective on time spent with a prospective segregated fund client[2]

Initial meeting: On average, 2-3 hours with a client in an initial meeting collecting the information they need to understand the client's needs for a segregated fund.

Needs analysis/recommendation: Based on client's information, advisor conducts a needs analysis, evaluates suitable product choices, and prepares a recommendation. Many advisors told us this can take 15-20 hours. Some spent considerably more time.

[2] Based on sample of IFB members who actively sell segregated funds

Follow up client meeting: The next stage is the client meeting where the advisor explains their research and explains and documents the choice of fund. 2-4 hours, often with one or two other team members.

Client decision: At this point the client decides to proceed, delay the investment, or decline. Hours spent with no compensation = minimum 19-27 hours. If sale proceeds, paperwork submitted to life insurance company, and commission earned.

Ongoing service/ plus preparation for client meeting: Ranges in frequency, often depending on client, from annual, 2X/year, quarterly, or as needed/on call. Average per client = 30 hours/year.

Approximate total hours per client who invests = 49 -57 hours year one.

Different business models: Integrated financial institutions, like banks, benefit from ongoing contact with individuals and businesses who deal with them on a regular basis. This provides them with the opportunity to continually up-sell and cross-sell. Independent advisors, on the other hand, build their own book of business and fund their own business expenses. These advisors must reach out to potential clients and be persistent to attract and retain them as clients. They spend a great deal of time – often unpaid – before this happens. Commissions and trailers help compensate for this. We question how reducing their income, while not affecting those who receive salaries or bonuses, will lead to better investor outcomes or a better industry.

Business owners: The insurance component of segregated funds makes it attractive for business owners or other professionals seeking creditor protection.

Demographics: As the population continues to age and near retirement, or are already in retirement, there is an increased focus for clients on estate planning and capital preservation, making segregated funds an attractive alternative to traditional mutual funds.

Advice is being repriced/the role of Advisors is changing: The rise of robo advice, ETFs, etc., is putting pressure on those aspects of the advisor value proposition that can be performed by automation, such as asset allocation, portfolio maintenance and what some coin "light financial planning". Consumers of investment products are increasingly aware of the costs of investing and the impact of those costs on their investment returns.

Incentive guidance and upfront compensation: The life insurance industry has been built on competition and rewards more successful performers, over those with low performance. The CCIR/CISRO working group acknowledged in its incentive guidance that insurers and intermediaries need to compensate those involved in the sale and servicing of their products.

IFB considers that with proper risk management systems in place, sales-related conflicts or risks to consumers can be effectively managed. We also note that the traditional sales role has transitioned into a more advisory role. There are certainly opportunities for insurers to incorporate a variety of metrics, other than compensation, to reward positive behaviours and that encourage the fair treatment of customers. These could include successfully completing enhanced product education and training, training on FTC expectations, monitoring client retention and persistency rates and client complaints

timely processing of claims and complaints and encouraging advisor succession and business continuity planning.

Regulatory arbitrage
Several times in the paper, the CCIR/CISRO raised regulatory arbitrage as a risk of mis-selling segregated funds, if there are different approaches taken to address upfront compensation in the securities and life insurance sectors. IFB notes that the CCIR and the CSA have previously stated that they have no evidence to support claims that dual-licensed advisors have stopped selling mutual funds or moved clients into segregated funds to get higher compensation or, more recently, in advance of the DSC ban for segregated funds.

Recent research conducted by Investor Economics examined data regarding the increase in segregated fund sales since 2020. The report noted that there was also a large spike in mutual fund and ETF sales as consumers looked to participate in the strong investment markets. Investment Executive reported that the research results showed that the increase in segregated fund sales, post the announcement of the ban on upfront commissions in mutual funds, was not due to dually-licensed advisors selling segregated funds over mutual funds. In fact, Investor Economics' research showed that most segregated fund sales were from insurance licenced only advisors who wanted their clients to get market exposure, along with the protection, and estate planning advantages segregated funds provide. *The largest volume of seg fund gross sales last year came from advisors who were insurance-licensed only, said Guy Armstrong, executive director with Investor Economics in Toronto.*

Similarly, the data showed there was no evidence of advisors selling mutual funds to reinvest client funds in segregated funds. The report said: *While a substitution of flows to ETFs from mutual funds has been identified, no such effect has been identified with seg funds versus other funds.* In fact, the report pointed out that many large securities dealers discontinued sales of new DSC and low-load segregated funds at the same time they stopped those sales for mutual funds.

> **IFB member***: Commission arbitrage would be visible if it existed. For example, annuities pay much higher upfront commissions and there has not been a mass migration of advisors moving assets to annuities.*

IFB urges regulators to be cautious in responding to allegations of regulatory arbitrage, particularly as there is no empirical evidence to support such claims, and it may drive policy decisions that lack substance in fact.

Distribution: Advisor use of multiple MGAs creates oversight risk
IFB was surprised that this section on Distribution was included in this Paper, since the purpose is to examine upfront compensation in segregated funds. Specifically, the Discussion Paper seems to suggest that the restriction on securities registrants that require them to place business through a single dealer firm in the securities sector is preferable to the existing insurance approach where licensees can have multiple contracts with insurers and MGAs.

We understand that insurers have argued that they can only review the suitability of sales of their own products and that the advisor may be placing business with other insurers or MGAs. The CCIR/CISRO paper suggests that this may create a potential FTC gap.

We are also aware that some insurers, and MGAs, have reduced the number of agents authorized to conduct business through them in response to growing compliance pressure. We understand that FSRA collects information on the specific insurers an agent is contracted with and may have noticed this trend.

As we pointed out earlier in this response, insurance regulators have introduced a number of significant guidance and compliance documents in recent years, aimed at enhancing the protection of consumers dealing in the life insurance market. We urge regulators to allow time for these processes and principles to take hold in the industry, while monitoring for poor uptake or systemic issues which may need to be addressed.

The CSA has also put many consumer protection and enhanced oversight requirements in place for the securities sector. We support consumer protection initiatives, like the CFRs and the FTC; however, the business of investing and the giving of investment advice is not bullet-proof. Investing is by its nature a risk-based activity and consumers benefit by being able to access professional financial advice. The securities dealer model is not without its challenges, as evidenced by the number of complaints the MFDA and IIROC deal with every year against securities registrants and their firms.

A major difference between MGAs and securities dealers is that MGAs are not client-facing. They provide administrative services - acting as a conduit between the insurer and licensed agents. As the role of the MGA has grown over the years, insurance regulators continue to consider how best to integrate them into the overall supervisory system of insurance oversight. There may be merit in requiring some of the oversight obligations that securities dealers have, but this would need to be the subject of considerable study and consultation. Insurance regulators must be assured that there is a need for this level of intervention given the differences in distribution between the securities and life insurance sectors.

The life insurance industry embraced, indeed encouraged, the move to independent sales distribution in the 1980's. Many advisors, who began in the career channel, have made successful careers as independent advisors, and are dedicated to the clients they serve. Despite this, we have not identified a trend of IFB advisors spreading their business around, between insurers or MGAs, other than for business reasons set out in the following excerpts from IFB members. We encourage the CCIR/CISRO to conduct its own review.

IFB advisor perspective on use of MGAs
In response to the concerns identified in the Discussion Paper, we asked IFB members about their MGA relationships:
Most place all their business through one MGA (62%) Reasons include that it is less complicated, their MGA provides good compliance support, and the need to consolidate FYC so they meet minimum contracting requirements, bonus rates may vary
Only 22% use 2 MGAs
9% use an MGA and place insurance direct with the insurer

When asked, if there should there be a requirement to use one MGA?
60% said No
25% said Yes.
Despite most using only 1 MGA, respondents would not support this becoming a requirement. Reasons included: not all MGAs offer wide access to the same products, better product choice of providers is better for clients, MGAs have different levels of competence, makes MGAs compete for business, advisor can be left at risk if use single MGA and it loses an insurance contract or becomes bankrupt, some MGAs offer specialty products an advisor may need for a specific client. Diversifying MGAs allows the advisor some flexibility as well, particular during high volume times of the year (i.e., Christmas/yearend, RRSP's in Jan/Feb, RESPs in August/September)

IFB advisor perspective on use of insurer segregated funds
We asked IFB members how many insurers they typically would use when recommending a segregated fund?
60% said they use the seg funds of 2 or 3 insurers
31% place most clients in a seg fund with a single insurer.

Reasons include:
Advisor gets better service if places more product with a single insurer, insurers give better MER discounts depending on amount invested, freedom to pick best fund for client, too complicated to understand all products available so I keep my shelf smaller.

Intermediaries' Product Offerings
In this section, the Paper addresses an advisor's ability to access multiple products which the Paper suggests may increase the risk for them to choose those which pay the highest compensation. Advisors are, of course, limited to the products of the insurers or MGAs they are contracted with. Mutual fund dealers are permitted to offer a variety of products from various product manufacturers, subject to them meeting their KYP requirements under CFRs.

As insurance regulators consider this, IFB notes that these KYP requirements have led to consequences for consumers. Industry stakeholders, including IFB, pointed to the likelihood that securities firms would reduce the number of products on their shelves in response to the strict product approvals that the CSA put in place, and the CCIR/CISRO have referred to in this Discussion Paper.

The unintended outcome has been that Canada's banks, along with at least one large career investment firm, have removed investment products from independent product manufacturers from their shelves, and only offer investors access to their proprietary products. This, in turn, has led to criticisms from investor advocates, the CSA, the Ontario Taskforce on Securities Modernization and the Ontario government which launched an investigation through the OSC. These are serious considerations for insurance regulators as they consider any next steps.

The Distribution and Product Offerings sections in this Paper make comparisons between securities dealers and independent distribution. We note that there is no consideration of other the forms of insurance distribution, such as career sales (captive), national accounts or direct to insurer contracts. IFB draws attention to the observations by the Ontario Taskforce on Securities Modernization, in which it expressed concerns related to restricted product shelves and proprietary only shelves:
The Taskforce recommended that all dealers that sell proprietary products be required, by OSC rule, to document, in detail, their rationale when independent products are refused access to their product shelves and, by OSC rule, that dealers that sell proprietary products report to the OSC, on a quarterly basis, the percentage of proprietary versus independent products on their product shelves, segmented by channel and product category, and the percentage of proprietary versus independent products sold to clients in the same format.

In September 2022, the CSA announced it would review the distribution of proprietary mutual fund sales and consider whether it needs to make changes to ensure investors are treated fairly when they are sold proprietary funds.

We recognize that independent distribution is the largest for life insurance sales, however, we urge insurance regulators to consider regulatory policies that are distribution neutral, except where there is a compelling reason to do otherwise. In this case, we believe the topic of upfront compensation in segregated funds applies equally to all distribution channels.

Advisor chargeback option
Many IFB members who responded to our survey said the advisor chargeback sales option is good for clients:

- It allows clients to exit early or if unexpected circumstances arise with no penalty.
- Advisors who explain the chargeback series and can also offer fee for service, find clients prefer chargeback.
- Offers the advisor the opportunity to do a better job for the client by being paid for the time and effort spent with the client upfront.
- If advisor chargeback is taken away, it will encourage asset gathering, rather than advice
- Holds the advisor accountable, and
- Allows advisor to earn a living and service the client while client incurs no penalty. Win-win.

To help address some of the concerns expressed in the Paper, we saw support for:

- lowering the chargeback period to 2-3 years and capping the upfront charge. Up to 7% is currently available in the market, which was considered to be too high.
- Level chargebacks @ 2%. Some suggested paying no trailer for 2 years.
- 5-year LL should be discontinued.

IFB member perspectives on the Discussion Paper's suggested changes:
The Paper proposes the following potential changes, which we asked members to respond to (they could check all that they agreed with):

(i) a total ban on upfront commissions, (19%)
(ii) a cap on the amount of the commission, (27%)
(iii) limits on the duration of chargeback periods, (46%)
(iv) enhanced disclosure of potential costs or negative effects, (43%)
(v) requiring upfront commissions to be reasonably proportionate to the value of the product and the amount of service provided to the investor (15%)
(vi) increased monitoring of intermediaries with chargeback debt owing to an insurer or a managing general agent (29%)

Concluding remarks

We approached our response to the Discussion Paper with the question, "what is different about segregated funds, as compared to mutual funds, that might lead to different considerations in the treatment of upfront commissions?". At its most basic, segregated funds are life insurance products which are intended to be long-term investments, and provide guarantees backed by the life insurance company. Mutual funds are more transaction-based and easily traded, even without advice, and offer no protection of downside market risk. Beyond these observations, we hope we have added some additional thoughts to help flush out this question to a deeper level.

It is our hope that we have not only provided insights into the questions the CCIR/CISRO have identified but have helped regulators better understand the perspectives of our members, who operate as self-employed, independent life insurance licensees. It is evident to us, as it often is, that our members care deeply about their clients and the industry they work in.

Lastly, as regulators review the various responses submitted to the Discussion Paper, we trust that the insights we have shared will help create conversation around whether issues like regulatory arbitrage or the perception that advisors use many MGAs to skirt oversight are endemic. Of course, our sample is small, and we encourage insurance regulators to undertake their own research to be assured that the same, or similar, considerations regarding the potential client harms that arise from upfront compensation exist for segregated funds.

IFB appreciates the opportunity to comment. Please contact the undersigned, or Susan Allemang, Director Policy & Regulatory Affairs (email: sallemang@ifbc.ca), should you have questions or wish to discuss our response in greater detail.

Yours truly,

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