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# **Joint Forum of Financial Market Regulators**

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**Recommendations for  
Changes in the Regulation  
of Mutual Funds  
and Individual Variable Insurance Contracts**

**DECEMBER 15, 1999**

## **BACKGROUND**

In May 1999, the Joint Forum of Financial Market Regulators released a *Comparative Study of Individual Variable Insurance Contracts (Segregated Funds) and Mutual Funds*. This study examined 100 features of these two products and their regulation, including the entities that offer and manage the products, the product structure and their system of distribution and disclosure to consumers. The purpose of the *Comparative Study* was to inform and accordingly, did not make any recommendations.

Following completion of the *Comparative Study*, the Joint Forum directed that a working group of regulators be established to look at the existing regulation as documented in the *Comparative Study* to identify good practices which have not currently been adopted by both regulatory regimes. In short, what can each regulatory regime learn from the other.

The working group of regulators recommended fifteen areas where harmonization between the regulation could be undertaken. These recommendations have been adopted by the Joint Forum and are set out in this report.

In this rapidly evolving business, there are continually new issues that require regulatory assessment. The recommendations outlined in this report do not make recommendations in such areas. The members of the Joint Forum intend to work together to deal with these issues as they arise. In particular, some work is underway on fund-on-fund arrangements, including those segregated funds that invest in mutual funds (so-called wrap products).

Decisions whether to adopt the recommendations of the Joint Forum are, of course, subject to the process used by each regulatory regime in implementing changes. The Joint Forum is a means of exchanging ideas and developing consensus, but each jurisdiction has autonomy over any changes to be made.

## **THE RECOMMENDATIONS**

It is clear from the *Comparative Study* that the regulatory objectives for IVICs and mutual funds are similar, but because the products are based on fundamentally different legal principles, are satisfied in different ways. IVICs are based on contracts and mutual funds are based on beneficial ownership interests in a pool of securities.

The Joint Forum has concluded that, apart from the areas highlighted in the recommendations that follow, the regulation of IVICs and mutual funds is essentially the same. As was stated in the *Comparative Study*, the goals of both regulation are the same -- the protection of consumers. Because of the differences in the legal nature of the products, regulators have, however, traditionally placed differing emphasis on the regulation of the areas noted in the recommendations; it is these areas where harmonization is warranted.

There is no intention in these recommendations to make one product into the other. This is not desirable, nor could it be done.

As a result of the *Comparative Study*, regulators and industry have gained a better understanding of these competing products and can look to see what they might learn from the practices in each regulatory regime. Since there are fundamental differences between the products, harmonization of *result*, rather than harmonization of *rules* should be the goal. However, where there are choices to be made, regulators are encouraged to look first to the requirements established by their colleagues.

To stimulate thinking, this report has avoided the use of industry specific terminology. The terms used are defined below:

“Manufacturer” - is used to describe the operator of the fund structure, whether it is the insurance company or the mutual fund manager.

“Product” - is used to describe the benefits that the consumer is purchasing.

“Distribution firm”- is used to describe an intermediate body in the distribution chain between the sales person and the manufacturer. This will include the dealer in the mutual fund context and corporate insurance agencies, if used, in the insurance context.

“Sales representative” - is used to describe the person interacting with the consumer to effect the sale.

“Consumer”- is used to describe the purchaser of the product. In the insurance context, these consumers are called policyholders and in the securities context, these people are called investors.

With these definitions in mind, it is instructive to look at the distribution chain between product manufacturer and consumer to understand the recommendations in this report. In the case of IVICs, the relationship with the consumer is contractual between the consumer and the manufacturer (the insurance company), the manufacturer is accountable for the sales process, and the holding out to the public is at the manufacturer level. There may or may not be a distribution firm involved. In the case of mutual funds, the consumer holds a beneficial ownership interest with a specific fund, the distribution firm (dealer) is accountable for the sales process, and the holding out to the public occurs at the manufacturer level (the mutual fund manager). These relationships are depicted in the chart attached to this report.

## **RECOMMENDATIONS**

The recommendations are grouped into four categories:

- Product regulation
- Disclosure regulation
- Manufacturer regulation
- Distribution regulation

The table that follows outlines the fifteen areas where the Joint Forum is of the view that harmonization is warranted.

#### **NEXT STEPS:**

The Joint Forum has formed a regulatory sub-committee of the Joint Forum with a mandate to:

- Develop detailed summaries of the regulations that need to be amended to give effect to the recommendations;
- Identify the priorities to be given to the projects represented by the recommendations;
- Identify what regulatory work has been done or is underway related to the recommendations;
- Determine how to integrate any existing regulatory work into the directions set out in this report;
- Identify what level of industry involvement or consultation is required, at what stage and how this consultation could be carried out; and
- Identify broad project work plans for each recommendation.

The Joint Forum has asked the regulatory sub-committee to complete this third phase of its mandate by the Spring 2000 meeting of the Joint Forum.

It is contemplated that the recommendations contained in this Report would be implemented in phases over the next two years.

Questions on the recommendations and the next steps of the Joint Forum

regulatory sub-committee can be directed to:

**Grant Swanson**

Director, Licensing and Enforcement Division  
Financial Services Commission of Ontario  
(416) 590-7120  
Email: [gswanson@fSCO.gov.on.ca](mailto:gswanson@fSCO.gov.on.ca)

**Rebecca Cowdery**

Manager, Investment Funds  
Capital Markets  
Ontario Securities Commission  
(416) 593-8129  
Email: [rcowdery@osc.gov.on.ca](mailto:rcowdery@osc.gov.on.ca)

Recommendation	Commentary
<p><b>Product Regulation</b></p> <p>1. Consumers should have defined rights where fundamental changes occur.</p>	<ul style="list-style-type: none"> <li>• Need to define “defined rights” and articulate what changes are “fundamental changes.”</li> <li>• Fundamental changes could include: increases in maximum fees, changes in investment objectives, changes in operator of product, decrease in timing of calculating value of units of product, product mergers, changes in investment manager, product termination.</li> <li>• Defined rights could include: consumer rights to pre-approve proposed change (whether by meeting or otherwise) and/or rights to receive advance notice of proposed change coupled with rights to cash in the value of the product at no exit cost.</li> <li>• Minority rights must be considered.</li> <li>• Disclosure of proposed fundamental changes to prospective consumers is important.</li> </ul>
<p>2. Investment rules for derivatives usage and investment practices such as short selling, securities lending and the investment in physical commodities and real estate should be harmonized.</p>	<ul style="list-style-type: none"> <li>• Rules permitting derivatives usage, the use of short selling, securities lending and physical commodities are different between the two regimes.</li> </ul>

<p><b>Disclosure Regulation</b></p> <p>3. (A) It should be clear who is responsible for delivering the disclosure documents to the consumer.</p> <p>(B) Consumers should be empowered to make informed purchasing decisions by having a reasonable opportunity to review the disclosure documents before making a binding purchase decision.</p>	<ul style="list-style-type: none"> <li>Accountabilities for delivery and evidence of delivery of the disclosure documents should be clear.</li> <li>Key to informed decision making is getting the disclosure documents in time to review the information (and ask any relevant questions of the sales representative) before the investment decision is final.</li> </ul>
<p>4. Consumer education would be enhanced and product disclosure simplified by delivering to the consumer a standardized consumers' guide upon opening an account to purchase a product.</p>	<ul style="list-style-type: none"> <li>If standardized consumers' guide is required, the product specific disclosure documents could be streamlined.</li> <li>Consumers' guide should enhance the ability of consumers to make informed decisions and must contain objective, non-promotional, reliable information about the product.</li> </ul>

<p>5. Consumers are entitled to regular financial reports about the products they own. These reports should include annual audited financial statements and semi-annual unaudited statements, together with a discussion from the manufacturer about the past period's performance and operation of the product.</p>	<ul style="list-style-type: none"> <li>• Financial reporting requirements and practice, including reporting of product performance and expenses (MER) for both mutual funds and segregated funds should be substantially similar.</li> <li>• Product performance and expenses (MER) should be calculated following a standardized methodology.</li> <li>• Neither regime requires an annual report (as opposed to annual audited financial statements) or a discussion of product performance for the past period.</li> <li>• CICA Research Report of 1997 expected to provide guidance.</li> </ul>
<p><b>Manufacturer Regulation</b></p> <p>6. There should be independent participants in the governance of product.</p>	<ul style="list-style-type: none"> <li>• Key is to have effective independent participants responsible for oversight of the management of the product and for protecting the interests of consumers.</li> </ul>
<p>7. An appropriate regulatory regime should apply to the manufacturer to ensure the interests of consumers are protected and that the manufacturer has sufficient resources to properly manage the product.</p>	<ul style="list-style-type: none"> <li>• Regulatory requirements applicable to manufacturers need to reflect the nature of the product, its regulation and the roles undertaken by the manufacturer. For example, a manager of a mutual fund is not a guarantor and the financial viability of a mutual fund should be (and legally is) independent of the financial status of manager.</li> </ul>

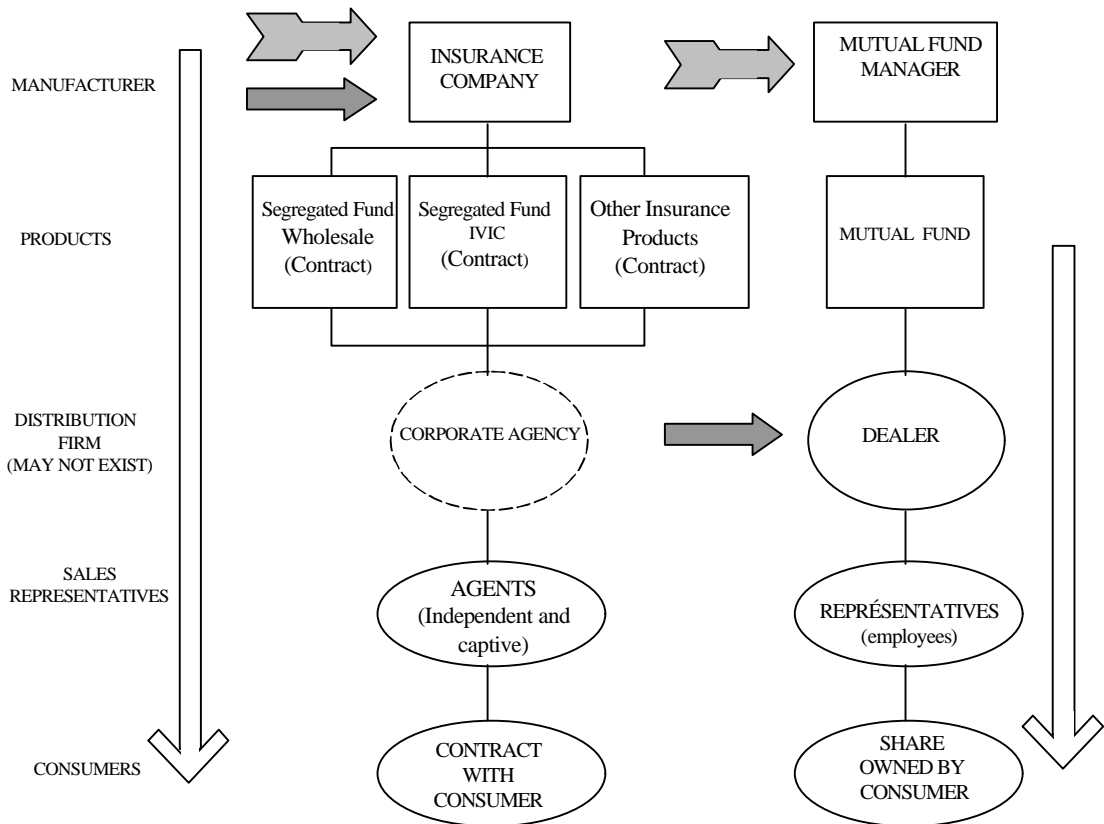


<p>8. Relevant standards should be developed to protect consumers' interests while invested in small or start-up funds. Standards could include disclosure, seed capital requirements or other related matters.</p>	<ul style="list-style-type: none"> <li>• Alternatives include: setting a minimum start-up investment by the manager (which will not be of much utility unless it is very substantial); requiring small funds to either wind-up or merge if they continue of a small size for a defined period of time; requiring certain minimum capital to start to purchase a portfolio (relevant number would be minimum purchase price for reasonably diversified portfolio meeting the investment objective of the fund); manufacturer to lose money if product doesn't get to critical size or require manufacturer to fund costs up to certain point after which it only is repaid after that size reached; require disclosure of "break points."</li> </ul>
<p>9. Appropriate mechanisms should be in place to allow for speedy resolution of consumer complaints.</p>	<ul style="list-style-type: none"> <li>• There are a number of possible models for addressing consumer complaints that do not involve the regulator directly where the complaint is not about a breach of a legislative requirement. Securities regulators are not in the dispute resolution business and do not want to be directly. Securities regulators do support the creation of third party dispute resolution systems.</li> </ul>
<p>10. People who manage assets for the benefit of consumers should have the appropriate level of proficiency.</p>	<ul style="list-style-type: none"> <li>• Proficiency may be established through various means.</li> </ul>

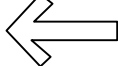
<p style="text-align: center;"><b>Distribution Regulation</b></p>		
<p>11. The respective duties and responsibilities owed the consumer by the manufacturer, distributor and sales representative should be clear. The consumer should be made aware of these responsibilities.</p>	<ul style="list-style-type: none"> <li>• Among other things, consumers should understand whether information supplied to them is the representation of the manufacturer, the distributor or the sales representative. Consumers should understand who is accountable for information about the product.</li> </ul>	
<p>12. (A) All compensation paid, and incentives given, in respect of product sales should be fully disclosed to the consumer.</p> <p>(B) Opportunities for conflicts between the self-interest of sales representatives and their duties to their clients should be minimized.</p>	<ul style="list-style-type: none"> <li>• Consumers should understand what incentives their representative is receiving to encourage the sales representative to sell the product or will receive (from all sources) on the sale of the product.</li> <li>• Some conflicts cannot be policed by disclosure or competitive market forces and should simply be prohibited, such as non-educational trips, incentives contingent on meeting specified assets and sales thresholds, excessive promotional events and items, excessive payment of marketing expenses and reciprocal commissions.</li> </ul>	

<p>13. Proficiency standards including continuing education, for sales representatives, should be reviewed periodically.</p>	<ul style="list-style-type: none"> <li>• Rapid change in the financial services industry leads to the need for continuing education so that participants can remain current; regular review of entry standards will ensure appropriate standards for those seeking to enter the business.</li> </ul>
<p>14. Products sold to retail consumers should be suitable for that particular consumer's circumstances.</p>	<ul style="list-style-type: none"> <li>• Consider suitability standards and enforcement and compliance mechanisms to monitor how effectively these standards are working.</li> </ul>
<p>15. The activities of sales representatives should be supervised effectively to ensure compliance with applicable laws.</p>	<ul style="list-style-type: none"> <li>• Both the Financial Services Commission of Ontario and the Canadian Securities Administrators have released discussion papers that deal with, among other things, effective supervision.</li> </ul>

### CHART A - COMPARATIVE RELATIONSHIPS



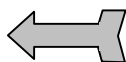
Legend



Direct relationship to consumer



Responsibility for supervision of sales force



Holding out to consumer