

June 30, 2023

Financial Services Regulatory Authority of Ontario (FSRA)
Submitted via the FSRA website

Re: Amendment 2 – Deferred Sales Charges – Deposits to Pre-June 1, 2023 Individual Variable Insurance Contracts – Rule 2020 - 002 Unfair or Deceptive Acts or Practices Rule

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

FAIR Canada is a national, independent, non-profit 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. As part of our commitment to be a trusted, independent voice on issues that affect retail investors, we conduct research to hear directly from investors about their experiences and concerns. FAIR Canada has a reputation for independence, thoughtful public policy commentary, and repeatedly advancing the interests of retail investors and financial consumers.¹

General Comments

FAIR Canada supports FSRA's efforts to address sales charge options that present a risk of harm to consumers. We were pleased to see that, effective June 1, 2023, FSRA banned the use of deferred sales charges (DSCs) on new segregated fund products. This ban is consistent with the Canadian Securities Administrators' (CSA) ban on DSCs for mutual funds in June 2022.

Research has shown that DSCs distort the advice process and influence advisors to recommend products with these charges, rather than products that best serve consumers.² The Canadian Council of Insurance Regulators (CCIR) and the Canadian Insurance Services Regulatory Organizations (CISRO) also concluded "there is a high risk of poor consumer outcomes associated with DSCs in segregated fund sales and this form of sales charge is not consistent with treating customers fairly."³ Extending the DSC ban to include segregated funds is a positive step towards reducing mis-selling and promoting a fairer financial marketplace for Canadians.

¹ Visit www.faircanada.ca for more information.

² Douglas Cumming, Sofia Johan and Yelin Zhang, "[A Dissection of Mutual Fund Fees, Flows, and Performance](#)" (2016).

³ CCIR and CISRO, [News Release](#) - Statement on Deferred Sales Charges and Upfront Commissions in Segregated Fund Sales, February 10, 2022.

We appreciate that FSRA is now focusing on another sales charge option that is potentially equally harmful to consumers – advisor chargebacks (ACBs). Although structured differently from DSCs, ACBs raise similar consumer protection and conflict of interest concerns that can lead to poor customer outcomes.

We support FSRA’s efforts to try to mitigate the potential harm to consumers through control measures and increased disclosure when clients are switched from a segregated fund with a DSC option to one with an ACB option. In this respect, we agree ACBs are not unequivocally better than DSCs.

We believe, however, the conflicts ACBs raise cannot be effectively managed through disclosure or internal controls. In our view, the potential harm or negative impact ACBs may have on clients, including on the overall market integrity, warrants a similar regulatory response to DSCs – ACBs ought to be banned.

Finally, while the use of DSCs and ACBs is a critical issue that deserves regulatory attention, there are many other regulatory issues that raise concerns about market conduct and consumer harm. To properly address them, it will be important that insurance regulators receive the support they need to impose clear, rule-based conduct requirements on those engaged in manufacturing, selling and advising the public on insurance products, including segregated funds.

Our detailed comments on the Consultation follow.

Advisor Chargebacks are Not “Unequivocally Better”

Some in the industry laud the benefits of ACBs. They assert that ACBs align the interests of the advisor and the client, and that the upfront commission provides the necessary motivation to provide long-term advice. As one organization stated, “the charge back option helps align the advisor’s incentives with the investor’s buy-and-hold mindset. This long-term approach allows consumers to benefit from the insurance guarantees of the segregated fund.”⁴ Another organization maintained that ACBs align the parties’ interests because “advisors will want to be confident that the investment horizon is beyond the chargeback period, otherwise the advisor risks a financial loss.”⁵

Apart from being self-serving, these arguments ignore a common fact – clients often change their minds and/or experience changes in their personal lives. Such changes are impossible to predict and often result in clients wishing or needing to sell their funds during the chargeback period. Once this happens, the interests of the client (who wants to sell) and the advisor (who does not want to repay the commission) are in direct conflict. Given this serious, irresolvable conflict of interest, we support FSRA’s position that ACBs are not unequivocally better than DSCs.

⁴ Advocis, [Submission on CCIR and CISRO Discussion Paper on Upfront Compensation in Segregated Funds](#), November 7, 2022, at p. 3.

⁵ Canada Life, [Submission on CCIR and CISRO Discussion Paper on Upfront Compensation in Segregated Funds](#), November 7, 2022.

At a Minimum – Disclosure and Control Measures

FAIR Canada also supports FSRA's efforts to try to mitigate and reduce the potential for harm when ACBs are used.

The Consultation proposes different disclosure requirements depending on what type of sales charge option the insurer substitutes for a DSC under the segregated fund contract. If the new option is unequivocally better for the consumer, simplified disclosure requirements apply. If the new option is not unequivocally better (e.g., the client is switched to a fund with an ACB option), the disclosure is more onerous.

One stated benefit of the proposed change is that it will encourage insurers to offer unequivocally better sales charge options to avoid the cost and effort of the more complex disclosure. We support this intended outcome.

In addition to the enhanced disclosure obligations, we are pleased that the CCIR and CISRO have called for insurers to put in place the following risk control measures to encourage the fair treatment of customers when ACBs are used:⁶

- managing conflicts of interest by
 - using a short duration for chargeback schedules;
 - not inappropriately increasing management expense ratios as a result of paying upfront commission;
 - permitting a portion of an investment to be redeemed each year without incurring an ACB;
 - avoiding time-limited increases to commissions for promotional purposes;
 - offering sales charge and fee options to customers at the point of sale;
- educating customers about their sales charge options and raising their awareness and control over the conflict of interest that ACBs represent; and
- monitoring for unfair treatment of customers.

CCIR and CISRO stated that, without these additional control measures, there is a risk that consumers could be harmed by segregated funds with ACBs. Additionally, they emphasized that upfront commissions may motivate advisors, particularly those with lower incomes and less experience, to sell segregated funds to customers for whom the product is not suitable. We agree with these potential risks and regulatory concerns regarding ACBs. We also strongly encourage FSRA to undertake regular monitoring reviews to assess whether the controls are being implemented as intended.

Limits to How Much Disclosure Can Manage Conflicts

FAIR Canada appreciates FSRA's efforts to reduce the likelihood of consumers being subject to ACBs through additional disclosure obligations. We agree with the simplified

⁶ CCIR and CISRO, [News Release](#) - Position on the Discussion Paper on Upfront Compensation in Segregated Funds, May 15, 2023.

disclosure requirements for sales charge options that are unequivocally better than DSCs. For ACBs, we believe, at a minimum, the additional disclosure is required.

FSRA should be mindful that, in both disclosure scenarios, it will likely be challenging for the average consumer to understand the proposed disclosure. Various studies have demonstrated that consumers struggle to understand disclosure. For example, research for the Mutual Fund Dealers Association of Canada examined how retail investors review, comprehend, and use information in annual investment fee summaries. The study found that investors have difficulty understanding this information. Fewer than one in five respondents correctly identified what types of costs are included in fee summaries. Even experienced investors found it challenging to understand key terms and how their choices affect the type and amount of fees they pay.⁷

The more extensive disclosure in the case of ACB sales charges could be particularly difficult to understand. One requirement is to include a list of available sales charge options, how they work, and the fees associated with them. Research has shown the difficulties consumers have in understanding commission structures. One study 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.⁸ Clearly, simply mandating what information insurers should provide to consumers is insufficient.

Increasing the Effectiveness of Disclosure

To help ensure consumers understand the disclosure they are provided, it will be important for FSRA to find ways to promote readability and comprehension by a lay person.

Based on research, we know that consumers need to receive the disclosure in clear, simple, plain language so they can properly assess the sales charge option(s) and determine its suitability. For instance, based on its research, the U.S. Securities and Exchange Commission concluded that “investors want disclosures that are brief, readable and delivered before they have to make an investment decision.”⁹

To this end, FSRA should consider prescribing specific wording for the disclosure or providing sample disclosure to help ensure it is clear, easy-to-read, and consistent across different insurers.

This approach will help ensure consumers receive similarly worded and easy-to-understand information regardless of who produced it. The alternative of leaving it to each insurer to draft their own disclosure, in our experience, will result in a myriad of different styles and formats. Some may be written in a clear, simple manner designed to promote

⁷ The Behavioural Insights Team, [Improving Fee Disclosures for Canadian Investors](#) – Research Report, June 2021 at p. 2.

⁸ Edwin Weinstein, The Brondesbury Group, [Mutual Fund Fee Research](#), Spring 2015 at p. 48.

⁹ Securities and Exchange Commission, [Recommendation on Disclosure Effectiveness](#) at p. 4.

comprehension by a lay person, while others will be very technical and densely written with the aim of protecting the insurer from potential liability rather than for readability and comprehension.

Time permitting, FSRA should conduct behavioural insights (BI) research to determine the best format for presenting the disclosure and promoting consumer comprehension. This was done, for instance, in the case of the total cost reporting proposal jointly developed by the CSA, CCIR and CISRO. At a minimum, FSRA should draw on insights from BI research to provide guidance on how to draft the disclosure.

Improving the written disclosure, however, will not in itself be sufficient. It will also be important that advisors discuss the ACB option with their clients and clearly explain the potential conflict that may arise. As such, we recommend that FSRA require advisors to discuss the disclosure with their clients to help ensure they understand it. This could be done by way of guidance in the absence of rule-making authority. The guidance should also outline the expectation that insurers and advisors document how they fulfilled their disclosure obligations.

To ensure effective consumer protection and fair treatment, the disclosure obligations and control measures for ACBs should be accompanied by rigorous monitoring and compliance assessments. CCIR and CISRO have indicated that the risks of negative outcomes of upfront commissions such as ACBs call for regular reviews of the effectiveness of the control measures. They have also stated that they will continue to monitor the customer outcomes relating to upfront compensation in segregated funds.¹⁰

We support regular reviews and monitoring to assess the effectiveness of the disclosure and control measures. As an additional measure, we recommend requiring insurers to periodically report to FSRA on their use of ACBs, such as the number of new segregated fund clients subject to ACBs in the reporting period.

Banning Advisor Chargebacks

While the disclosure requirements and control measures are important steps in enhancing protection for owners of segregated funds, we believe they are insufficient to manage the risks of consumer harm. As such, we urge FSRA to go one step further and ban ACBs altogether.

From our perspective, ACBs are worse than DSCs. This is because ACBs put the client's and the advisor's interests in a direct conflict should the client want to, or need to, sell the fund during the chargeback period. This conflict risks distorting the advice process at the time of the sale in ways that are harmful to consumers. The prospect of paying the chargeback could lead the advisor to counsel the client not to sell their investment, even though selling may be in the client's best interest.

¹⁰ CCIR and CISRO News Release, *supra* note 6.

While the control mechanisms and disclosure requirements may help to mitigate some of the potential harm, we do not believe the conflicts ACBs pose can be fully managed through these measures. We also believe they pose significant risks to the fair treatment of clients and may undermine trust in the financial system. As such, they should be banned.

Banning ACBs would also bring Canada closer to other jurisdictions, such as the United Kingdom and the Netherlands, which have banned third-party commissions on all retail investment products. Instead, advisors must charge their clients a separate fee tied to the advice they provide. Evaluations of these bans have shown improved consumer outcomes through increased competition and lower product prices.¹¹

The Need for Binding Rules

In addition to trying to regulate the use of harmful sales charge options, we encourage FSRA and other insurance regulators to look at how they could better regulate market conduct more generally. Simply put, regulators need stronger tools to protect consumers of insurance products.

In this regard, we support the work CCIR and CISRO are doing to develop expectations for the standards of care for the sale and servicing of segregated fund contracts. This guidance will include standards relating to know-your-client (KYC), know-your-product (KYP) and suitability. It will call on insurers to create measures to help ensure customers receive suitable advice, and their salespeople have appropriate product training and understand what information they need from their customers to determine if a product is suitable.¹²

These regulatory expectations, however, will only be issued in the form of guidance and not binding, enforceable rules. This contrasts with the KYC, KYP and suitability requirements that are imposed on securities dealers and advisors by securities regulators, which have been granted broad rule-making powers to protect investors and promote fair and efficient markets.

From a consumer protection perspective, it makes little sense that two financial advisors dealing with the public – one selling insurance and one selling securities – should be subject to two very different regulatory regimes: one that primarily sets expectations through guidance and one that imposes mandatory, enforceable requirements through rules. From the consumer's perspective, these differences make little sense and create an unlevel playing field among market participants. They also impact the extent or degree to which consumers can be effectively protected.

¹¹ Europe Economics, [Retail Distribution Review Post Implementation Review](#), December 16, 2014; Bureau Européen des Unions de Consommateurs AISBL, [The Case for Banning Commissions in Financial Advice](#), September 9, 2019.

¹² This work, while important, is limited to segregated fund contracts. FAIR Canada recommends that the insurance regulators establish comprehensive conduct rules for the sale and servicing of *all* insurance products.

We urge government to consider whether FSRA’s existing rule-making authority is sufficient to truly protect consumers and ensure a level playing field within the financial services industry in Ontario. Providing FSRA with broader rule-making authority will better protect consumers and reduce the risk of regulatory arbitrage between the insurance and securities sectors.

Thank you for considering our comments on this important issue. We welcome any further opportunities to advance efforts that improve outcomes for consumers. We intend to post our submission on the FAIR Canada website and have no concerns with the FSRA publishing it on its website. We would be pleased to discuss our submission with you. Please contact Jean-Paul Bureaud, Executive Director, at jp.bureaud@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