

INSURING DISCLOSURE

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REGULATORS HAVE THEIR EYES ON POINT-OF-SALE DOCUMENTS AND AGENT COMPENSATION.

An increased focus on compliance matters has filtered through almost all financial industry sectors, and insurance is no exception. While concerns regarding potential conflicts of interest permeate discussions about insurance sales compliance, the standard regulatory response to the thorny issue is often mandated disclosure.

The role disclosure plays in a strong compliance program is drawn out in the context of two topics: The proposed point-of-sale disclosure rules for segregated funds, and disclosures about compensation of insurance agents and brokers.

Recent Developments

The last couple of years have seen the conclusion of several, industry-wide consultations about disclosure issues, conflicts of interest and compensation. In 2003, the Joint Forum of Financial Market Regulators (Joint Forum) issued a con-

sultation paper (81-403: “*Rethinking Point of Sale Disclosure for Segregated Funds and Mutual Funds*”) covering point-of-sale disclosure for both Individual Variable Insurance Contracts (IVICs) and mutual funds. The proposals were a response by the Joint Forum to concerns that investors didn’t understand the IVICs, segregated funds, and mutual fund products they were purchasing.

Nearly four years later, proposed Framework 81-406: “*Point of Sale Disclosure for Mutual Funds and Segregated Funds*” was released as a result of the Joint Forum’s review of the comments made on its consultation paper, as well as the testing and review of two new summary documents.

Reviews of compensation disclosure issues that were already in the works were postponed to ensure a coordinated result among industry players. In particular, the Canadian Council of Insurance

Regulators (CCIR), which had issued a consultation paper in January 2004 regarding referral fees, deferred its efforts to permit the Industry Practices Review Committee (IPRC) to complete its work and ensure recommendations were consistent and didn’t create confusion within the industry. IPRC was established to examine relationships between insurance companies and their sales intermediaries. In June 2006, CCIR agreed on three principles for managing actual or potential conflicts of interest:

- Agents must put the interests of policyholders and purchasers ahead of their own;
- Consumers must receive disclosure of any actual or potential conflicts of interest associated with a transaction or recommendation; and
- Recommended products must be the right fit and meet the needs of the **continued on page 36**

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These principles are in addition to provincial rules and regulations; as well as various codes of conduct and ethics that impose similar requirements on insurance sellers.

Point of Sale

Meanwhile, the proposed seg fund framework (81-406) issued last June focused on three principles:

- Providing investors with key information about a fund;
- Providing that information in a simple, accessible and comparable format; and
- Providing the information before an investor makes the decision to buy.

Currently, information in connection with segregated funds is disclosed via an information folder that's provided at the point of sale, and within the insurance contract that may follow after the sale. Under the proposed framework, distributors of segregated funds will have to provide two new disclosures—written in plain language—to potential investors:

- A Fund Facts document for each segregated fund an investor selects on his or her application. This document summarizes the key features of the segregated fund and is substantially similar to the Fund Facts document that's been proposed for mutual funds. A Fund Facts form is required for each variation of a fund that has a separate MER (e.g. series, classes and guarantee options); and
- A Key Facts document, which summarizes the main features of the insurance contract under which the segregated funds are offered.

The Fund Facts document would include a series of bullet points about the fund as well as information about the type of investments, sales charge options, costs and how the advisor is compensated. It would also include information about the suitability particulars for different types of investors, and overall risk of the fund. The Key Facts document would include information about why the product should be purchased, investment options, guarantees, choosing beneficiaries, making withdrawals, the list of segregated funds available under the contract and where to get additional information.

Together, the two documents will be incorporated by reference into the insurance contract, so that investors would have the right to take action against the insurer for breach of contract if there's a misrepresentation in the Fund Facts or Key Facts. Investors also may be required to sign an acknowledgment that they received the two disclosures for all the segregated funds selected on the application.

Insurers, meanwhile, would be responsible for meeting delivery obligations and for making sure their agents delivered the required new disclosures, which would become part of the information folder given to clients. The documents would have to be delivered to each investor (by hand, fax, mail or electronically) before or at the point of sale, which is when an investor signs the application for the insurance contract and selects his or her funds.

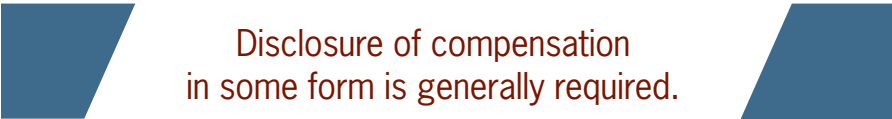
Requirements regarding the delivery of the information folder for initial sales are not expected to change. Agents would have to bring both documents to

the attention of the investor once they'd been delivered and there's no provision for substituting access for delivery—so posting the documents on an insurer's website and drawing an investor's attention to that website won't be sufficient for compliance purposes.

The requirement to provide the forms, however, seems to assume investors review and make decisions on their own based largely on disclosure documents. This emphasis on written disclosure, I think, fails to recognize the critical role of the insurance agent in an investor's decision-making process. Segregated funds can only be acquired through licensed insurance agents, and comments received by the Joint Forum in response to its proposal strongly suggest investors are more likely to rely on the advice of an insurance agent than on a two-page document that outlines certain prescribed facts.

The role of the advisor is particularly important because the Fund Facts will be, at best, a somewhat superficial document that sets out only the key features of the financial instrument. By its very nature, it can't provide all the information required to fully understand a complex segregated fund product. And, as the framework is currently drafted, the Fund Facts and Key Facts do not incorporate other permanent disclosure documents by reference. Since the Fund Facts will, by necessity, omit the disclosure of many material facts, incorporation of these other key disclosures in the document is required to ensure investors don't have rights of action against the insurance company for those omissions.

The Joint Forum also proposed a cooling-off period whereby seg fund investors would be allowed to cancel a purchase within two business days of giving buy instructions to the insurer.



Disclosure of compensation
in some form is generally required.

To do this, the investor would have to provide written notice to the insurer. In addition, investors will have a two-day period during which they could cancel the contract—again through written notice. It's important to note that, under existing insurance laws, it may be considered an unfair or deceptive act or practice if an insurer fails to deliver the Fund Facts when required. Investors could not cancel their purchase where the Fund Facts were never delivered (as they could with mutual funds).

IVICs and segregated fund products will continue to fall within the jurisdiction of insurance regulators and insurers will have to update their Key Facts and Fund Facts documents semi-annually and meet jurisdictional filing requirements for insurance contracts. Insurers will be permitted to update and file the Fund Facts quarterly. Key Facts and Fund Facts must also be updated whenever a material change is made to the fund. Agents would, of course, distribute the most recent Fund Facts (once received, if required) to investors.

Given the pre-purchase delivery requirements, agents would be required to carry around a significant number of correct versions of documents, particularly since a separate document is required for each variation of a fund. Processes also would have to be put in place to ensure past versions of Fund Facts were disposed of and new versions made available for delivery.

Compensation Disclosures

While not a new issue, questions about compensation disclosure continue to be a hot-button industry issue. Of particular interest are referral fees, a form of revenue sharing which may be a component of an agent's compensation. When determining whether you can give or receive referral fees, an insurance agent

has to ask:

- How am I registered?
- Who is giving or receiving the fee?
- What did I do to get that fee? Or, for what am I paying the fee? and,
- Who needs to know about the fee?

While certain disclosures about compensation arrangements have always been required, the specifics of insurance compensation are often considered too complicated to lend themselves to simple disclosure.

In setting out best practices, the CCIR fell short of requiring that disclosure of specific compensation amounts be provided to insureds, but does require disclosure of conflicts of interest. Disclosure gives consumers the option to decline an insurance product if the compensation arrangements are bothersome.

Despite implementation of the CCIR principles, certain insurance regulators have created (or not changed) their own prescribed rules. For example, in January 2007, the regulator in Newfoundland and Labrador produced a document titled "*Principles for the Sale of Insurance*," which requires certain information to be provided to clients at the point of sale, including:

- The various coverages available;
- The cost of the coverages and any discounts;
- The total premium of all quotations with a detailed breakdown; and
- Compensation disclosure.

It doesn't appear other jurisdictions will follow Newfoundland's example. Nevertheless, disclosure of compensation in some form is generally required. In connection with referral fees, some regulators are very clear about the actions that must be taken to get or give a referral fee. The Registered Insurance Brokers of Ontario (RIBO), for example, states in its marketing guidelines that a broker may generally pay or

receive referral fees from intermediaries in various financial services sectors, but prohibits referral fees being paid to non-financial industry parties.

The RIBO guidelines require, among other things, that the broker disclose such arrangements to clients in advance of the referral and obtain written client consent.

Other regulators require agents to take a close look at their practices to determine the existence of conflicts of interest or other concerns that must be disclosed to clients. Life insurance agents in Ontario are required to consider privacy and disclosure issues (e.g. are you releasing personal information contrary to privacy legislation? Or, will the referral create a conflict of interest that must be disclosed?) and to ensure they don't trip over the prohibition against paying unlicensed persons for acting as insurance agents.

In some provinces, referral fees calculated as a percentage of the agent's commission are not allowed because such a structure tends to indicate the recipient of the fee is doing more than merely referring a potential client.

Given the role of disclosure in compliance programs across industry sectors, clients may become attuned to expect disclosure—including disclosure of referral fees and other compensation arrangements, due to their dealings with other financial services intermediaries. That alone should prompt insurance firms to review their practices and ensure their disclosures meet investor expectations. ^{AE} **SPAGNOLO**

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