Advocis The Financial Advisors Association of Canada

November 7, 2022

CCIR Secretariat
25 Sheppard Avenue West, Suite 100
Toronto, ON M2N 6S6

VIA EMAIL: ccir-ccrra@fsrao.ca

Dear Sirs/Mesdames,

Re: Canadian Council of Insurance Regulators (CCIR)
Canadian Insurance Services Regulatory Organizations (CISRO)
Discussion Paper on Upfront Compensation in Segregated Funds

On behalf of Advocis, The Financial Advisors Association of Canada, we are pleased to provide our comments to the CCIR/CISRO discussion paper on upfront compensation in segregated funds (Paper).

1. ABOUT ADVOCIS

Advocis is the association of choice for financial advisors and planners. With over 17,000 member-clients across the country, we are the definitive voice of the profession. Advocis champions professionalism, consumer protection, and the value of financial advice. We advocate for an environment where all Canadians have access to the professional advice they need.

Advocis members advise consumers on wealth management; risk management; estate, retirement and tax planning; employee benefits; and life, accident and sickness, critical illness and disability insurance. In doing so, Advocis members help consumers make sound financial decisions, ultimately leading to greater financial stability and independence. In all that they do, our members are driven by Advocis' motto: *non solis nobis* – not for ourselves alone.

2. COMMENTS

We thank the CCIR and CISRO for their efforts to harmonize the rules for segregated funds with those in the mutual fund sector. We share the regulators' concern regarding regulatory arbitrage. Recommendations should be driven by product suitability and client need, not by differences in regulatory regime.

However, segregated funds provide unique benefits to consumers, distinct from mutual funds. The segregated fund guarantees reduce the risk exposure in comparison to comparable mutual funds. Further, as an insurance contract, segregated funds also provide estate planning and creditor protection benefits.

Despite this, most of the studies relied upon in the Paper relate to deferred sales charges (DSC) in mutual funds. Given the differences between the products and their compensation structures, additional research is required before significant changes are made.

A complete prohibition on upfront compensation might unintentionally discourage advisors from offering segregated funds and impose barriers for consumers who wish to have access to these products. The regulatory regime must allow continued access to these products by retail investors.

We urge regulators to maintain the advisor chargeback as a form of upfront commission. Segregated funds require a principles-based approach that recognizes their insurance component rather than simply a duplication of securities regulation. Instead of a complete prohibition, regulators should explore measures, such as additional monitoring, to address the risks arising from the sale of these products.

In our response to this Paper, we discuss the key features of segregated funds and lay out possible regulatory measures that can address existing concerns related to advisor chargeback options.

Benefits of Segregated Funds

Segregated funds are an important investment and insurance product. They provide Canadians with long-term financial stability and allow for efficient estate planning. The Canadian public values ready access to these products. Market research indicates that more than 80% of consumers are satisfied with segregated funds when it comes to reliable retirement income, protection against risk, and reasonable returns.[1] Any regulatory reform must ensure that Canadian investors—particularly small investors—continue to have access to these valuable products.

Unlike mutual funds, segregated funds are underpinned by an insurance contract that reaches maturity after a long period. Segregated funds are meant to be bought and held. Investors recognize this. Data from the Canadian Life and Health Insurance Association (CLHIA), indicates that the average hold period for a segregated fund is nearly 8 years.[2] This is significantly longer

[1] On behalf of the Canadian Life and Health Insurance Association (CLHIA), Abacus Data interviewed 709 people who had experience with segregated funds and 782 who had experience with mutual funds between September 4 and October 3, 2022. “Data to Advocis – CCIR Upfront Commissions for Segregated funds,” CLHIA Discussion Paper, October 28, 2022.
[2] “Data to Advocis – CCIR Upfront Commissions for Segregated funds,” CLHIA Discussion Paper, October 28, 2022.

than the average hold period for a mutual fund of only 4.5 years.[3] Investors hold segregated funds for the long-term to reap the full benefits of the insurance guarantees.

Since a segregated fund is a long-term investment, consumers need to carefully consider the benefits and costs at the time of initial sale. An upfront commission with the advisor chargeback option provides advisors with the necessary incentive to provide this long-term advice. The charge back option aligns the advisor's incentives with the investor's buy-and-hold mindset.

We must carefully approach the incentive framework for advisors. Advisors must be paid for the advice that they provide; however, any incentive could potentially result in a conflict with the client's interests. Despite this, 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.

Further, unlike the DSC, if the consumer exits prematurely, they are not penalized. The cost of the chargeback due to an early exit is borne entirely by the advisor through the chargeback.

Upfront commissions also help ensure access to these insurance and investment products. As the adage goes: "insurance is sold, not bought." Segregated funds fulfill an important market niche, providing an insurance solution for low-risk capital accumulation and succession planning. Advisors incur significant costs early in the life of the contract, as they assess the suitability of the product and provide advice to their clients. Without upfront compensation, advisors may not find it economical to service clients with limited capital to invest.[4] In addition, upfront commissions enable new advisors to enter the industry and provide their services to clients. By supporting new advisors as they grow their business, upfront commissions ensure continued access to these important financial products. Without this compensation model, the availability of segregated funds to the Canadian public could be reduced.

Regulatory Concerns Have Not Materialized

We share the regulators' concerns about the potential for regulatory arbitrage and churning. For this reason, we are generally supportive of harmonization between segregated fund and mutual fund regulatory regimes. However, the evidence does not show an increased risk of regulatory arbitrage or churning due to upfront commissions with advisor chargeback.

[3] "Quantitative Analysis of Investor Behavior, 2020," DALBAR, Inc. www.dalbar.com

[4] For instance, the CLHIA reports that FEL-0 represents 43% of sales in segregated fund accounts at $200,000 and above. However, that declines to 31% in segregated accounts at $50,000 and below. The chargeback option is required to allow advisors to economically offer segregated funds to clients with smaller pools of investable capital. "Data to Advocis – CCIR Upfront Commissions for Segregated funds," CLHIA Discussion Paper, October 28, 2022.

In practice, the evidence shows that advisors do not engage in regulatory arbitrage between segregated funds and mutual funds. As the CCIR has noted: "the CCIR has sought statistical evidence to demonstrate that regulatory arbitrage is occurring within the mutual fund/segregated fund sectors. Despite anecdotal statements from stakeholders and in the media, no such evidence has been found." [emphasis added][5] Further, existing regulatory standards—particularly the product suitability requirement—prevent an advisor from pushing a product on a client due solely to differences in the regulatory regime.

Similarly, concerns regarding churning in the segregated fund sector have not materialized in practice. The average hold period for a segregated fund (almost 8 years) is substantially longer than the chargeback period (2-5 years). Insurance agents are not transferring their clients to new segregated funds once the threat of chargeback passes.

In addition, there is no evidence that the presence of a chargeback is detrimentally impacting the advice provided by advisors. Data from the CLHIA indicates that segregated funds sold under the chargeback option are held for the same length of time on average as those subject to other load types.[6] The chargeback does not cause advisors to keep their clients invested longer than they should.

Alternative Regulatory Measures

Instead of wholesale changes, we believe that regulatory concerns can be addressed through targeted and proportionate regulatory reforms.

Concerns surrounding inappropriate advice can be mitigated through enhanced monitoring. By tracking redemptions during and following the chargeback period, the benefits of upfront commission can be preserved while the risks to investors are addressed.

To further reduce the risks, the duration of chargeback schedules could be reduced and standardized across the industry. This would reduce the potential for arbitrage by independent agents between different insurers when advising their clients on segregated funds.

We also support clear, simple, actionable disclosure for investors. This disclosure should include an easy-to-understand explanation of the compensation that the advisor is receiving for providing their services. Clear disclosure is consistent with the Fair Treatment of Customers and enables the client to make an informed decision when purchasing segregated funds.

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[5] Canadian Council of Insurance Regulators Segregated Funds Working Group Position Paper (December 2017), pg. 4, available here: https://www.ccir-ccrra.org/Documents/View/3369

[6] "Data to Advocis – CCIR Upfront Commissions for Segregated funds," CLHIA Discussion Paper, October 28, 2022.

3. CONCLUSION

We welcome the work the CCIR/CISRO have undertaken towards regulating upfront commissions in segregated funds.

We urge regulators to be cognizant of the distinct features of segregated funds when crafting regulatory requirements for these products. As such, we do not support the elimination of upfront commissions and the advisor chargeback for segregated funds. Instead, we support improving the regulatory regime through enhanced monitoring, and standardized disclosures, and chargeback schedules across the industry.

We look forward to further productive discussions with CCIR/CISRO on the issues highlighted in this submission. Should you have any questions, please do not hesitate to contact the undersigned, or James Ryu, Vice-President, Advocacy and General Counsel at jryu@advocis.ca.
Sincerely,

"original signed by"

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