UPFRONT COMPENSATION FOR SEGREGATED FUNDS: IS A TOTAL BAN ON THE HORIZON?

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On September 8, 2022, the Canadian Council of Insurance Regulators (the "**CCIR**") and the Canadian Insurance Services Regulatory Organizations (the "**CISRO**"), collectively, (the "**Insurance Regulators**") commenced a sixty-day consultation period with respect to their *Discussion Paper on Upfront Compensation in Segregated Funds* ("**Discussion Paper**").

The Discussion Paper comes on the heels of the Insurance Regulators' February 2022 joint statement with respect to the negative impact of Deferred Sales Charges ("**DSCs**") on customers. Pursuant to DSCs, the customers generally pay a redemption fee if they withdraw their funds before the end of the redemption period (which is usually 3 to 7 years). DSCs were banned for mutual funds as of June 1, 2022. On the insurance side, insurers have been urged to refrain from new segregated fund ("**Seg Fund**") sales involving DSCs as of as of June 1, 2022, with full cessation of such sales by June 1, 2023. DSCs can be differentiated from advisor chargebacks (currently allowed) where the intermediary must pay back the commission they received from a sale if the customer withdraws their funds during a charge-back period (which is usually 2 to 5 years).

Putting DSCs aside, the consultation seeks to understand current compensation arrangements for seg funds and whether additional changes are required with respect to upfront compensation more generally in order to ensure the fair treatment of customers, to minimize conflicts of interest and to enhance harmonization between mutual funds and seg funds. Potential changes identified for consultation include (i) a total ban on upfront commissions, (ii) a cap on the amount of the commission, (iii) limits on the duration of chargeback periods, (iv) enhanced disclosure of potential costs or negative effects, (v) requiring upfront commissions to be reasonably proportionate to the value of the product and the amount of service provided to the investor and (vi) increased monitoring of intermediaries with chargeback debt owing to an insurer or a managing general agent.

Background information on seg funds, and the CCIR's understanding can be found in the 2016 Issues Paper and the 2017/2018 Position Papers (2017, 2018(1), 2018(2)) which were identified in the Discussion Paper as recommended stakeholder reading.

Targeted Customer Outcomes

The Insurance Regulators are targeting a regulatory approach that achieves the following Targeted Customer Outcomes:

1. Effectively addresses conflicts of interest created by upfront compensation;
2. Enhances customer awareness, understanding and control of intermediary compensation;
3. Fosters alignment of any upfront compensation with the services provided to Customers at point of sale and on an ongoing basis;
4. Avoids insurers and intermediaries relying more on compensation than fund performance and Individual Variable Insurance Contracts ("**IVICs**") features to sell their products;
5. Balances the need for quality advice and personal recommendations for IVICs while enabling access to affordable and ongoing service;
6. Reduces the risk of mis-selling of segregated funds and IVICs over securities products by dually licensed intermediaries due to differing upfront compensation arrangements;
7. Manages the risk of mis-selling other life insurance products over segregated funds and IVICs; and
8. Enables innovation and encourage flexibility in the way that customers can pay for advice.

Discussion Questions

The Discussion Paper asks the following questions:

1. Does the Discussion Paper accurately describe the current environment in which customers are offered IVICs and segregated funds?
2. Should other Targeted Customer Outcomes besides those presented be considered?
3. Questions relating to different sales charge options, including their prevalence, whether there are common rates, how charges to the customer are determined, how the options align with the Targeted Customer Outcomes, and how insurers and intermediaries can encourage innovation and flexibility in the ways that customers can pay for advice.
4. What is the extent to which insurers and intermediaries provide payments or benefits for the sale of seg funds or IVICs (other than the commission rates set out in Information Folders and Fund Facts) and how do these payments or benefits align with the Targeted Customer Outcomes?
5. If a total ban on upfront compensation or upfront commissions were implemented, what are the insurance sector considerations to take into account for achieving the Targeted Customer Outcomes (for example, transition time, qualitative and quantitative costs and benefits to insurers, intermediaries and customers)?
6. If alternative or complementary regulatory measures to a ban were considered, which regulatory

measures would help achieve the Targeted Customer Outcomes?

Key takeaways

- Insurers, intermediaries and industry associations should ensure that their views are submitted to the CCIR Secretariat at ccir-ccrra@fsrao.ca by November 7, 2022.
- Following the consultation process, it is expected that the Insurance Regulators will move forward swiftly with a policy position and guidance setting out their expectations for insurers and intermediaries.
- Canadian insurers and intermediaries should be prepared for updated expectations surrounding the design, distribution, issuance, sale, and administration of IVICs.

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A Cautionary Note