November 7, 2022

Canadian Council of Insurance Regulators Secretariat
ccir-ccrra@fsrao.ca

Re: Discussion Paper on Upfront Compensation in Segregated Funds (Consultation)

FAIR Canada is pleased to provide comments in response to the above-referenced Consultation.

FAIR Canada is a national, independent charitable organization dedicated to being a catalyst for the advancement of the rights of investors and financial consumers in Canada. We advance our mission through outreach and education, public policy submissions to governments and regulators, and proactive identification of emerging issues. FAIR Canada has a reputation for independence, thoughtful public policy commentary, and repeatedly advancing the interests of retail investors and financial consumers.

A. OVERVIEW

We support the efforts of the Canadian Council of Insurance Regulators and the Canadian Insurance Services Regulatory Organizations (together, the Insurance Regulators) to gather information from the industry to better understand upfront compensation in segregated funds and determine how to improve customer outcomes.

A key regulatory objective should be to ensure compensation structures are aligned with, and help promote, fair outcomes for consumers. Where compensation structures do not further this goal, or where they create conflicts of interest that cannot be adequately managed, they should be banned. In line with this principle, FAIR Canada supports banning deferred sales charges (DSCs) and advisor chargebacks (ACBs) for segregated funds.

Below is a summary of our comments on select issues in the Consultation. More detailed comments follow.

Deferred Sales Charges

- We support the ban on DSCs for segregated funds, and recommend it be implemented as soon as possible.
- Research on commission structures demonstrates that DSCs distort the advice process and skew advice towards products that pay these fees, as opposed to products that best serve consumers. (This research is equally relevant for ACBs.)
- Moreover, the ban will close-off opportunities for regulatory arbitrage between mutual funds (where DSCs have been banned since June 1, 2022) and segregated funds.

Advisor Chargebacks

- Even though ACBs are structured differently than DSCs, they raise similar consumer protection concerns.
- Like DSCs, ACBs create a potential conflict between the interests of the intermediary and the client, which could lead to poor customer outcomes.
- The fact that the intermediary pays the chargeback does not diminish the potential for conflicts or poor client outcomes.
- Pending a ban, the intermediary should disclose these conflicts to the client, resolve them in the client's best interest, and illustrate how they executed these steps.
- In addition, the Insurance Regulators should enhance their monitoring and enforcement to ensure that insurers and intermediaries are taking these steps.
- Banning ACBs would promote effective competition that works in the consumer's interest. It would also move us closer to other jurisdictions, such as the United Kingdom and the Netherlands, which have banned commissions on all retail investment products.
- A ban on ACBs would encourage industry participants to develop alternative compensation structures that better serve consumers to replace ACBs. This aligns with targeted customer outcome No. 8 in the Consultation, which is to enable innovation and encourage flexibility in the way customers can pay for advice.
- Given the similarities between ACBs and DSCs, the ban on ACBs should coincide with the June 1, 2023 ban on DSC sales in segregated fund contracts.

Finally, we note that the Insurance Regulators may need to consider whether other compensation structures that come to light from the Consultation should also be banned or regulated in some way.

B. DEFERRED SALES CHARGES

Beginning June 1, 2022, the Canadian Securities Administrators (CSA) banned fund organizations from paying upfront sales commissions to advisors, effectively ending the use of DSCs in connection with mutual fund sales.

DSCs create a conflict between the interests of the intermediary recommending the product and the consumer, which can have a negative impact on consumer outcomes. The CSA adopted the DSC ban[1] after independent empirical research showed that commission structures, such as the DSC sales option, distort the advice process in a way that is harmful to consumers. The study, which examined the extent to which sales commissions and trailing commissions affect mutual fund sales, revealed that:

[1] Canadian Securities Administrators, Canadian securities regulators adopt ban on deferred sales charges, February 20, 2020. The CSA stated that upfront commissions create conflicts of interest, incentivize product recommendations that may not be in the client's best interest, and lead to suboptimal consumer outcomes.

- The impact of past performance on fund sales is significantly lower when fund manufacturers pay sales and trailing commissions.
- As past performance becomes less influential on fund sales, future fund performance is poorer.
- Fee-based mutual fund sales are highly influenced by past performance, which has a positive effect on future fund performance.[2]

Similarly, a review of the literature on mutual fund compensation found that:

- Funds that pay commissions to advisors have lower returns than funds that do not pay commission.
- Advisor recommendations are sometimes biased in favour of alternatives that generate more commission for the advisor.
- Compensation influences the flow of money into mutual funds. Higher embedded commissions stimulate sales.[3]

A ban in the insurance sector is necessary to ensure that clients purchasing segregated funds receive the same protections as mutual fund investors. It would also support targeted customer outcome No. 6 in the Consultation, which is to reduce the risk of mis-selling segregated funds over securities products by dually licensed intermediaries due to differing upfront compensation arrangements, and prevent such individuals from engaging in regulatory arbitrage.

Given the lengthy notice of a pending ban, fund managers and intermediaries have had sufficient time to prepare for the ban without the need for additional delays. In line with the ban in the securities sector, FAIR Canada, therefore, supports the Insurance Regulators' commitment to prohibiting DSC sales by June 1, 2023, at the latest.

Pending implementation, we support the Insurance Regulators' efforts to discourage new DSC sales in segregated fund contracts. To paraphrase the CSA, the Insurance Regulators should "… be highly attuned to inappropriate sales of DSC products ahead of the ban."[4]

Lastly, the Insurance Regulators should assess whether temporary measures may be needed where clients continue to hold DSC segregated funds in their accounts after the ban. This could include, for example, requiring intermediaries to inform clients that, despite the ban, they may still be charged a DSC on segregated funds they continue to hold. The Insurance Regulators may also wish to encourage fund managers to consider waiving DSCs in certain circumstances, such as in cases of hardship.

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[2] Douglas Cumming, Sofia Johan and Yelin Zhang, A Dissection of Mutual Fund Fees, Flows, and Performance, October 19, 2015. The study examined 43 mutual fund companies representing 67% of fund assets in Canada.
[3] Edwin Weinstein, The Brondesbury Group, Mutual Fund Fee Research, Spring 2015.
[4] Canadian Securities Administrators, Canadian securities regulators adopt ban on trailing commissions for order-execution-only dealers, September 17, 2020.

C. ADVISOR CHARGEBACKS

We are pleased that the Insurance Regulators are turning their attention to ACBs. We have concerns about the conflicts of interests ACBs raise and recommend they also be banned.

Except for the fact that the intermediary pays the chargeback, ACBs are essentially DSCs masquerading under a different name. Both involve payment of a sizeable upfront commission to the intermediary. Like DSCs, ACBs create conflicts of interest that risk distorting the advice process. Simply put, some intermediaries may recommend products that pay the most commissions upfront, as opposed to products that best serve the client's interests or needs.

Our concern about distorting the advice process is not academic. To encourage the sale of their segregated funds, Canada Life recently announced it was increasing the amount of advisor compensation for the sale of such funds from 3% to 4% until April 24, 2023.[5]

This development is troubling because it shows that insurers are keenly aware that the amount of the upfront commission influences sales. By incentivizing the sale of certain products over others, they further demonstrate the risks upfront commissions pose to a fair and efficient marketplace when compensation, rather than advice, drives the business. Not only is this detrimental to the client's interests but, over time, it reduces consumer confidence in the value of financial advice.

Some argue that ACBs do not harm consumers because it is the intermediary, not the client, who pays the costs of early redemptions. Doubling-down, they then argue that ACBs promote better outcomes because they focus the intermediary's attention on selling ACB segregated funds to only select clients—that is, those they believe will not need to redeem them during the chargeback period. From their perspective, the ACB enhances the intermediary's suitability assessment at the point of sale.

These arguments are fallacious in several respects. First, even though the intermediary may be responsible for paying back the commission, the client ultimately bears the financing cost of the ACB through higher fund management expenses. Secondly, the distinction regarding who pays the charge does nothing to eliminate the conflicts either at the point of sale or when funds are redeemed during the chargeback period. Just like DSCs, ACBs misalign the interests of the intermediary and the customer and raise serious consumer protection concerns:

- Most intermediaries, particularly those starting out in the business, will be hard pressed to overlook the substantial upfront commissions they can earn from ACBs. Based on behavioural insights and human psychology, we know that we tend to weigh immediate rewards more heavily than future events.[6]

- The upfront commission could incentivize intermediaries to recommend segregated funds with the highest commission or to recommend segregated funds with ACBs over comparable cheaper products without ACBs that may be more or equally suitable. Thus, as with the use of DSCs for mutual funds, ACBs could distort advice at the point of sale in ways that could saddle consumers with more expensive, less suitable products.

[5] Canada Life, Chargeback option sales compensation increase.
[6] This phenomenon is known as time or temporal discounting.

- ACBs also place the interests of the intermediary and the client in direct opposition during the entire redemption period. In some ways, this conflict is materially worse than in the case of DSCs for mutual funds. This is because the intermediary may actively counsel the client not to redeem the funds because of the financial implications for the intermediary. And unlike DSCs, where the client can choose whether or not they want to sell and pay the deferred commission, the client may not even be aware of the ACB, or why their intermediary would be advising them not to sell the segregated fund.

In our view, banning ACBs would support targeted customer outcome No. 1 in the Consultation, which is to effectively address conflicts of interest created by upfront compensation. We recommend the ban on ACBs be implemented at the same time as the ban on DSC sales, that is, no later than June 1, 2023.

D. EUROPE: BANS ON COMMISSIONS FOR RETAIL INVESTMENT PRODUCTS

The approaches in the United Kingdom and the Netherlands are instructive when considering an ACB ban in Canada. In both these countries, all third-party commissions on retail investment products are prohibited and product providers are not permitted to remunerate advisors. Instead, advisors must charge their clients a separate fee tied to the advice they provide.

Reviews on the impact of these bans show they have enhanced consumer outcomes through increased competition and lower product prices. Given the comprehensive measures these European countries have implemented to protect consumers, banning DSCs and ACBs would represent an incremental, but important, step towards making advice the key driver in the advisor-client relationship.

United Kingdom

In 2006, the UK Financial Services Authority (FSA) launched the Retail Distribution Review (RDR) to address concerns with the distribution of retail investment products. The FSA noted several issues, including complex charging structures and a lack of clarity as to how they benefit consumers. The FSA was also concerned about misalignment between the interests of advisors and consumers because product providers often remunerate advisors.[7]

In January 2013, as a result of the RDR, the Financial Conduct Authority (FCA)[8] banned intermediaries from receiving commissions on retail investment products from product providers. The FCA also required advisors to be paid for their services by charging the client a separate fee.

An evaluation of the RDR found that the ban had reduced the sale of products that had higher commissions pre-RDR and increased the sale of those with lower or no commission. There was also a move towards lower-cost products and products that did not attract high commissions pre-RDR, and increased competition between product manufacturers.[9]

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[7] Financial Services Authority, A Review of Retail Distribution, June 2007.
[8] The Financial Conduct Authority is the successor to the Financial Services Authority.
[9] Europe Economics, Retail Distribution Review Post Implementation Review, December 16, 2014.

In 2015, the Financial Advice Market Review (FAMR) built on the work of the RDR. The objective of the FAMR was to encourage the market to deliver affordable, accessible financial advice. The FAMR included a call for stakeholder input on various questions about the UK's financial advice market.

Most respondents who commented on advisor compensation structures agreed that the post-RDR requirement to charge financial consumers directly for services and advice produced positive consumer outcomes. A minority of respondents recommended a return to commissions for financial advice. The final report on the FAMR concluded that "[g]iven the strong arguments against a commission-based system, such as the lack of transparency and distortion of incentives, FAMR does not believe there is a case to consider this, and is therefore not recommending a return to commission-based financial advice."[10]

Netherlands

In 2009, following a series of mis-selling scandals, the Dutch Authority for the Financial Markets introduced a cap on commissions for financial intermediaries. A subsequent evaluation of the regime revealed that consumers were not well-informed about services and costs. It also found that the provider, rather than the consumer, was the party determining the amount of the intermediary's remuneration.[11]

The Dutch government decided that to give consumers more transparency and control, it was necessary to unbundle products and the related compensation.[12] In 2013, the Netherlands introduced a ban on commissions for various financial products, including insurance and investment funds. The ban was later broadened to cover all other forms of retail investment products.

Despite fear mongering by some in the industry, reviews of the effects of the ban concluded that competition between product manufacturers had increased, product prices had decreased, and the quality of advice had improved.[13]

We believe these results are equally attainable in Canada. But we must first acknowledge how upfront commissions distort the advice process and competition, which harms the industry and consumers.

E. INTERIM MEASURES: DISCLOSURE AND CLIENT BEST INTERESTS

Given the significant consumer protection concerns DSCs and ACBs raise, it will be important to find ways to mitigate consumer harm pending their ban. Until then, intermediaries should be required to disclose how they create conflicts, how they will undertake to resolve them in the client's best interest, and to document how they have taken these steps.

These interim measures are consistent with the Guidance – Conduct of Insurance Business and Fair Treatment of Customers, which states that:

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[10] HM Treasury and Financial Conduct Authority, Financial Advice Market Review Final Report, March 2016 at p. 46.
[11] Allen & Overy LLP, Ban on commissions for complex products in the Netherlands announced, October 3, 2011.
[12] Rijn van der Linden, A Ban on Commissions: The Netherlands Approach to Transparency and Remuneration, June 24, 2019.
[13] Bureau Européen des Unions de Consommateurs AISBL, The Case for Banning Commissions in Financial Advice, September 9, 2019.

- The Insurance Regulators expect that any potential or actual conflicts of interest be avoided, or properly managed and not affect the fair treatment of customers.
- To achieve this outcome, insurers and intermediaries should place a customer's interests ahead of their own.
- Insurers and intermediaries should ensure that, when relying on disclosure for managing conflicts of interest, it is used appropriately and does not put an unreasonable onus on the customer.[14]

The Insurance Regulators should clarify their expectations regarding the timing of the disclosure under the Guidance. In our view, it should be made at the point of sale, when the customer is seeking to redeem segregated fund units, and when the customer is considering exiting the individual variable investment contract. Further, there should be monitoring and enforcement mechanisms to ensure that customers are receiving appropriate disclosure, that conflicts are resolved in the best interests of the client, and that intermediaries are documenting how they fulfilled these obligations.

We are proposing enhanced disclosure as a temporary measure until the ban takes effect because we believe disclosure is an inadequate long-term solution for managing conflicts. According to the G20 High-Level Principles on Financial Consumer Protection (the Principles):

> Where the potential for conflicts of interest arise, financial services providers and authorised agents should endeavour to avoid such conflicts. When such conflicts cannot be avoided, financial services providers and authorised agents should ensure proper disclosure, have in place internal mechanisms to manage such conflicts, or decline to provide the product, advice or service.[15]

Thus, avoiding conflicts of interest (by, for example, removing certain conflicts altogether) is the preferred approach to controlling conflicts of interest.

Recently, the Organisation for Economic Co-operation and Development proposed strengthening the Principles by adding the following language addressing the shortcomings of disclosure: "Disclosure as a means of effectively managing conflicts of interest may be limited due to the way some consumers are likely to behave in response, and behavioural insights should be used, where relevant, to test and inform approaches."[16]

Research supports the limits of disclosure in addressing conflicts of interest. It suggests that disclosure would be more effective when recipients of advice have expertise or experience to help them assess the potential effects of the disclosed conflict.[17] As one study noted, "[f]or disclosure to be effective, the

[14] Canadian Council of Insurance Regulators and Canadian Insurance Services Regulatory Organizations, Guidance – Conduct of Insurance Business and Fair Treatment of Customers, September 2018.
[15] Organisation for Economic Co-operation and Development, G20 High-Level Principles on Financial Consumer Protection, October 2011 at p. 7.
[16] Organisation for Economic Co-operation and Development, Public consultation on draft proposed revisions to the Recommendation on G20/OECD High-Level Principles on Financial Consumer Protection at p. 12.
[17] Daylian M. Cain, George Loewenstein, and Don A. Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest" (2005) 34(1) J. Legal Stud. 1 at p. 20.

recipient of advice must understand how the conflict of interest has influenced the advisor and must be able to correct for that biasing influence."[18]

Similarly, research found that even when different types of commission are explained to retail investors, half were unable to form an opinion about whether the commission structure posed a potential conflict of interest. Among those that did form a viewpoint, three-quarters believed the advisor would look out for their best interest. The researchers concluded that based on this belief, investors have little reason to seek out alternative forms of compensation.[19]

These findings show that disclosing conflicts to the average retail client, who is in the greatest need of protection, is insufficient to manage conflicts. The better approach is to avoid them altogether. For these reasons, we support banning both DSCs and ACBs for segregated funds.

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Thank you for considering our comments on this important issue. We welcome any further opportunities to advance efforts to improve outcomes for segregated fund customers. We intend to post our submission on the FAIR Canada website and have no concerns with the Insurance Regulators publishing it on their websites. We would be pleased to discuss our submission with you. Please contact Jean-Paul Bureaud, Executive Director, at jp.buread@faircanada.ca or Tasmin Waley, Policy Counsel, at tasmin.waley@faircanada.ca.

Sincerely,

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FAIR Canada | Canadian Foundation for Advancement of Investor Rights

[18] Ibid. at p. 3.
[19] Brondesbury Group, *supra* note 3, at p. 48.