

June 6, 2011

Mr. Philip Howell
Chief Executive Officer and
Superintendent, Financial Services
Financial Services Commission of Ontario
5160 Yonge Street, Box 85
Toronto, Ontario M2N 6L9

Delivered via email to: priorities@fSCO.gov.on.ca

Dear Mr. Howell:

Re: Financial Services Commission of Ontario ("FSCO") Draft Statement of Priorities & Strategic Directions dated April 2011

FAIR Canada is pleased to offer comments on FSCO's Draft Statement of Priorities & Strategic Directions (the "Draft Statement").

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investment protections in regulation. Visit www.faircanada.ca for more information.

FAIR Canada Comments and Recommendations – Executive Summary

The core of FSCO's mandate is its responsibility to protect the public interest and its priorities, strategies and initiatives must ensure that financial consumers will be protected. FAIR Canada has a number of recommendations in respect of certain initiatives set out in the Draft Statement which impact financial consumers.

1. Initiative - Review and Recommend Changes to Better Mitigate Risk – Perform a Market Conduct Review of Suitability of Product Recommendations for Insurance

- 1.1. FAIR Canada advocates for the adoption of a new model of consumer protection for complex financial products, including segregated funds. This new model would place the burden on parties who sell complex financial products to consumers (meaning insurance companies, distributors and agents) to ensure that their sales force, clients and the end consumer actually understand the products being sold; the costs and risks associated with those products; and the implications of the

disclosure documents provided. In other words, FAIR Canada advocates the replacement of a standard of informational disclosure with a standard of active knowledge.

- 1.2. FAIR Canada recommends that FSCO consult with stakeholders on increasing proficiency standards for insurance agents.
- 1.3. FAIR Canada recommends that FSCO consider setting out *regulatory* requirements for product suitability in a fashion similar to IIROC Dealer Member Rules 1300 and 2500 and MFDA Rule 2.2.1 and Policy No. 2 in order to improve outcomes for consumers.
- 1.4. FAIR Canada recommends that FSCO make it a regulatory requirement that, in order to be licenced to sell segregated funds, an agent must also be licensed to sell mutual funds or other lower cost products.
- 1.5. We recommend that FSCO add as a specific strategy the issuance of a consultation paper in 2011 on implementing a best interest of the client standard for all market intermediaries.

2. Initiative - Work with the Ministry of Finance to Review Major Parts of the Insurance Act and other Insurance-Related Legislation

- 2.1. FAIR Canada urges FSCO to consult with stakeholders when considering legislative change so that consumer and retail investor advocates have an opportunity to provide their input into the policy-making process.

3. Examine CCIR Recommendations to Reflect Changes in Distribution Channels

- 3.1. FAIR Canada recommends that FSCO and the CCIR reach out to consumer-based organizations, if they have not already done so, to obtain the views and perspectives of the consumer when determining whether there are any regulatory gaps or risks to consumers, and in respect of any recommendations or proposed changes to the regulatory framework.
- 3.2. FAIR Canada recommends that FSCO undertake a specific initiative to further the ways in which it communicates with and is accountable to financial consumers.
- 3.3. FAIR Canada recommends, as one means to do this, the strengthening of the Consumer Advisory Committee (the “Committee”) which FSCO created in 2001. The Committee should be provided greater resources and its members should be compensated for their time and effort in meeting the Committee’s mandate in a manner similar to the Ontario Securities Commission’s Investor Advisory Panel so that that it can provide more meaningful, publicly-transparent consumer input to FSCO.

1. Mandate and Vision of FSCO

- 1.1. FSCO is an integrated financial services regulator that regulates several sectors including insurance companies, agencies and insurance intermediaries who sell life and health insurance,

including segregated fund contracts and other insurance products which have an investment component. FSCO's strategic priorities and activities directly impact many financial consumers who obtain products and services from life insurance agents in Ontario. Many of these life insurance agents are financial service providers (also known as "financial planners", "financial advisors" or "wealth management specialists" (amongst other terms)), are also licensed to sell mutual funds and other securities products.

- 1.2. FAIR Canada, as a voice of financial consumers, would like to provide input into the development of policy pertaining to the distribution and sale of insurance products with an investment component, with a view to increasing protection for financial consumers.
- 1.3. FSCO's legislative mandate is "to provide regulatory services that protect the public interest and enhance public confidence in the sectors it regulates". FSCO has set as its vision "[t]o be an effective regulator that protects the public interest and supports a strong financial services sector". **The core of FSCO's mandate is its responsibility to protect the public interest and its priorities, strategies and initiatives must ensure that financial consumers will be protected.**

2. FSCO's Priorities, Strategies and Initiatives

2.1. FSCO has established three proposed priorities:

1. Risk Based Delivery;
2. Foster a Coordinated National Approach to Regulatory Issues; and
3. Continuous Service Improvement.

2.2. FSCO has developed a number of strategies and initiatives to achieve these proposed priorities. FAIR Canada welcomes the opportunity to provide its comments on these priorities, strategies and initiatives and its recommendations to improve regulation for the benefit of financial consumers.

3. Initiative - Review and Recommend Changes to Better Mitigate Risk – Perform a Market Conduct Review of Suitability of Product Recommendations for Insurance

- 3.1. FAIR Canada agrees that many insurance products, such as segregated funds, are complex. Segregated fund contracts can run over 200 pages in length and often have complicated reset, guarantee minimum withdrawal benefits and other provisions. The information folder is to provide to consumers brief and plain disclosure of all material facts relating to the segregated fund contract and FAIR Canada agrees that many consumers will have difficulty understanding such complex products. FAIR Canada agrees that this creates a risk for consumers.
- 3.2. FAIR Canada believes that more needs to be done in order to adequately protect consumers of these complex financial products. FSCO has indicated that it is going to undertake a market conduct review to determine how the industry is ensuring that consumers are being "empowered to make informed decisions and are presented with suitable product recommendations". FSCO will seek to "...understand and assess the process agents use in

making recommendations to consumers and the processes in place at insurance companies when developing and distributing products”. FAIR Canada would like to see more detail in the Statement of Priorities of the approach and scope of the market conduct review that will be conducted by FSCO in order for FSCO to obtain a better understanding of what is typically done by an agent to ensure suitability of product recommendations. In order to ensure an independent review, FAIR Canada recommends that FSCO not rely on self-assessment of compliance through the use of a questionnaire (as was done by the Canadian Council of Insurance Regulators (“CCIR”) to assess compliance by agents in its 2008 Final Report on the Implementation of the Three Principles).

Investors Need to Understand the Product, Its Associated Risks and Costs

- 3.3. FAIR Canada believes that regulators need to ensure that retail investors are not sold a product, particularly a complex product, unless the intermediary is satisfied, based on objective evidence, that the financial consumer actually understands the product and its associated risks and costs. Simply increasing the volume of information disclosed to consumers will not provide adequate protection. The provision of lengthy, complex and legalistic documents (for example, a 200 page Information Folder for a segregated fund contract) will not be effective for investor protection. This is particular so for retail consumers dealing with professional “advisors” intent on selling products, especially complex ones, to their clients rather than putting the clients’ interests first.
- 3.4. FAIR Canada believes that regulators must take a more proactive role and use substantive measures to protect consumers. It is not enough to require complex legalistic disclosure which shifts responsibility onto unsophisticated consumers. FAIR Canada advocates for the adoption of a new model of consumer protection for complex financial products, including segregated funds. This new model would place the burden on parties who sell complex financial products to consumers (meaning insurance companies, distributors and agents) to ensure that their sales force, clients and the end consumer actually understand the products being sold, the associated costs and risks, and the implications of the disclosure documents provided. **In other words, FAIR Canada advocates the replacement of a standard of informational disclosure with a standard of active knowledge.**
- 3.5. This will require insurance companies and intermediaries to reach out to their clients and build their knowledge and understanding of the products in question. This approach will help to protect the interests of the retail investor in a market of sophisticated financial products and help to ensure that clients’ best interests are put first.

Pre-Requisite Qualifications Need to Be Improved

- 3.6. The prerequisite qualifications that are required in order to sell financial products, particularly complex financial products such as segregated fund contracts, should also be examined to determine whether higher standards are necessary in order to protect financial consumers. The ability of agents to support the financial literacy of their clients depends on the proficiency, knowledge and skills of the agent. At present, agents simply need to write and pass the LLQP in order to sell complex products such as segregated funds. They do not need to have a high

school diploma. FAIR Canada does not consider this to be adequate given the complexity of financial products, and the degree of unconditional trust and confidence that is placed in financial service providers¹. **FAIR Canada recommends that FSCO consult with stakeholders on increasing proficiency standards for insurance agents.**

Suitable Product Recommendations – Regulatory Requirements Needed

- 3.7. FAIR Canada urges FSCO, as part of the market conduct review, to consider whether the Industry Practices Review Committee (“IPRC”) of the CCIR and the Canadian Insurance Regulatory Organizations (“CISRO”) product suitability principle, that “the recommended product must be suitable for the needs of the consumer” is adequate to protect consumers.
- 3.8. The IPRC states that the recommendation of a suitable product should be based on the following:
- Fact finding appropriate to the circumstances, and assessment of the client’s specific needs;
 - A flexible needs assessment. The assessment should reflect factors including the underlying risk, the client’s objectives, and the complexity of the product being sold; and
 - An agent or broker’s product recommendation that meets the client’s identified needs.
- 3.9. FAIR Canada urges FSCO, when conducting its market conduct review, to assess whether consumers are, in fact, being provided with suitable product recommendations and whether this process has been adequately documented.
- 3.10. **FAIR Canada recommends that FSCO consider setting out *regulatory* requirements for product suitability in a fashion similar to IIROC Dealer Member Rules 1300 and 2500 and MFDA Rule 2.2.1 and Policy No. 2 in order to improve outcomes for consumers.**

Harmonization and Consistency in Regulatory Requirements of Segregated Funds and Mutual Funds Necessary for Fairness for Consumers

- 3.11. FAIR Canada urges FSCO and other regulators such as the Joint Forum of Financial Market Regulators to examine whether the risks to consumers of being sold an unsuitable segregated funds contract and being placed in unsuitable investments within that contract are greater than the risks to consumers of being sold an unsuitable mutual fund. Additionally we recommend that they determine whether greater harmonization and consistency of regulatory requirements would better protect consumers. Regardless of which segment of the financial services industry they are dealing with, consumers should be treated fairly. FAIR Canada notes that there is increasing convergence between products offered in the insurance and securities sectors².

¹ See the OSC Investor Advisory Panel’s submission on the Ontario Securities Commission’s Draft Statement of Priorities at http://www.osc.gov.on.ca/documents/en/Securities-Category1-Comments/com_20110427_11-765_ananda.pdf.

² For example, the BMO Life Product was recently reported in the media as the insurance industry alleges that it is an annuity and therefore, should not be allowed to be sold by a bank; see <http://www.theglobeandmail.com/globe-investor/rivals-call-foul-claim-bmo-breaching-insurance-rules/article1980936/>.

Regulators must ensure that consumers are adequately protected regardless of which sector of the financial services industry the product or sale originates from. Fairness would suggest that the rules for determining what funds are suitable for the consumer should be equivalent. This is especially true since the access point for the sale of these products is often the same individual financial services provider (the dually licensed salesperson) and can even involve investment in the same mutual funds (with a 'wrap' product).

Joint Forum Recommendations Not Implemented

3.12. The Joint Forum of Financial Market Regulators released a Comparative Study of Individual Variable Insurance Contracts (Segregated Funds) and Mutual Funds in May 1999 and issued a report on December 15, 1999 entitled "Recommendations for Changes in the Regulation of Mutual Funds and Individual Variable Insurance Contracts" (the "Joint Forum Report"). The Joint Forum Report recommended harmonization between regulation for fifteen areas, including product suitability. More than a decade has passed since the issuance of this report and in that time there has been: a significant increase in the amount of money invested by Canadians in these fund products; a significant increase in the number of consumers who are purchasers and investors in these products; and a proliferation in the number and complexity of the products available to consumers. The comparative study may be outdated to a certain extent, given regulatory changes or developments, but a number of fundamental recommendations which seem to be obvious steps to improve consumer protection have not been implemented despite the long passage of time. Recommendations that would help protect consumers and would be in the public interest include:

- All compensation paid and incentives given in respect of product sales should be fully disclosed to the consumer (Recommendation #12 (A));
- Opportunities for conflicts between the self-interest of sales representatives and their duties to their clients should be minimized (Recommendation #12(B)) including the prohibition of certain conflicts such as non-educational trips, incentives contingent on meeting specified assets and sales thresholds, excessive promotional events and items, etc.; and
- Products sold to retail consumers should be suitable for that particular consumer's circumstances (Recommendation #14) including considering suitability standards and enforcement and compliance mechanisms.

3.13. **FAIR Canada recommends that FSCO reexamine these recommendations in light of its current priorities, strategies and initiatives.**

Dual-licensing is Required to Protect Consumers

3.14. In order to ensure that suitable products are recommended to a client, FAIR Canada urges FSCO to only permit agents to sell segregated funds if they can also offer the client mutual funds and other financial products which have lower fees. A segregated fund contract will not be a suitable product for many financial consumers and other products may very well be more suitable. Nonetheless, the agent who is not dually licensed will be incented to sell the

segregated fund contract, even though mutual funds or other products may be more suited to the needs of the client, since they are not able to sell those products. Some insurance companies have recognized this issue and only allow an agent to sell segregated funds if they are also licensed to sell mutual funds. **FAIR Canada recommends that FSCO make it a regulatory requirement, that in order to sell segregated funds, the agent should also be licensed to sell mutual funds or other lower costs products.**

Clients' Best Interest Standard

- 3.15. In order to improve fairness and protection for investors, FAIR Canada recommends that FSCO undertake to propose a regulatory requirement that all market intermediaries including insurance agents put their clients' interests first. ***We recommend that FSCO add as a specific strategy the issuance of a consultation paper in 2011 on implementing a best interest of the client standard for all market intermediaries.*** We have recommended that the Ontario Securities Commission (the "Commission") also undertake such a consultation in our submission to the Commission on the 2011-2012 Statement of Priorities³. We believe that both regulators should undertake such a consultation in 2011.
- 3.16. FAIR Canada believes that financial service providers should be providing recommendations that are not just "suitable" or meet the client's "identified needs" but are also in the client's best interest. While the IPRC put forth the principle-based recommendation of priority of the client's interest – that all insurance intermediaries must place the interests of insurance policyholders and prospective purchasers ahead of his or her own interests - this does not accord with the actual sales practices of the insurance industry or the product suitability principle. Ensuring that a product is suitable for the client does not necessarily mean that it is in the client's best interest, especially since there are frequent misalignments of interests between the financial service provider and the clients, given how financial service providers are compensated and incentivized to sell products.
- 3.17. Many investors believe that their advisor already has a duty to act in their best interests or has a fiduciary duty but there is no clear legal obligation that advisors are bound by any fiduciary obligation⁴. This creates obvious risks for financial consumers.
- 3.18. FAIR Canada believes that it is crucial that Canada not fall behind other jurisdictions in consumer protection; the U.S., the U.K., Australia and other leading jurisdictions have moved ahead of Canada in their initiatives to strengthen investor protections within the client-financial advisor relationship.

³ See a copy of our submission to the Ontario Securities Commission at: <http://faircanada.ca/wp-content/uploads/2011/01/110427-FAIR-Canada-submission-OSC-Statement-of-Priorities.pdf>.

⁴ Supra, note 2 at page 4 to 5.

4. Initiative - Work with the Ministry of Finance to Review Major Parts of the Insurance Act and other Insurance-Related Legislation

- 4.1. This is to be the first review of the legislation relating to life insurance and accident and sickness insurance since 1962. FSCO will be working with the Ministry of Finance to consider changes to further promote consumer protection and harmonization with other Canadian jurisdictions.
- 4.2. **FAIR Canada urges FSCO to consult with stakeholders when considering legislative change so that consumer and retail investor advocates have an opportunity to provide their input into the policy-making process.** FAIR Canada believes that FSCO and the Ministry of Finance should consider, among other things, the following legislative provisions:
- product suitability and/or a best interest of the client legislative requirement;
 - the requirement to disclose to the consumer the amount of compensation and incentives in relation to the sale of a product in order to have a transparent relationship between the financial consumer and the financial services provider;
 - specific provisions which address referral fees; and
 - legislative changes to address the role and responsibilities of the Managing General Agency.

5. Examine CCIR Recommendations to Reflect Changes in Distribution Channels

- 5.1. FSCO indicates that it will review recommendations made by the CCIR regarding the Managing General Agency (MGA) distribution channel in light of developments in the growth of that channel in the last forty years, and in particular, its development into the dominant distribution channel in the last ten years. The CCIR's Issue Paper seeks to obtain clarity as it relates to the roles, responsibilities, accountabilities, and appropriate oversight of the agent, the MGA and the insurer. It deals with a number of important areas such as:
- the supervision of agents (both initial screening and ongoing monitoring of conduct);
 - responsibility for detecting and reporting unsuitable conduct of agents and the difficulty of doing so given the structure of the MGA channel;
 - the level of transparency to consumers of compensation structures of advisors and MGAs and whether there are misalignments of incentives taking place;
 - how complaints are dealt with by the agent, MGA and insurer; and
 - whether the existing OmbudService for Life and Health Insurance ("OHLI") has too narrow a mandate as only insurance companies, but not those who distribute insurance – such as MGAs and agents – are required to participate in OLHI. For example, complaints about an advisor's activities do not fall within the scope of OHLI and, therefore, the consumer on the insurance side does not have access to the same free, non-binding comprehensive dispute resolution service as he or she does on the securities side with the Ombudsman for Banking Services and Investments ("OBSI").
- 5.2. The CCIR is trying to determine whether there are regulatory gaps and risks to consumers and whether, given the changes in the distribution model and the changes in the marketplace that

have occurred, the regulatory framework must change to ensure that the regulatory goals of fair treatment to consumers and compliance with laws can be met.

- 5.3. FAIR Canada has reviewed the submissions that were posted on the CCIR's website and notes that the CCIR did not receive any written submissions from individuals who are not affiliated with the insurance industry nor did it receive any comments from non-profit organizations who seek to protect the interests of consumers. **FAIR Canada recommends that FSCO and the CCIR reach out to consumer-based organizations, if they have not already done so, to obtain the views and perspectives of the consumer when determining whether there are any regulatory gaps or risks to consumers, and in respect of any recommendations or proposed changes to the regulatory framework.**
- 5.4. In furtherance of its legislative mandate to provide regulatory services that protect the public interest and enhance public confidence in the sectors it regulates, one of FSCO's strategies is to "communicate, share knowledge and engage our staff and stakeholders". **FAIR Canada recommends that FSCO undertake a specific initiative to further the ways in which it communicates with and is accountable to financial consumers.** FSCO should set as a specific initiative means of obtaining the views of financial consumers, in order to understand their concerns and be accountable to their interests. **FAIR Canada recommends a means of doing so would be to strengthen the Consumer Advisory Committee (the "Committee") which FSCO created in 2001.** The mandate of the Committee is to provide advice from the consumer's perspective on matters that affect FSCO's regulated sectors⁵ and the Committee is to serve as FSCO's principal consultation vehicle with consumers⁶. The Committee's role includes providing advice to the Superintendent of Financial Services on matters of interest to consumers, providing a consumer's perspective on consultation documents and undertaking specific initiatives designed to assist consumers in respect of the purchase of financial products.
- 5.5. FAIR Canada notes that the Consumer Advisory Committee has not provided any written submissions that are available publically since its inception. We understand that it has provided comments through quarterly discussions with FSCO. The lack of any written submissions is likely due to the limited resources provided to the Committee and the fact that the Committee members are not paid for their time. **FAIR Canada recommends that the Committee be provided with greater resources and its members be compensated for their time and effort in meeting the Committee's mandate in a manner similar to the Ontario Securities Commission's Investor Advisory Panel so that that it can provide more meaningful consumer input to FSCO that is transparent to the public.** Otherwise, the Committee will not have the ability to communicate with individual consumers, conduct any research of its own, or, it appears, prepare written submissions.

⁵ See the press release of FSCO dated July 6, 2011 at <http://www.fSCO.gov.on.ca/english/pubs/news/archived/20010706-committee.asp?view=print>.

⁶ See FSCO's Annual Report 2001-2002.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-572-2282/Ermanno.pascutto@faircanada.ca or Marian Passmore at 416-572-2728/marian.passmore@faircanada.ca.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Ermanno Pascutto', is positioned below the 'Sincerely,' text.

Canadian Foundation for Advancement of Investor Rights