AUM LAW

September 2022 | Bulletin

Seasonal (Regulatory) Change Edition

Ah, September - cold mornings followed by warm and sunny afternoons. We may not be able to stop the plants from breaking down chlorophyll into smaller molecules (allowing other pigments to show their colours), but we can help break down regulatory changes and the potential new policies on the horizon.

In this month's bulletin edition, we cover the recent consultation on upfront compensation for segregated funds, an OSC study finding many investors overestimating their knowledge, amendments to National Instrument 45-106, and more below.

In this bulletin:

1. Discussion Paper Released on Upfront Compensation for Segregated Funds and IVICs: Transition Time

The Canadian Council of Insurance Regulators (**CCIR**) and the Canadian Insurance Services Regulatory Organizations (**CISRO**) are consulting on concerns they have regarding upfront commissions used in the sale of segregated funds and individual variable insurance contracts (**IVICs**). Earlier this year, CCIR and CISRO stated that the use of Deferred Sales Charges (**DSCs**) in segregated fund contract sales was inconsistent with treating customers fairly, highly discouraged and should cease fully by June 1, 2023.

The current consultation paper notes that upfront commissions in the sale of segregated funds create potential issues relating to conflicts of interest where consumers rely on advisors to sell them a suitable product and the advisor is paid by the insurer for the sale and servicing of those products. These concerns are similar to those raised in connection with the sale of other financial products including mutual funds. In the paper, “upfront compensation” is defined as:

> “any compensation, including money, arrangement for financing a payment similar to upfront commission or anything else of value, an Insurer or Intermediary provides to another Intermediary immediately after a Customer invests in an IVIC, because of the investment.”

An insurance intermediary can be a licensed individual, or a business, authorized to sell and service IVICs.

As noted, some of the concerns raised are similar to the discussions previously held in the securities industry relating to the sale of mutual funds, but others are unique to the insurance industry. One example provided in the consultation relates to an intermediary having to repay some or all of their compensation because a customer withdraws from an IVIC (the “advisor chargeback option”, discussed below) and the intermediary does not have funds to do so. In that circumstance, the intermediary may become a debtor to an insurer or managing general agency. This relationship could possibly motivate the intermediary to sell products of a different insurer to avoid a reduction in compensation from new sales from the creditor, even if the creditor’s products are most suitable for a customer.

The primary purpose of the consultation is to better understand compensation arrangements in segregated funds and IVICs, and what changes to upfront compensation may be needed to improve customer outcomes. A number of targeted customer outcomes are outlined in the consultation, including a regulatory approach which effectively addresses conflicts created by upfront compensation which can misalign the interests of insurers, intermediaries and customers, as well as enhance customer awareness of intermediary compensation. Other targeted outcomes include reducing the risks of mis-selling segregated funds and IVICs over securities products by dually licensed intermediaries due to different upfront compensation arrangements.

The paper spends time discussing the “advisor chargeback option”, which is similar to DSCs where the insurer pays an intermediary an upfront commission, except that in the event a customer redeems an investment in a segregated fund prior to the expiry of the fixed schedule, it is the intermediary rather than the customer who must reimburse the insurer for the cost of intermediary compensation. In effect, the intermediary would have to return all or a portion of the commission the intermediary received from the sale of segregated funds to the insurer. It is noted that other compensation may also be paid to intermediaries, such as bonuses based on sales placed with any particular insurer. Licensed individuals may also be compensated by intermediaries for sales placed with an insurer through the intermediary. Concerns have been raised that not all of these arrangements are required to be disclosed, especially not on an ongoing basis, which could be very relevant to a customer if a chargeback period continues to exist.

A potential supervision gap is also noted in the consultation, as licensed individuals are not restricted in most jurisdictions from distributing products for more than one intermediary or insurer. As a result, those intermediaries and insurers responsible for overseeing licensed individuals may not know what IVICs were sold to customers nor be aware of any monetary influences on those sales.

Many of the specific questions in the paper are targeted at gathering information about the current environment in which segregated funds and IVICs are sold as well as particulars about sales charge options. It will be interesting to follow these developments as the CCIR and CISRO express their desire to keep the regulatory regime for financial products as harmonized as practical and appropriate, to avoid regulatory arbitrage and provide similar investor protection for both segregated funds and other financial products. The deadline to provide comments is November 7, 2022.

2. Back to the Books: OSC Study Finds Many Investors Overestimate Their Knowledge

The Ontario Securities Commission's (**OSC**'s) Investor Office leads the OSC's efforts in investor engagement, education, outreach and research. The Investor Office launched a survey that ran between September 27 to October 4, 2021, to assess the financial literacy of Canadian investors. The overall objective of the survey was to determine how Canadian investors' perceptions of their financial knowledge compare to their ability to answer questions measuring financial literacy. The survey polled 2,591 Canadians nation-wide, and on September 7, 2022, the OSC released the results and insight gathered from the survey results.

In the introduction to the report, the OSC notes that as Canadians are taking on more responsibility for their own investing, to do this effectively they must have the financial acumen to participate in Canada's capital markets. The results of the survey revealed some interesting tidbits, including the following key highlights:

- Investors have the least knowledge when it comes to investment costs and investor protections;
- About 3-in-10 Canadian investors self-assessed their financial knowledge too highly; and
- On average, self-directed investors were the most financially-literate.

There were 27 questions, which were broken up into 5 financial literacy themes:

1. **Organization for Economic Co-operation and Development (OECD) Core Questions** – these questions are used by the OECD internationally as a benchmark for financial literacy. They are used to gauge basic understanding of the importance or impact of investment risk, diversification, compound interest, inflation, diversification, bond vs. interest rate, and that mutual fund returns are not guaranteed. Of the Canadians polled, 68% of these questions were answered correctly.
2. **Core Investing Principles and Concepts** – these questions tested the understanding of investing principles and concepts, such as leveraged investing, past performance, time horizon, and break-even calculation. These questions were answered correctly about half of the time.
3. **Investment Costs** – these questions gauged awareness of the link between fees and returns, Management Expense Ratio (**MERs**), advisor costs, and the different types of funds. This section received the lowest number of correct responses, with only 36% correctly answered. While respondents correctly answered the question about whether fees are linked to returns 76% of the time, the impact of MERs only had 35% correct responses, and advisor cost questions received only 22% correct responses. The results of this portion of the study may help to explain some of the emphasis by regulators on current initiatives such as the proposals relating to total cost reporting.
4. **Registered Accounts** – the key features of these questions centered around the differences between registered account types (RRSPs, TFSAs, and RESPs). While respondents answered

69% of the questions correctly, one question pertaining to RESPs was only answered correctly 38% of the time.

5. **Protecting Your Portfolio** – of the questions posed about investor rights and responsibilities, complaint handling (internal and external), and checking registration, on average 44% of these questions were answered correctly.

The survey results will help the OSC's Investor Office understand the identified knowledge gaps of the respondents and direct its efforts in helping Canadians improve their investing knowledge, by re-engineering its investor resources, outreach efforts, and policy developments going forward.

3. Amendments to National Instrument 45-106 on the Horizon as the Listed Issuer Financing Exemption Takes Flight

In the Canadian Securities Administrators' (**CSAs'**) ongoing efforts to reduce regulatory burden and better provide for cost-effective capital raising mechanisms, the CSA has developed the Listed Issuer Financing Exemption (**Exemption**), a prospectus exemption aimed at providing reporting issuers, and particularly smaller issuers, the ability to raise capital through smaller-sized offerings. The Exemption was created in response to the impediments noted by many market commentators who highlighted that the short form prospectus regime created to facilitate capital raising for reporting issuers was often seen as a barrier and too costly, particularly for smaller issuers. The Exemption balances investor protection and the fostering of capital formation and efficient capital markets by incorporating the continuous disclosure regime for reporting issuers while also allowing eligible issuers to raise a limited amount of capital through the filing of a more cost-effective offering document (Form 45-106F19 *Listed Issuer Financing Document* or the **Offering Document**).

We previously reported on some of the features of the Exemption in our August 2021 bulletin. Since then, the following changes to the Exemption have been made:

- Restricting certain issuers from using the exemption, including investment funds and issuers that are or had been capital pool companies, among others.
- Reducing the dilution limit on distributions using the exemption from 100% to 50% of the issuer's outstanding securities.
- Limiting the type of securities that can be distributed using the exemption to listed equity securities and units consisting of listed equity securities and warrants convertible into listed equity securities.
- Requiring that the news release announcing an offering using the Exemption contain prescribed language on where an investor can access the Offering Document (e.g., on their website).
- Requiring that the Offering Document contain prescribed language on the risks of investing, on its cover page.
- Requiring that the Offering Document be signed by the chief executive officer and chief financial officer of the issuer.
- Requiring that the Form 45-106F1 *Report of Exempt Distribution* filed in connection with distributions using the Exemption include a completed Schedule 1 with purchaser information.

The exemption will come into effect on November 21, 2022. If you have any questions or are interested in learning more, please contact us. For additional insights from BLG's Capital Markets team, please refer to the article under "BLG's Resource Corner" below.

In Brief

Not All Autumn Skies and Apple Pies – Could New Trust Tax Reporting Rules Apply to You?

In August, the Canada Revenue Agency (**CRA**) released proposed legislation (that was first introduced in 2018) that if enacted will expand annual trust reporting requirements beginning with the 2022 taxation year (for trusts that have a December 31 year end). Under the proposed legislation, unless excluded from the rules, trusts will be required to file a T3 return annually that discloses additional information about the trustee(s), beneficiaries and settlor of the trust. This change is being made to improve the collection of beneficial ownership information with respect to trusts and to help the CRA assess the tax liability for trusts and their beneficiaries. Notably, the reporting requirement applies even if the trust has no tax liability and made no distributions or allocations during the year. Accordingly, a trust subject to the new requirement will need to file an annual return to disclose such information even if that trust would not have been required to file a T3 under the current rules. Trusts excluded from the new reporting requirements include mutual fund trusts, trusts with units listed on a designated stock exchange as well as registered savings plans. You can read more about the trust reporting rules in this BLG publication.

In addition to the new trust reporting rules, after December 31, 2022, all trusts filing returns in Québec (including non-Québec situs trusts reporting allocation of income to Québec beneficiaries) are required to include a trust identification number issued by Revenue Québec (in addition to the federal trust account number issued by CRA) when making tax filings. The trust identification number is included in the notice of assessment for trusts that have previously filed returns in Québec or can be obtained by completing an application with Revenue Québec. Until December 31, 2022, for trusts that have been formed in 2022 or that will be filing a Québec income tax return for the first time in 2022, Revenue Québec is permitting the return to be filed without including the trust account number and trust identification number and these numbers will be issued by CRA and Revenue Québec, respectively, when the return is processed and included in the notices of assessment for use in returns going forward. Failure to comply with the new trust reporting requirements once enacted or the requirement to provide a Québec trust identification number when making tax filings after December 31, 2022, could result in the imposition of penalties. **Additional details about the Québec trust identification number requirement can be found here.** For more information about how these rules may impact your particular trust, please contact your usual AUM lawyer who can make an introduction to a member of BLG's tax group.

It's Getting Cooler but the Regulators are Heating Up: Review of Mutual Fund Sales Practices

In early September, the Canadian Securities Administrators (**CSA**) began reviewing the sales practices of certain mutual funds, namely those that have a relationship with a registrant to act as a principal distributor of those funds. According to National Instrument 81-102 *Investment Funds*, a principal distributor is a person or company through whom mutual fund securities are distributed under an arrangement with the fund or its manager that provides either **(i)** an exclusive right to distribute the securities in a particular area, or **(ii)** a feature that gives or is intended to give the person or company a material competitive advantage over others in the distribution of the securities of the fund. The review is tied into a long-awaited potential review of National Instrument 81-105 *Mutual Fund Sales Practices,* which among many other provisions deals with permitted dealer compensation. Readers will want to follow any published results and next steps closely.

New School Year, New Potential Disclosure Policies from the Department of Finance Canada

Last month, the Department of Finance Canada released a consultation paper related to proposed changes to the existing governance framework for federally regulated financial institutions (**FRFI**s). The consultation dealt with a few topics, including diversity disclosure requirements and the ability for FRFIs to communicate with stakeholders electronically.

With respect to disclosure requirements, the consultation described the current requirements for public companies incorporated under the *Canada Business Corporations Act* (**CBCA**). For example, the CBCA requires those public companies to disclose the representation of women, visible minorities, Indigenous peoples, and people with disabilities in management and on the board of directors, as well as a company's policies and targets (or lack thereof) with respect to representation. The consultation requested comments on applying the CBCA's "comply or explain" provisions to FRFIs, as well as whether additional compliance measures such as mandatory use of a prescribed form or penalties for failure to comply should be added.

The consultation also sought feedback on permitting "all virtual meetings", as well as on the considerations for the use of electronic communications with owners/shareholders of FRFIs for governance documents. The consultation asked questions on both the "notice and access" model or, similar to recent proposals by the Canadian Securities Administrators, an "access equals delivery" model for governance documents.

Things to Contemplate Post-Equinox: IIROC Releases Third Phase of Competency Profiles for Comment

In late August, IIROC released the final phase of its multi-year consultation to set base line competency profiles for all of its registration categories. This third phase deals with Supervisors, Traders, Associate Portfolio Managers and Portfolio Managers and comments will be accepted on the proposal until December 28th. In IIROC's parlance, a "competency" is a set of knowledge, behaviour and skills that an individual must have to perform effectively in their role.

Each proposed profile consists of high-level competencies along with numerous sub-competencies specific to the role. For example, the proposed profile for Supervisors consists of three high-level competencies associated with their oversight responsibilities, related to the general regulatory framework, supervisory firm responsibilities and specific supervisory responsibilities related to the individual. With respect to Portfolio Managers and Associate Portfolio Managers, there are a proposed six categories of high-level competencies related to expected relationship, regulatory and technical skills, which focus on the regulatory environment and ethics, investment policy, research and analysis, portfolio construction, portfolio monitoring and servicing institutions. In addition to all of the specific knowledge requirements set out in the relevant sub-competencies, Portfolio Managers and Associate Portfolio Managers must also meet the competencies that had been proposed for Registered Representatives in Phase 1 of the project, as these individuals are also permitted to carry out Registered Representative activities.

IIROC intends to publish the final profiles in advance of the expiry of the current contract held by IIROC's education service provider; a request for expressions of interest will be sent out later this year as a first step in the procurement process for potential education service providers moving forward.

BLG's Resource Corner

Our colleagues at BLG have provided the following insights we thought might interest our readers:

- No prospectus, no problem: the Listed Issuer Financing Exemption allows for free trading securities without a prospectus
- Cyber liability insurance exclusions: Is this upgrade covered?
- Recent developments in the digital assets space
- New Single SRO and Protection Fund for year-end 2022 – status and next steps
- Canada's First Home Savings Account

For more information, please visit the BLG website.

News

Welcome Michelle Racine Stacey to AUM Law

We are delighted to welcome Michelle Racine Stacey as a Knowledge Management Consultant to AUM Law. In her role, Michelle will focus on initiatives to progress solutions for how our lawyers and paraprofessionals develop, maintain, and share knowledge to ensure efficient and cost-effective delivery of services. Before joining AUM Law, Michelle was part of the BLG team as a Research Librarian where she provided in-depth legal research and reference services, current awareness monitoring for legislative and judicial information, and legal research and technology training to lawyers, students, and library research staff.