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Canadian Council of Insurance Regulators (CCIR)
CCIR Secretariat
5160 Yonge Street, Box 85
17th Floor
Toronto, Ontario
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Dear Sirs/Madams:

Re: An Approach to Risk-based Market Conduct Regulation

Advocis appreciates the opportunity to provide input on the Canadian Council of Insurance Regulators' consultation paper: *An Approach to Risk-based Market Conduct Regulation*.

Advocis, the Financial Advisors Association of Canada, is Canada's oldest and largest voluntary professional membership association of financial advisors representing life and health insurance licensees, and mutual fund and securities registrants across the country.

We provide our comments from the perspective of insurance intermediaries in the distribution channel, and represent the views of our thousands of members across Canada. As our members are the direct link to the consumer, we believe that their insights on market conduct regulation may also be helpful from a consumer protection perspective.

We support the CCIR's overall goal, as outlined in its *Strategic Plan 2008-2011*, of facilitating and promoting an efficient and effective regulatory system without imposing unnecessary regulatory burdens on participants.

Moreover, we applaud the CCIR's willingness to explore progressive regulatory approaches and for seeking industry input in order to assess their potential impacts on various market participants and their potential effectiveness in achieving desired regulatory outcomes.

We understand the CCIR's desire (as a multi-sector regulator) to adopt uniform regulatory approaches to address common issues facing both large and small financial services providers, in a manner that best utilizes resources. Moreover, we appreciate the CCIR's desire to raise the standards for consumer protection while reducing the cost of compliance for industry.

Based on our analysis of the CCIR's proposed risk-based approach to market conduct regulation, we believe that this approach is not particularly well suited for market conduct regulation of insurance intermediaries, specifically financial advisors, and has the potential

of creating more regulation, not less. Moreover, the “challenges” identified by the CCIR may be insurmountable.

In our view, the conditions that make a risk-based approach suitable for prudential regulation, such as a clear definition and identification of risks, comprehensive assessments, and extensive ongoing dialogue between the regulator and a relatively few number of large institutions, simply do not exist or are impractical for market conduct regulation of thousands of financial advisors. In addition, pro-active, preventative regulation creates the potential of regulating “perceived” risks that have not demonstrated themselves to be a problem.


Moreover, we believe that adopting a risk-based approach and trying to make it “fit” for market conduct regulation may lead to the development of complex risk management systems and unnecessary compliance requirements. Ultimately, we believe such an approach could create market distortions, an un-level playing field, and frustrations among market participants, without achieving the CCIR’s stated potential benefits or public policy goals.

Advocis remains a strong advocate of principles-based regulation, and it is our hope that the CCIR will continue to work cooperatively with industry in promoting the adoption of best practices, professionalism of financial advisors, and a principles-based approach for market conduct regulation.

We are confident that over time, many regulators will recognize the merits of a principles-based regulatory regime, such as that recently adopted by the Financial Services Authority (FSA) in the UK, as an effective and efficient means of regulating certain market participants while enhancing consumer protection.

In our view, regulation of insurance intermediaries should be developed using a “bottom-up” approach specifically designed to address their particular business environment and circumstances, rather than “importing” an approach used by other financial regulators to regulate a significantly different business. An important element of a “bottom-up” approach involves the direct input from consumers and financial advisors as to what the key risks are that need to be regulated.

Our detailed comments, concerns, and recommendations are attached, and we would be pleased to meet with you to discuss this matter in more detail, including our suggestions for alternative regulatory approaches, at your earliest convenience. We note that our response generally addresses most, if not all, of the questions raised in the CCIR consultation paper.



Steve Howard, CA
President and CEO
Advocis



Teresa Black Hughes CFP, CLU, RFP, FMA, CIM
Chair,
National Board of Directors, Advocis

GENERAL COMMENTS

1. Real “Challenges” to Risk-based Approach for Market Conduct

Risk-based regulation is well established in the prudential regulation field, and we are encouraged by the many listed potential benefits of risk-based regulation, in particular, a focus on outcomes and regulatory relief. However, we agree with the CCIR’s observation that there are “some challenges” with its application to market conduct, including:

- i) the “potentially thousands of intermediaries” (i.e., financial advisors),
- ii) the difficulty in defining and quantifying the risks.

Based on our analysis, we believe that these “challenges” (as well as others we note below) present real obstacles to the adoption of risk-based market conduct regulation that will be difficult, if not impossible, to overcome.

2. Principles for Effective Risk-Based Regulation Generally

As outlined in the CCIR proposal, certain principles (or conditions) must or should exist for a risk-based approach to work effectively. According to the CCIR proposal, these include:

1. Regulatory understanding of the market and its participants
2. Reliance on governance and controls
3. Exercising judgment
4. Risk assessment and management
5. Selective use of tools
6. Co-operation

It is important to note that CCIR’s above-noted principles or conditions for a risk-based approach are essentially those used by the Office of the Superintendent of Financial Institutions (OSFI) to regulate financial institutions in Canada under the Basel II framework – a risk-based capital standard for international banks. The Basel II risk-based framework is arguably regarded as “the model” for the application of risk-based regulation internationally among prudential regulators.

A consideration for all stakeholders is whether the risk-based framework for prudential regulation is the *most* effective approach for market conduct regulation. Also, can such an approach be effectively replicated and applied to insurers and insurance intermediaries? From our perspective, a key concern is whether provincial insurance regulators will be able to use a risk-based approach to obtain an accurate and clear understanding of the environment in order to appropriately identify, assess, and prioritize risks.

We believe that it would be useful to more fully understand the Basel II risk-based approach in order to identify the key success factors and whether they can be replicated to the same extent for market conduct regulation. Based on our research, including CCIR referenced material, we were unable to find any compelling information in support of risk-based market conduct regulation that we could use in our analysis.

3. Basel II Framework – the Model for Risk-based Approach to Regulation

Under Basel II, home-country bank regulators, such as OSFI, are responsible for the regulatory supervision of Basel II implementation. To understand why risk-based regulation works so effectively for prudential regulation (i.e., Basel II), it is worth considering what it potentially entails for all stakeholders.

Under Basel II, banks are required to accurately identify, measure and manage their risks using advanced models. The risks are clearly defined and commonly accepted by both regulators and financial institutions. Following extensive on-site examinations, comprehensive self-assessments, data collection, and ongoing dialogue with regulators, those banks assessed to have greater risks are required to set aside more capital.

It should be noted that the extent of the information gathering process and analysis required to obtain an accurate and reliable understanding of the risks is enormous and cannot be over-emphasized. To clarify, while the information gathering process would not be on the same scale as that under Basel II, there may be an expectation among stakeholders that it be of the same level of rigour and reliability.

4. Key Principles for Risk-based Regulation Not Prevalent for Market Conduct

In our view, it is difficult to envision how a risk-based framework (used successfully for prudential regulation under Basel II) could be replicated or applied to market conduct of insurance intermediaries.

The key to the success of risk-based prudential regulation is comprehensive, accurate, quantifiable, and transparent information that is commonly understood by regulators and industry through regular dialogue. In the area of market conduct, these conditions do not currently exist and are potentially impractical for regulators and financial advisors to implement.

The following are some of the concerns we have with a risk-based approach being applied to market conduct regulation:

1. Market conduct risks are:
 - not clearly defined or commonly accepted by both regulators and insurance intermediaries; for example, there are different interpretations among stakeholders as to what constitutes *proper disclosure*, *product suitability*, or *the client's best interest*, etc.;
 - typically qualitative, and are difficult to quantify, measure, and assess;
 - not accurately or adequately monitored or recorded.
2. Financial Advisors do not typically have:
 - corporate governance structures or compliance departments typically found in fully integrated financial institutions;
 - the ready access and ongoing dialogue with regulators, nor the opportunity to provide them with an accurate and thorough understanding of their risk profile and risk management practices;
 - the time and resources to complete comprehensive self-assessments of their businesses in order to identify and assess risks.

We believe that it would be a significant challenge for insurance regulators to obtain comprehensive and reliable information on the business environment of financial advisors in order to accurately assess and prioritize the risks.

5. Prioritizing Risk

As noted in the CCIR consultation paper, in addition to understanding and assessing risk, regulators are also required to exercise sound judgment and focus on high-risk issues or concerns. From the perspective of professional financial advisors, the key priority is the client's interest – everything else follows from that basic premise. While there are many aspects and responsibilities involved in providing comprehensive financial advice to clients, advisors generally regard them with more-or-less equal importance.

A concern to our members is how regulators will be able to set priorities. What factors determine the highest priorities? The number of complaints? The size of potential losses? The lack of timely disclosure? Given the challenges in determining high-risk versus low-risk issues/items, we would be pleased to work with the CCIR in developing a list of priorities in the area of market conduct. We would also be interested in obtaining a clearer understanding of the regulatory implications of low-risk issues, and what, if any, action is required in dealing with these issues.

6. Proposed Regulatory Tools Are Inadequate for Developing a Clear Understanding

While the CCIR notes that regulatory understanding and risk assessments can be conducted on a variety of levels (i.e., market and individual level) using a variety of techniques (i.e., scanning the media, conducting informal surveys, on-site examinations, or monitoring complaints), we do not believe that these methods are adequate or reliable for a task that requires considerable analysis and precision.

Moreover, we would have serious concerns if financial advisors across Canada became subject to increased regulation on the basis of a media report, a consumer/advisor survey, or a small percentage of complaints.

7. Complaint Systems Alone Are Not Reliable for Determining Public Policy

While there is limited experience and empirical evidence that supports a risk-based approach for market conduct regulation, either globally or domestically, reliance on a "complaint system" is often cited by regulators as a means of obtaining information about the behaviours and practices of financial advisors and companies.

We recognize that a "complaint system" can provide useful information if properly used and interpreted to identify significant trends. However, in our view it is not an accurate indicator of risk and therefore not a reliable tool. We are aware of too many incidents in the industry in which customer complaints have been unfounded and unjustified, and we would therefore be strongly opposed to the use of this tool for public policy purposes.

While it is incumbent upon regulators to make judgments as to what constitutes an "unacceptable" level of complaints, we would hope that the threshold be based on a "significant" number of fully substantiated complaints and that the statistical supporting data be made publicly available. We caution against relying solely on the use of complaints for determining risks.

8. A Risk-Based Focus on Prevention Could Potentially Create Unnecessary Regulation

One of the basic concepts or potential benefits of risk-based regulation is for regulators to be proactive, and to prevent problems from arising as opposed to “fixing” them once they have occurred. While prevention makes sense conceptually and is useful in certain instances, we believe that the danger of this approach is that it can lead to pre-emptive regulation, and the regulation of “problems” that do not yet exist and may not occur. In effect, a preventative risk-based approach could potentially result in unnecessary, over-regulation.

In addressing the CCIR’s question regarding principles, including proper disclosure and avoidance of misleading information, we believe that the CCIR’s current principles-based approach to market conduct regulation is working successfully and see no evidence in the market to indicate that the current system is broken and needs fixing. In our view, the current regulatory approach will not be enhanced by an additional layer of regulation, or by applying certain elements of this risk-based approach in a piecemeal manner.

Advocis supports the principles-based approach recently recommended by the Industry Practice Review Committee (IPRC) of the CCIR and the Canadian Insurance Services Regulatory Organizations (CISRO) with respect to mitigating actual or potential conflicts of interest between insurance advisors and their clients. These principles include:

1. Priority of the client’s interest: An intermediary must place the interest of policyholders and prospective purchasers of insurance ahead of his or her own interests.
2. Disclosure of conflict or potential conflict of interest: Consumers must receive disclosure of any actual or potential conflict of interest that is associated with a transaction or recommendation.
3. Product suitability: The recommended product must be suitable for the needs of the consumer.

We note that these same principles are already firmly entrenched in the Advocis Code of Professional Conduct and Best Practices Manual, and financial advisors must adhere to them (as a membership requirement) in their dealings with consumers. In this regard, Advocis has been proactive in protecting consumer interests.

Finally, while traditional methods of enforcing market conduct are inherently reactive, and designed to “catch and punish”, we believe that they are nonetheless an effective means of regulating market participants and positively influencing behaviour. Enforcement, combined with regulatory recognition of professionalism of financial advisors, will help create a positive business environment and consumer confidence in the marketplace.

9. Next Steps – Exploring More Moderate Regulatory Reforms

In our view, regulators may want to consider more moderate regulatory reforms that focus instead on, for example, high-risk financial advisors who exhibit high-risk behaviour and use high-risk products, such as excessive leverage and complex structured products, that are inappropriate for clients with low risk tolerance.

We believe that regulators may wish to consider exploring regulatory approaches that distinguish between high-risk and low-risk financial advisors. One way this could be achieved is by *directly* targeting *low-risk* financial advisors, and thereby *indirectly* identifying high-risk advisors. Financial advisors who are required, either by the terms of their contracts or as part of their professional membership with associations such as Advocis, to adhere to high standards of conduct and best practices, would be considered low-risk. Those advisors who are *not* bound by some form of compliance measures, such as codes of conduct, continuing education, standards of best practices, etc., would be considered *high-risk*.

Moreover, regulators could play an effective role in promoting and encouraging low-risk financial advisors by providing incentives, such as regulatory relief (in the form of less regulatory scrutiny or intervention), to advisors who can effectively demonstrate to the regulator on a voluntary basis that they are low-risk market participants. We would be pleased to work with the CCIR to fully develop criteria that could be used to distinguish between low-risk and high-risk financial advisors.

For Advocis, a low-risk financial advisor is someone who:

- has a professional designation,
- adheres to a professional code of conduct,
- maintains membership in a recognized professional body,
- subscribes to practice standards,
- acquires meaningful continuing education credits, and
- maintains adequate errors and omissions (E&O) insurance coverage to protect both the consumer and the financial advisor.

We appreciate the CCIR's acknowledgment of industry association efforts in promoting high standards of market conduct and its support for a principles-based approach to regulation as an alternative to detailed prescriptive rules.

While we believe that a risk-based approach to market conduct regulation may not be the most effective means by which to accurately identify and manage high risks or priorities, we would be pleased to explore more practical and moderate measures of achieving this objective within the existing regulatory framework, which we believe is working successfully.

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