FINANCIAL PRODUCT DEVELOPMENT
STANDARDS AND PRACTICES

Report prepared by:
Joint Forum Product Disclosure and Regulation Committee

April 2, 2013
EXECUTIVE SUMMARY

There are many factors driving the introduction of new products in the marketplace. These include financial innovation, increased cross-sectoral competition amongst both product manufacturers and intermediaries, and the changing needs of consumers as Canadians live longer.

The range of financial products and services that consumers can choose from is increasing. Some new products are complex in nature with risks not easily understood by consumers themselves or the intermediaries that advise them. The need for consumers to purchase suitable products with a full understanding of the features of these products and associated risks is of critical importance. Product manufacturers, intermediaries, and investors themselves all bear responsibility in meeting this objective.

The Joint Forum established a Product Disclosure and Regulation Committee to undertake an initiative to examine the responsibilities of financial product manufacturers, intermediaries and consumers in ensuring that Canadian consumers are offered suitable products and are able to make informed decisions, particularly in this uncertain financial environment. The initial focus of the work of the Committee was on product manufacturers and their risk assessment and product disclosure practices at they relate to consumers.

In 2010, as a first step, a research paper was prepared on the issues described in the objective, examining both international and Canadian practices. A draft survey questionnaire for product manufacturers was circulated to industry associations for feedback. Based on the feedback, a roundtable discussion was held with Advocis, CBA, CLHIA, IFIC and IIAC and representatives from their member organizations in September 2011. It was agreed that the next step would be to redesign a fact-finding survey that would be focused on the processes and controls around product development as they relate to impact on consumers, with the involvement of the industry associations.

A Joint Regulator/Industry Product Manufacturer Working Group was established and started meeting in November 2011. The Working Group acknowledged that there is currently a greater degree of uncertainty in financial markets, together with increasing consumer expectations and increasing complexity of products. Firms are managing in this environment with various risk assessment practices, while regulators continue to need to understand how firms are responding to these challenges. Both regulators and firms have a common interest in ensuring a competitive market where consumers’ needs are met. Consequently, there is a desire for regulators to have an understanding of the practices and processes involved in manufacturing a product, as it relates to consumers.

The advice from the industry representatives on the Working Group was that a survey was not the most suitable first step in obtaining information from manufacturers. They felt that, in the absence of a greater level of understanding, a survey would be constructed too broadly resulting in inconsistent interpretations and responses from participants.
To that end, the CLHIA and IFIC each submitted detailed written reports that described the product development practices used by the life insurance industry and the mutual funds industry to manage risk in IVICs and mutual funds, respectively.

The Committee has now completed its work and prepared the following materials which are included in this report:

1. **Research Paper**
   The paper reflects the current requirements, standards and practices for product manufacturers in the United Kingdom, United States and Canada, as summarized below:
   - United Kingdom - A principles-based regulatory scheme whereby the regulator has the ability to impose penalties on those that fail to meet regulatory requirements, while providing firms with the autonomy to decide how to meet such requirements.
   - United States - A mix of mandatory regulatory requirements and suggested ‘best practices’.
   - Canada - An overview of the practices and processes presented in the CLHIA and IFIC reports.

2. **Summary of Findings**
   The document is a summary of the findings on international practices and standards in the research paper and the practices and processes detailed in the CLHIA and IFIC reports. These reports describe product development practices used by the life insurance industry and the mutual funds industry to manage risk in IVICs and mutual funds, respectively. In preparing this material, the CLHIA and IFIC conducted a broad consultation with their member companies. About 25 companies were given an opportunity to provide input. This document reflects input received from the CLHIA and IFIC.

3. **Product List**
   Mutual funds and segregated funds are the most mature financial products with established risk practices and processes. A comprehensive list of other financial products for which risk practices and processes could be examined was prepared and circulated to the Working Group for comment. Upon completion of the review, the Working Group has recommended that rather than creating a new list, the list of financial products most commonly held by Canadian households for the purpose of accumulating wealth, as derived from the Investor Economics’ Household Balance Sheet Report, could be used.
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ATTACHMENTS:
- CLHIA Report
- IFIC Report
PRODUCT MANUFACTURERS REGULATORY REQUIREMENTS AND GOVERNANCE STANDARDS FOR CONSUMER PRODUCTS (RESEARCH PAPER)

Global Practices

A 2008 report by the international Joint Forum (Basel Committee on Banking Supervision, International Organization of Securities Commissions, and International Association of Insurance Supervisors) surveyed both regulator and firms regarding customer suitability\(^1\). While the report does not cover specifically regulatory requirements / firm governance standards for product manufacturers on identification and disclosure of risks to consumers, it sheds light on the extent suitability is examined by manufacturers in product design.

Regulatory practices

The international Joint Forum report reflects the results of a survey of bank, securities and insurance regulators in eleven countries.

Product Design

In product design, the report notes, in general, countries do not have regulations that impose requirements on the product design process, particularly retail products. With few exceptions, there are generally no restrictions on the design of new products. The exceptions noted in the report are:

- The US Financial Industry Regulatory Authority (FINRA)\(^2\) has issued guidance on product design for structured products.

- The UK Financial Services Authority (FSA) expects firms to ensure products are soundly designed, even where manufacturers distribute solely or mainly through intermediaries. The Joint Forum report notes this expectation is derived from an outcome under the FSA’s “Treating Customers Fairly Initiative,”\(^3\) which states that products sold in the retail market should be designed to meet the needs of identified consumer groups and targeted accordingly.

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1. The Joint Forum, “Customer suitability in the retail sale of financial products and services.” April 2009. Available at [http://www.bis.org/publ/joint20.htm](http://www.bis.org/publ/joint20.htm). The report was prepared by a working group that included AMF participation.

2. The Financial Industry Regulatory Authority (FINRA), is the largest independent regulator for all securities firms doing business in the United States.

3. Under this initiative, although the FSA does not regulate the design of financial products, it does expect firms to treat their customers fairly when considering the design of those products.
- US insurance regulators review insurance products for compliance with applicable laws, including the requirement that the product meet actuarial standards.

**Evaluation of Risk Posed by Mis-selling**

Although regulations or restrictions of product design are not common, the report notes that several jurisdictions require firms to have risk management systems that include the evaluation of legal and reputational risk.

**Firm practices**

The international Joint Forum report also includes the results of a survey of 90 firms (asset managers/mutual fund companies, financial planners/advisers, investment/securities firms, banks, insurance companies).

The survey covered product design practices. The survey found that almost all firms across all sectors take into account legal and reputation risks in the design or approval process of new products as shown in Table 1.

**Factors Taken into Account in the Design and Approval Process of a new Product**

<table>
<thead>
<tr>
<th></th>
<th>Legal and Reputation Risks</th>
<th>Potential Conflicts of Interest</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank or DTI</td>
<td>94%</td>
<td>91%</td>
<td>62%</td>
</tr>
<tr>
<td>Insurance company</td>
<td>94%</td>
<td>65%</td>
<td>18%</td>
</tr>
<tr>
<td>Investment/securities firm</td>
<td>94%</td>
<td>89%</td>
<td>67%</td>
</tr>
<tr>
<td>Asset manager / mutual funds</td>
<td>95%</td>
<td>89%</td>
<td>63%</td>
</tr>
<tr>
<td>Financial planner</td>
<td>75%</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>Total</td>
<td>93%</td>
<td>84%</td>
<td>53%</td>
</tr>
</tbody>
</table>

Table 1: Factors Taken into Account in the Design and Approval Process of a new Product

Under the “Other” category, ten firms indicated they took into account other risks, including risks for customers. Eight firms indicated that they were making sure that the product was coherent with the needs of the targeted customers. A Swiss bank noted they assess the need for “specific risk warnings, disclosures, limitations to specific client segments, requirements for independent controls.”

Although there was no specific question in the survey regarding approval processes, one third of banks and investment firms noted in their comments the existence of a special committee (seven firms), the necessity of approval by the compliance function (3 firms) or the existence of a formal approval process (10 firms).
**IOSCO**

The International Organization of Securities Commissions (IOSCO) released in September 2009 a report on Unregulated Financial Markets and Products\(^4\). The report focused on two systemically markets: securitization and credit default swaps. The report’s recommendations to regulators for the securitization market include considering requiring originators and/or sponsors to retain a long-term economic exposure to the securitization to align interests, provide regulatory support for improvements in disclosures by issuers to investors, review investor suitability requirements as well as the definition of sophisticated investor, and encourage the development of tools by investors to assist in understanding complex financial products.

**UK Financial Services Consumer Panel**

The Financial Services Consumer Panel (FSCP) is an independent statutory body in the UK that was set up to represent the interests of consumers in the development of policy for the regulation of financial services. On October 14, 2009, the FSCP released a press release\(^5\) calling for the financial services industry to develop product design criteria to improve consumer confidence in the industry. The press release noted an excerpt from a speech by the FSCP Chairman, “We need to find a way to regulate product design which will provide better products that can be described fairly simply and which do ‘what it says on the tin’. Consumer confidence would be hugely improved if there was a range of financial products from different providers that were presented in a way which is simple and honest, with prices that can be easily compared with other products of the same type. The industry should consider developing design criteria for particular types of product which would guide ‘good’ product innovation and restrict innovation that conceals cost or risk in the pursuit of providing an apparently better price or higher rate of return. Doing this would be a major step towards improving consumer confidence in financial services.”

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Practices in Canada

Regulatory

OSFI
For federally regulated financial institutions, OSFI published a Corporate Governance Guideline\(^6\) in 2003 that includes a section on risk management. The Guideline states that “Risk management systems and practices will differ, depending on the scope and size of the institution and the nature of risk exposures. But whatever the particular approach, every institution should have integrated policies that, taken together, apply to the organization’s significant activities regarding the corporate philosophy on risk management, the institution’s permissible exposure to risk, objectives of risk management, delegation of authorities and responsibilities, and processes for identifying, monitoring and controlling/managing risk. The Guideline does not attempt to identify specific risks. Hence, there is no reference to legal or reputational risks that may be associated with product design. An earlier OSFI standard for the life insurance industry on Product Design and Pricing Management\(^7\) outlined a product design process and included a list of risks to be assessed including contingent risk.

In January 2013, OSFI officially published a revised version of their Corporate Governance Guideline, which will help boards of directors and senior management to identify and manage risks being undertaken by their financial institutions. The updated guideline reflects OSFI’s supervisory observations, the results of a cross-system review and enhancements to international best practices. The most significant changes to the guideline from the 2003 publication are in the areas of board effectiveness - its composition and competencies; risk governance, including risk appetite frameworks; and the roles of the chief risk officer and the audit committee. The 2013 guideline provides a comprehensive enterprise-wide risk governance section, which is broader in scope than the Risk Management section previously provided.

Securities and Insurance Regulation
While the regulation of mutual funds and IVICs does not extend to the product design process, disclosure requirements under securities regulation\(^8\) and the CLHIA IVIC Guideline\(^9\) of product risks would require product manufacturers to assess these risks in the


\(^{9}\)CLHIA “Guideline G2; Individual Variable Insurance Contracts Relating to Segregated Funds” Available at
design process. The disclosures required in a mutual fund prospectus include risk factors as described in Table 2. The IVIC Guideline states the information folder should include information on each segregated fund on the principal risks applicable (9.1c).

**Information Required in an Investment Form Prospectus: Risk Factors (12.1)**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Under the heading “Risk Factors”, describe the risk factors material to the investment fund that a reasonable investor would consider relevant to an investment in the securities being distributed, such as the risks associated with any particular aspect of the fundamental investment objectives and investment strategies.</td>
</tr>
<tr>
<td>2.</td>
<td>Include a discussion of general market, political, market sector, liquidity, interest rate, foreign currency, diversification, leverage, credit, legal and operational risks, as appropriate.</td>
</tr>
<tr>
<td>3.</td>
<td>Include a brief discussion of general investment risks applicable to the investment fund, such as specific company developments, stock market conditions and general economic and financial conditions in those countries where the investments of the investment fund are listed for trading.</td>
</tr>
<tr>
<td>4.</td>
<td>If derivatives are to be used by the investment fund for non-hedging purposes, describe the risks associated with any use or intended use by the investment fund of derivatives.</td>
</tr>
<tr>
<td>5.</td>
<td>If there is a risk that purchasers of the securities distributed may become liable to make an additional contribution beyond the price of the security, disclose the risk.</td>
</tr>
</tbody>
</table>

**Table 2: Information Required in an Investment Form Prospectus: Risk Factors (12.1)**

Securities regulation\(^\text{10}\) and the IVIC Guideline both also both also include investment restrictions for mutual funds and IVICs. For instance, mutual funds are restricted from holding real property (2.3a) and IVICs are restricted in their use of leverage (9.2).

**Individual Firms**

To assess the extent manufacturers in Canada examine risks to consumers in their product design, publicly available information was reviewed by the Joint Forum Secretariat for a selection of banks, life insurers and mutual fund companies. Information available varied from company to company reviewed.

**Corporate Governance Practices**

As required under OSFI’s Corporate Governance Guideline, banks and life insurers have integrated risk management processes. The review of public information disclosed by these institutions indicates that it is standard practice for a committee of the Board to be assigned responsibility for risk management including policies implemented for the management and control of risk. The information disclosed on the activities of these committees was mostly general about risks examined. However, some explicitly noted reputational risk. Sun Life’s Charter\(^{11}\) for its Risk Review Committee specifically refers to product design and the management of risk to reputation. The charter\(^{12}\) for TD Bank’s Risk Committee notes seven risks including reputational and legal/regulatory.

Information in the disclosures of the selection of mutual companies reviewed tended to be more succinct about Board committees and contained little or no information on management of risk.

**Codes of Conduct**

The Joint Forum Secretariat also reviewed codes of conduct for a selection of companies. Product design, including addressing risk to consumers, was not mentioned in any of the codes reviewed. However, some codes included general principles or values that could apply. For example, Sun Life’s code\(^{13}\) lists, as a value, “we provide sound financial solutions for our customers and always work with their interests in mind.” Desjardin’s\(^{14}\) code includes, under its principle for respect for persons, “meet the needs of people in the most effective way.” Manulife’s code\(^{15}\) states that “Every employee and representative of

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the Company must conduct their business activities in a manner that protects and enhances the Company’s reputation.”

**Corporate Responsibility and Public Accountability Statements**\(^{16}\)

The Royal Bank of Canada (RBC) publishes a Corporate Responsibility Report. The 2008 version\(^{17}\) states, regarding development of products and services, “RBC has a formal policy that sets out a defined, rigorous process for launching any new product or significantly changing an existing one. We evaluate products for a range of risks and ensure they align with client needs, out Code of Conduct, laws and regulations, and voluntary consumer protection codes that we have signed. Approval levels within RBC correspond to the level of risk identified for a particular product or service.”

Manulife’s Public Accountability Statement\(^{18}\) states regarding prudent risk management “We have a rigorous risk management framework that is applied globally and ensures all the Company’s risk-taking activities are measured, monitored and managed. This framework requires each individual product in every market to meet strict enterprise-wide criteria on its own stand-alone basis.” TD Bank’s Public Accountability Statement\(^{19}\) states, under Product Responsibility, that the Bank designs and delivers all the products it offers in a responsible manner. That means ensuring its products and services: align with TD’s corporate values and Guiding Principles, adhere to strict internal development standards, risk management processes and industry codes of conduct; and meet or exceed all applicable laws and regulations where TD operates.

**Conclusions**

Based on a review of the international Joint Forum report and public information on a selection of Canadian banks and insurers, it appears that it is common practice to have policies and procedures for reviewing the risk inherent in products that are designed for retail consumers. Key drivers for this include managing reputational / legal risk as well as adherence to internal codes of conduct.

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\(^{16}\) All federally regulated financial institutions with equity greater than $1 billion are required to publish annually a public accountability statements


While the review of public disclosures provides some insight into the practices of product manufacturers, more information would be useful in ascertaining what are best practices and consistency in practices across sectors and firms.
INTERMEDIARIES – UNDERSTANDING AND EXPLAINING RISKS

Global

The 2008 international Joint Forum report on customer suitability also discussed regulatory and firm practices of distributors.

Regulatory Practices

It is common practice for jurisdictions to have continuing education/training requirements. For example, the EU Markets in Financial Instruments Directive (MiFID) requires investment firms to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. Regarding disclosure of risks for specific investment products, the international Joint Forum report notes that in the banking and insurance sectors, in general, there are no additional suitability obligations. However, some examples of disclosure obligations were noted in the securities sector. In Switzerland, whenever investment funds pose a materially distinct risk when compared to securities and real estate funds, that distinct risk needs to be specifically disclosed. MiFID requires firms to provide clients with a general description of nature and risks of financial instruments including an explanation of the nature of the specific type of instrument concerned, as well as the risks particular to that specific type of instrument in sufficient detail to enable the client to make decisions on an informed basis.

Firm Practices

The international Joint Forum’s survey of firms included training practices. As shown in the table below, the sale of specific products limited to specifically trained sales agents / advisers.

Training Provided to Sales Agents or Advisors

<table>
<thead>
<tr>
<th></th>
<th>Compliance training provided</th>
<th>Suitability is part of the training</th>
<th>Sale of specific products limited to specifically trained sale agents / advisers</th>
<th>Verification that agents understand compliance training and products offered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank or DTI</td>
<td>94%</td>
<td>88%</td>
<td>84%</td>
<td>84%</td>
</tr>
<tr>
<td>Insurance company</td>
<td>94%</td>
<td>82%</td>
<td>82%</td>
<td>76%</td>
</tr>
<tr>
<td>Investment/securities firm</td>
<td>94%</td>
<td>94%</td>
<td>78%</td>
<td>89%</td>
</tr>
<tr>
<td>Asset manager / mutual funds</td>
<td>89%</td>
<td>63%</td>
<td>47%</td>
<td>68%</td>
</tr>
<tr>
<td>Financial planner</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Total</td>
<td>93%</td>
<td>83%</td>
<td>76%</td>
<td>81%</td>
</tr>
</tbody>
</table>

Table 3: Training Provided to Sales Agents or Advisors
The survey included questions on what information firms provide customers including investment risk. Information about investment risks was provided in 95% of cases.

**Practices in Canada**

Both securities and insurance advisers have requirements for suitability which create a need for advisers to know their products including risks associated with them. In a stakeholder consultation by the Intermediary Regulation Committee in 2009, some stakeholders noted that, while product knowledge training is available, there are some products that are complex and not always fully understood by advisers.

**Joint Forum Practice Standards**

The following standards\(^20\) are relevant to the issue of advisors understanding risks and explaining them to clients:

**Needs of Client**

In order to understand the client's interests, the intermediary must obtain or confirm information about the needs of the client and, when making a recommendation, must reasonably ensure that any product or service offered is suitable to fulfill those needs.

*Commentary: In assessing the needs of the client, the intermediary should take into account the financial significance and complexity of the product or service being sold.*

**Professionalism**

Intermediaries must act in good faith at all times. They must acquire an appropriate level of knowledge relating to their particular business and meet professional ethical standards, including acting with honesty, integrity, fairness, due diligence and skill. The concept of professionalism includes but is not limited to the following:

- Education - In a rapidly changing financial marketplace, intermediaries must keep abreast of changes in products, regulations and other factors that will affect their ability to provide high standards of service to clients. Education, including continuing education, is a necessary component of professional skill.

- Advertising and all other Client Communications - Intermediaries must ensure that all references to their business activities, services and products are clear, descriptive and

not misleading.

*General Information Disclosure*

The intermediary has the responsibility to ensure that the client is fully informed of all relevant information before the client makes a decision. The client is entitled to disclosure of the risks and benefits of the financial products being considered and information about the intermediary’s business relationships that are relevant to the transaction.

*Commentary: There are two aspects to disclosure and both must be satisfactorily taken into account under these principles and practices: (1) "product information" regarding product or service features, as well as the main risks and benefits inherent in the transaction or purchase; and (2) "intermediary information" regarding relationship issues which are important to the consumer.*

- **Product Information** - In addition to clearly describing the product or service for the client and the ways in which the transaction will fulfill the needs of the client, product information includes disclosure of important assumptions underlying any illustrations or examples that have been provided to the client, as well as the fact that actual results may differ significantly from those shown. The intermediary should avoid using examples or illustrations which he or she knows, or ought to know, are based on unusual results or a period that generated much better than normally anticipated performance.

*Securities*

Know your client and product suitability requirements exist under CSA requirements as well as self-regulatory organizations (SROs). These regulators have paid greater attention to this issue subsequent to developments such as problems with asset backed commercial paper (ABCP).

*Canadian Securities Administrators*

Securities regulatory requirements include “know your client” and product suitability rules. Under these requirements, registrants must take reasonable steps before making a recommendation or accepting a client instruction to ensure the purchase is suitable for the client (13.3 1). Before following a client instruction, a registrant must advise the client if the registrant’s opinion is that the security is unsuitable (13.3 2).

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Meeting suitability requirements requires in-depth knowledge of all products that a registrant buys, sells or recommends to clients.\(^2\)

In September 2009, the Canadian Securities Administrators (CSA) released Staff Notice 33-315\(^2\) regarding suitability and know your product. The intent of the notice was to remind registrants of their duties under securities law to satisfy their suitability obligations to clients, including the requirement the products recommended to clients.

The notice stated, regarding know your product, that registrants must understand the structure and features of each investment product they recommend including risks. The notice also stated that complex investment products may require a more extensive review than more straightforward products.

**Mutual Fund Dealers Association**

The Mutual Fund Dealers Association (MFDA) published a notice in October 2005 on know your product.\(^2\) In approving products, the notice states that, “Member procedures should provide for different levels of analysis for different types of products. For example, an extensive formal review may not be required for many conventional mutual funds. However, a more comprehensive review should be performed on products that are novel or more complex in structure.” It also states that members must follow up on any questions they have raised until they are satisfied that they have a complete understanding of the products they propose to sell. The due diligence review of a product should include an assessment of the risks associated with the product.

In April 2008, the MFDA published a notice with suitability guidance that provides additional guidance regarding know your product.\(^2\) The notice states that members and Approved Persons must understand the salient facts about the products they offer to their clients in order to fulfill their suitability obligation.

\(^2\) OSC “Companion Policy: NI - 31-103 - Registration Requirements and Exemptions” July 17, 2009
\(^2\) MFDA “Member Regulation Notice MR-0069; Suitability Guidelines” April 14, 2008 Available at http://www.mfda.ca/regulation/notices/MR-0069.pdf
MFDA rules on advertising and sales communications\textsuperscript{26} state regarding risks to consumers:

\textit{“2.7.2 General Restrictions. No Member shall issue to the public, participate in or knowingly allow its name to be used in respect of any advertisement or sales communication in connection with its business which:

(e) fails to fairly present the potential risks to the client.”}

\textit{Investment Industry Regulatory Organization of Canada}

The Investment Industry Regulatory Organization of Canada (IIROC) released in March 2009 a notice on product due diligence.\textsuperscript{27} The notice stated that dealer member’s suitability obligation in recommendations to clients requires knowledge of the products sold to those clients, and all dealer members that sell new products must have formal written policies and procedures appropriate to their business to ensure that no new product is introduced to the marketplace before it is has been vetted from a regulatory, risk management and business perspective. The notice includes a section on new product identification that states these guidelines are not directed at listed equities and fixed income products, but to more complex and non-transparent products having features such as embedded derivatives, variable maturities, complex fee structures or opaque assets.

The notice also contains a section on best practices that an effective due diligence program includes an assessment of the extent of training in product features and risks necessary to ensure that registered representatives and supervisors can judge the suitability of recommendations and sales to clients and the development and implementation of the necessary training.

IIROC dealer membership rules\textsuperscript{28} state the following regarding risks to the client:

\textit{“29.7 (1) No Dealer Member shall issue to the public, participate in or knowingly allow its name to be used in respect of any advertisement, sales literature or correspondence, and no registered or Approved Persons shall issue or send any advertisement, sales literature or correspondence in connection with its or his or her business which:

(e) fails to fairly present the potential risks to the client”}

\textsuperscript{26} MFDA “Rules.” December 11, 2008 Available at \url{http://www.mfda.ca/regulation/rules/RulesDec-11-08.pdf}
\textsuperscript{28} Available at \url{http://iiroc.knotia.ca/Knowledge/Browse/BrowseTOC.cfm?kType=445&firstAccess=1&pageLanguage=En&nc=808230659843}
In June 2009, IIROC released a notice relating to leveraged and inverse exchange-traded funds (ETFs). These ETFs are securities that track the performance of an underlying benchmark or index, and take short or leveraged positions through swaps, futures contracts and other derivative instruments. The notice described these products as highly complex financial instruments, and included a reminder that, in accordance with IIROC Dealer Member Rule 29.7, all sales materials and oral presentations used by Dealer Members regarding leveraged and inverse ETFs must present a fair and balanced picture of both the risks and benefits of the funds.

**Insurance**

A CLHIA October 2007 reference document on needs-based sales practices outlines supporting elements of a needs-based assessment. The element on product information states, “The client should be informed about options available through the advisor and provided with information about the products that the advisor recommends.” The document further notes “advisors should be familiar with product information provided by companies and able to relate this information to the needs of their clients.” and “specific measures to inform the client about products will vary with channels and circumstances.”

Under the CLHIA IVIC Guideline there are standards for advertising (7.10). However, unlike the rules for IIROC and the MFDA, there are no requirements for risk disclosures although the Guideline includes requirements on the display and visibility of warnings (7.9).

**Conclusions**

There are signs that, subsequent to recent market turbulence and the ABCP issue, that best practices regarding advisors understanding risks embedded in complex products and communicating these risks to consumers are evolving. The IIROC notice on leveraged and inverse ETFs is a good example.

The Joint Forum Practice Standards cover the need for the intermediary to be knowledgeable on the products sold to consumers and ensure that the consumer is fully informed of all relevant information to make a decision. The Standards also note clients are entitled to disclosure of the risks and benefits of the financial products being considered.

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31 Available at [http://www.clhia.ca/IVIC](http://www.clhia.ca/IVIC)
 Guidance exists in the Joint Forum’s CAP Guidelines\textsuperscript{32} in areas such as selecting investment items and disclosures to plan members. Factors a CAP sponsor should consider when choosing investment options, including a default option, include the level of risk associated with the investment options (2.2.1). Information provided by CAP sponsors to members should provide sufficient detail so that members can make informed decisions (4.2). This includes risks associated with funds and other investment options.

CAPSA is examining the risks inherent in defined contribution (DC) pension plans. This initiative by CAPSA is a result of feedback on its 2008-2011 Strategic Plan that certain provisions in pension standards legislation may not appropriately distinguish between DC and DB plans and, as a result, inappropriate regulatory requirements may be imposed on DC plans.

CONSUMER BEST PRACTICES IN DUE DILIGENCE

Stakeholder Feedback on Joint Forum 2009-2012 Strategic Plan

Two stakeholder comment letters noted consumer responsibility. A letter from the Independent Financial Brokers of Canada\(^{33}\) flagged, under the theme of consumer education, a discussion paper by the UK Financial Services Authority on responsibilities of the consumer.

A Quebec based consumer group\(^{34}\) also provided a letter identifying awareness for consumers of their rights and responsibilities as a priority. The letter recommended increasing awareness on the part of all consumers of financial products with respect to their rights and responsibilities, and urging them to exercise extreme caution in their quest for outstanding performance in order to offset their financial losses of recent months.

UK Financial Services Authority Discussion Paper

In December 2008, the Financial Services Authority (FSA) in the UK released a discussion paper on consumer responsibility.\(^{35}\) The discussion paper was published to solicit views on the boundaries of responsibility between firms and consumers and how consumers could be better enabled to act in their own interests.

The paper noted that while the FSA does not regulate consumers themselves and cannot make rules to oblige them in some way, the FSA believes it can work with stakeholders to encourage and enable consumers to consider their own interests more effectively in their decision making.

The paper included several actions the FSA could take to help consumers better recognize and engage with their own responsibilities including:

- Reaching more consumers (i.e. alternative communications channels)
- Being more explicit such as warnings for consumers on what could go wrong if they do not take certain actions.
- Developing case studies that help consumers realize the consequences of particular course of action.
- Improving transparency by publishing more information on firm performance and


FSA expectations.

• Sharing best practices.
• Simplifying the decisions consumers have to make.

The paper included an annex on “Sensible Actions” which consumers might take to protect their own interests. Some examples include:

• Read and make efforts to understand advertisements and other promotional material before acting upon it;
• Help adviser understand needs where applicable;
• Check the authorized status of the adviser firm on the FSA website;
• Ask questions if you don’t understand; and
• Complain promptly when problems occur.

The table of sensible actions also included what the FSA and firms could do in communicating these actions to consumers.

The FSA published a Feedback Statement\(^{36}\) in December 2008 that summarized the commentary it received on the discussion paper and its reaction. The feedback indicated that there is a lack of consensus over the balance of responsibilities between firms and consumers with some firms stating the current balance is skewed in the consumer’s favour while consumer representatives do not (and should not) have responsibilities in the sense that firms do. A submission by the Financial Services Consumer Panel (FSCP)\(^{37}\) described consumer responsibility as a flawed concept and unhelpful in discussions about how to create an effective and efficient retail market that delivers real benefit to the consumer, the industry and to society. The FSCP also expressed concern that the concept of consumer responsibility as described in the discussion paper reflects an approach that places unrealistic expectations on consumers and too little emphasis on the industry delivering products that are fit for purpose and designed to genuinely serve consumer needs.

The FSA’s Feedback Statement also noted that there was a broad consensus that consumers should be helped to protect their own best interests. The FSCP submission acknowledged that consumers do need to be more empowered to look out for their own interests and encourages the FSA to communicate sensible actions consumers might take. However, the submission argues that the list in the discussion paper highlights the extent to which firm behaviour is the root of the problem.


Existing Consumer Responsibilities in Canada Related to Financial Products

Member Responsibilities under CAP Guidelines

The Joint Forum’s CAP Guidelines outline and clarify the rights and responsibilities of CAP sponsors, service providers and CAP members. The responsibilities of CAP members include making decisions within the plan and for using the information and decision-making tools made available to assist them in making these decisions (1.3.3). CAP members should also consider obtaining investment advice from an appropriately qualified individual in addition to using any information or tools the CAP sponsor may provide. In introducing the CAP plan to members, the sponsor should provide information to the new member with information outlining their rights and responsibilities (4.1.2).

When a roundtable was held with industry stakeholders in January 2009 as part of a review of the CAP Guidelines, service providers noted that best practices included reminding members of their responsibilities on a regular basis.

A Consumer’s Guide to Financial Transactions

When the Joint Forum released the Practice Standards in 2005, a companion piece for consumers was also published.38 The consumer guide (see Appendix One) sets out basic principles of fair transactions consistent with the Practice Standards. Although not generally described as a set of rights and responsibilities, it includes both. For instance, it states, “You have the responsibility to provide fair and honest information about your financial needs’ and that “in your dealings with a salesperson or a company, you should always seek further information if you do not feel comfortable with your level of understanding of products or services that you are purchasing.”

IBC Code of Rights and Responsibilities

The Insurance Bureau of Canada (IBC) has a Code of Consumer Rights and Responsibilities.39 The contents of the one page Code for insurance companies, brokers and agents are listed in Appendix Two.

**Financial Consumer Agency of Canada Website**

The Financial Consumer Agency of Canada (FCAC) website includes in its consumer section of its website a page on rights and responsibilities with links for further information on topics such as accounts, branch closures, cheques, and debit card fraud (refer to Appendix 3).⁴⁰

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APPENDIX ONE - A CONSUMER'S GUIDE TO FINANCIAL TRANSACTIONS

As a financial consumer, it is in your interest to find a suitable company and/or accredited financial salesperson to handle your business. You have the responsibility to provide fair and honest information about your financial needs. If you do not fully disclose your needs, it is possible that the salesperson may unknowingly offer products which are not suited to your financial requirements.

Salespeople may be insurance agents or brokers, investment advisors, educational savings plan salespeople, loan brokers, mortgage brokers, deposit brokers, financial planners or other advisors, securities sales representatives and others. You may want to take the time to meet with several salespeople to find the right person for your particular needs. You may also choose to deal directly with companies through telephone, mail or the Internet.

In your dealings with a salesperson or a company, you should always seek further information if you do not feel comfortable with your level of understanding of products or services that you are purchasing. Asking questions will help you avoid any potential misunderstandings regarding the information that is being presented to you.

This document sets out basic principles of fair transactions which you, as a consumer, should expect when you buy a financial product, whether you deal directly with a company or through a salesperson.

1. Your interests come first, before the interests of salespeople and companies.
2. If you choose to have a salesperson, you should expect to have your financial needs assessed by the salesperson and, when he or she makes a recommendation, to be offered products that meet your needs.
3. You should expect your instructions to be carried out faithfully. Your salesperson or company must not transact business which is unlawful.
4. You should expect your transactions to be handled with professionalism by a qualified salesperson. If you have any doubts you may inquire about the salesperson’s qualifications or conduct with the appropriate regulatory body.
5. You should expect to have your personal information safeguarded and only used for the purpose for which it was originally collected, unless you have given permission for it to be used for other reasons. Your personal information may be divulged without your consent to law enforcement agencies when required or authorized by law.
6. If you choose to have a salesperson, you should expect to be informed if he or she has a “conflict of interest”, and be given the opportunity to halt further dealings with the salesperson.
7. You are entitled to receive all relevant information before making a decision about a financial product. This includes product features, risks and benefits, the company(ies) involved, all fees that will be charged to you, how the salesperson is paid, and whether he or she may receive benefits from sales incentive programs. It also includes information on the existence of any business relationships that the salesperson knows of, with other companies or people, which may be relevant to your purchase.
8. You should expect to have any complaints dealt with in a timely and forthright manner. In the event that a dispute with your salesperson or company cannot be resolved, you should be given information, preferably in writing, about available avenues for resolving your complaint.
### Right to be Informed

You can expect to access clear information about your policy, your coverage, and the claims settlement process. You have the right to an easy-to-understand explanation of how insurance works and how it will meet your needs. You also have a right to know how insurers calculate price based on relevant facts. Under normal circumstances, insurers will advise an insurance customer or the customer’s intermediary of changes to, or the cancellation of a policy, at least thirty days prior to the expiration of the policy, if the customer provides information required for determining renewal terms of the policy at least forty-five days prior to the expiration of the policy. You have the right to ask who is providing compensation to your broker or agent for the sale of your insurance. Your broker or agent will provide information detailing for you how he or she is paid, by whom, and in what ways. Insurance companies will disclose their compensation arrangements with their distribution networks. Brokers and agents are committed to providing information relating to ownership, financing, and other relevant facts.

### Responsibility to Ask Questions and Share Information

To safeguard your right to purchase appropriate coverage at a competitive price, you should ask questions about your policy so that you understand what it covers and what your obligations are under it. You can access information through brochures and websites, as well as through one-on-one meetings with your broker, agent, or company representative. You have the option to shop the marketplace for the combination of coverage and service levels that best suits your insurance needs. To maintain your protection against loss, you must promptly inform your insurance company or broker or agent of any change in your circumstances. Information required to determine the renewal terms of your policy must be provided at least forty-five days prior to the expiration of the policy.

### Right to Complaint Resolution

Insurance companies, their brokers and agents are committed to high standards of customer service. If you have a complaint about the service you have received, you have a right to access your company’s complaint resolution process. Your insurer, agent or broker can provide you with information about how you can ensure that your complaint is heard and promptly handled. Consumers may also contact the independent General Insurance OmbudService (www.gioca.org).

### Responsibility to Resolve Disputes

You should always enter into the dispute resolution process in good faith, provide required information in a timely manner, and remain open to recommendations made by independent observers as part of that process.

### Right to Professional Service

You have the right to deal with insurance professionals who exhibit a high ethical standard, which includes acting with honesty, integrity, fairness and skill. Brokers and agents must exhibit extensive knowledge of the product, its coverage and its limitations in order to best serve you.

### Right to Privacy

Because it is important for you to disclose any and all information required by an insurer to provide the insurance coverage that best suits you, you have the right to know that your information will be used for the purpose set out in the privacy statement made available to you by your broker, agent or insurance representative. This information will not be disclosed to anyone except as permitted by law. You should know that insurers are subject to Canada’s privacy laws.
APPENDIX THREE - FCAC WEBPAGE ON RIGHTS AND RESPONSIBILITIES

Your Rights and Responsibilities

In Canada there are laws, voluntary codes of conduct and public commitments in place to protect consumers of financial products. FCAC ensures that Federally regulated financial institutions include all banks, and all federally incorporated or registered insurance companies, trust companies, loan companies, and co-operative credit associations that carry on business in Canada. Click on the link to view a list on the website of the Office of the Superintendent of Financial Institutions. Federally Regulated Financial Institutions comply with these.

What should you do if you feel your rights are not being respected?

Every federally regulated financial institution must have a complaint-handling process in place and a copy on file at FCAC. The complaint-handling process includes access to an independent dispute-resolution process, such as an ombudsman. You can use FCAC's complaint-handling process search tool to find a federally regulated financial institution's filed process.

To learn more about the steps involved in making a complaint, visit the Making a Complaint section of our website. If you feel that a federally regulated financial institution is not respecting your rights, contact FCAC.

Click on the links below to learn more about your rights and responsibilities as a consumer when you deal with a bank or a federally regulated trust, loan or insurance company.

- Banking
- Credit cards
- Mortgages
- Credit and loans
- Investments
- Fraud
- Credit card fraud
- Debit card fraud
- Other
- Negative option billing
- Clear disclosure documents
- Receiving required documents in electronic format
- Tied selling
- Small businesses

For a complete list of the obligations of federally regulated financial entities, visit the Laws, Regulations and Other Obligations section of FCAC's website.

Learn more about the financial industry’s voluntary codes of conduct and public commitments.
**Code of Conduct for the Credit and Debit Card Industry in Canada**

FCAC also oversees payment card network operators and the provisions of the [Code of Conduct for the Credit and Debit Card Industry in Canada](https://www.fcac.ca). Payment card network operators have agreed to incorporate the Code of Conduct into their networks' contracts, governing rules and regulations.

FCAC will monitor payment card networks' compliance with the Code of Conduct and issues raised by merchants. If you are a merchant and you have a complaint or a problem with a payment card network operator, visit the [Making a Complaint](https://www.fcac.ca) section of our website to learn more about the steps you must take to make a complaint.
2. SUMMARY OF FINDINGS - FINANCIAL PRODUCT MANUFACTURERS RISK ASSESSMENT AND PRODUCT DISCLOSURE PRACTICES

**Background**

The broader objective of the Joint Forum Product Disclosure and Regulation initiative was to examine the responsibilities of financial product manufacturers, intermediaries and consumers in ensuring that consumers are offered suitable products and are able to make informed decisions. The initial focus of the initiative was on product manufacturers and their risk assessment and product disclosure practices.

This document summarizes the key findings of the research paper prepared by the Joint Forum Secretariat on international practices and standards for product manufacturers of financial products, as well as reports submitted to the Joint Forum by the Canadian Life and Health Insurance Association Inc. (CLHIA) and the Investment Funds Institute of Canada (IFIC) titled Managing Risk in Product Development: A Description of Practices in the Life Insurance Industry and Risk Assessment and Management During the Mutual Fund Product Development and Distribution Process, respectively. (Copies of the CLHIA and IFIC reports are provided as appendices to this document).

This high-level summary of key practices is based on the reports regarding investment funds and segregated funds. It is organized under the headings: Product Development and Approval, Post-Sale Review and Communication of Risk. A manufacturer's decisions about the implementation of specific practices will take into account a number of factors including its size, the number and range of products it manufactures and its history with these products.

In the case of products such as investment funds and segregated funds, the manufacturer is typically not in a position to directly assess the suitability of a fund to a particular investor; it is advisers that primarily perform this process.41

However, the manufacturer develops products that are designed to meet the needs of various sectors of investors with different risk appetites, investment objective and horizons: the individual investment decision as to which available product will be purchased is made, in most cases, when an investor sits down with an advisor. At this point the advisor is required to conduct a ‘know-your-client’ interview wherein specific information is obtained that establishes investment objective, time horizon and risk appetite. This information then informs the decision as to which investment is suitable for that individual. The work and processes of dealers and

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41 At the end of 2011, 91% of investment fund assets in Canada were acquired and held by investors through distribution channels involving the intermediation of an advisor, according to Investor Economics, Household Balance Sheet (updated and rebased forecast)(June 2012).
advisors who distribute such funds ensure the advisors know their products, that they know their clients, and that they will recommend funds that are suitable to the objectives, circumstances and risk tolerance of each client. This process occurs separately from the manufacturer but is an integral, and highly regulated, part of ensuring the investor is provided with the appropriate product. This is described in more detail in the CLHIA and IFIC reports in relation to investment funds and segregated funds.

Other products, such as term insurance or GICs, for example, which can be manufactured with a certain investment outcome or to cover a defined period of insurance, also come with certain risks that must be assessed and managed by manufacturers and disclosed to consumers although some of the risk information is left to the individual to consider. One such risk, purely for illustration, is that the rate of interest earned on a GIC may be lower than the rate of inflation resulting in a loss to the consumer in the real value of his investment.

When considering the responsibilities of financial product manufacturers, intermediaries and consumers in ensuring that consumers are offered suitable products and are able to make informed decisions, it should be considered whether the starting point should be to analyze these responsibilities in relation to all products that make up the household financial balance sheet. An examination of that balance sheet shows that Canadians own a range of products that compete with each other in the market place. The ability to make informed decisions as to what products Canadian consumers should own requires, at a minimum, that they have access to comparable information allowing them to understand the risks and benefits of each of the products they own and those that are available to them. This would allow them to re-balance their financial assets as appropriate.

**Product Development and Approval**

*(Primarily manufacturer processes, but in some cases distributor processes are inseparable)*

- The product design process typically takes into account a number of factors including the risk profile, investment strategies and objectives, financial situation, financial capability and experience of the target audience. These factors are considered generally as it is not possible for a manufacturer to design the product to meet every possible investor’s objectives and circumstances. This suitability analysis will take place, at least in the case of investment funds and segregated funds, between the advisor and the client.

- Written policies and procedures: establish clear roles and responsibilities; incorporate effective scrutiny and challenge; create layers of oversight; manage conflicts of interest; establish criteria for when abridged processes may be used; and account for changes in external environment. Likewise, distributors have policies and procedures in place to

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42 The Joint Forum was provided with an excerpt of the Household Balance Sheet, an analysis prepared by Investor Economics that indicates the relative size of holdings by Canadians of financial wealth products. The report confirms that Canadians hold many different types of financial assets with investment funds and segregated funds together comprising only about 1/3 of the overall total.
manage similar issues that may arise during the product distribution process, including trade reviews to confirm suitability of transactions

- Reviews of these policies and procedures are undertaken on a regular basis to ensure they are not unduly influenced by commercial pressures.

- A preliminary assessment of a proposed product determines the appropriate level of internal review based on, among other things, whether it is a new product or a material modification of an existing product.

- For new products or material modifications to existing products, a more detailed review is usually conducted, led by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales and operations.

- Decisions to approve, disapprove, or table the proposal are made by the firm’s senior management.

- Stress tests built into the product approval process establish how the product is likely to perform under a variety of conditions, both within and outside of the design parameters.

**Post-Sale Review**

- Once a product has been approved and is being sold, internal controls include a process to review and monitor the actual product as well as the product development process.

- Products are periodically reviewed to determine whether they continue to meet the needs of the target market and whether they are performing in a manner that is consistent with the expectations of the manufacturer. Regular review is undertaken by distributors of the products they sell to ensure continuing compliance and to meet SRO ‘know your product’ obligations.

- Firms use both proactive and reactive post-sale information to make any necessary changes to the product or the product development process.

- Where a product review discloses issues with a product the manufacturer will, as appropriate, consider what, if any, actions need to be taken with respect to existing customers.

- Firms provide on-going support and help to distributors and customers during the product lifecycle, including resources to deal with questions about the product.

- The distributor/advisor assists the individual investor in understanding the suitability of the product relative to their individual risk tolerance. The processes and information to be collected by the distributor/advisor is highly prescribed by regulators and includes
collecting specific individual personal financial information to inform the purchase or investment decision.

**Communication of Risks**

- Firms typically develop complementary communications strategies for distributors and consumers based on regulatory requirements and differences in the capability of the two groups to understand information and their respective needs. Manufacturers work to ensure sufficient product information is provided to distributors so that they can meet their “know your product” regulatory obligations and so that they can provide appropriate product suitability assessments and product advice to customers.

- Sufficient detail is provided to consumers at the point of sale and subsequent to their investment, in a fair and balanced manner and in plain language to enable them to identify risks and potential benefits, limitations and features of the product, how it has performed historically, the costs of the product, how changes in the risks associated with an investment in the product affect the suitability or risk tolerance of the product, and recent developments that have affected or may affect the product’s performance. The information required to be provided is highly prescribed by regulation.

- The release of a product is accompanied by a wide range of supports, including detailed, technical information about the product, sales and marketing materials, advisor training as well as plain language information about the product and its features, risks and other key information. Examples of the documents provided at the point of sale that contain risk disclosure are the Fund Facts and the Prospectus (in the case of mutual funds) and the Fund Facts and IVIC Information Folder (in the case of segregated funds).

- Concrete numerical examples illustrating past performance are accompanied by warnings about relying on this to predict future performance and advice about how this performance might be affected by changing conditions.

- Product information, sales concepts and numerical examples are reviewed and signed off by various business lines. This information is often contained in point of sale and continuous disclosure documents that are filed with regulators and must not contain any material errors or misrepresentations.

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43 Mutual funds are required to include this information in the Management Report of Fund Performance that is required under National Instrument 81-106, Investment Fund Continuous Disclosure.
3. LIST OF PRODUCTS

Source: Extract of Investor Economics 2011 Household Balance Sheet Report (used with permission)

Mutual funds and segregated funds are the most mature financial products with established risk practices and processes. The following list of financial products is the most commonly held by Canadian households for the purpose of accumulating wealth.

Short-Term
- Cash accounts (savings, chequing, etc)
- Paper (T-bills, etc)
- Money market funds

Long-Term

Fixed-term
- GICs
- GIAs
- Market-linked

Fixed-income
- Canada Savings Bonds
- Provincial Savings Bonds
- Bonds
- Mortgage-backed Securities
- Fixed income investment funds

Equities
- Income trusts
- Common and preferred shares
- Equity and balanced investment funds
- Hedge funds
- Closed-end funds
Managing Risk in Product Development

A Description of Practices in the Life Insurance Industry

A Report Prepared by the Canadian Life and Health Insurance Association

For the Joint Forum of Financial Market Regulators

May 2012
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EXECUTIVE SUMMARY

Individual Variable Insurance Contracts (IVICs) are insurance products that protect consumers against certain risks associated with financial investments. The death and maturity benefits available in all IVICs protect capital by guaranteeing to return at least 75 percent of amounts invested by the consumer, less withdrawals. The optional guaranteed withdrawal benefits available in some IVICs protect income by guaranteeing to return the capital invested over a specified period of time.

IVICs provide clients the upside potential of investing in market-linked funds while, at the same time, offering protection against the downside risks of market fluctuations.

The contractual guarantees that provide this downside protection impose long-term obligations on the life insurance company offering the product.

These long-term contractual obligations mean that insurers have a financial stake in the performance of the investment options that are provided in the IVIC. For this reason, risk assessment and risk management are critical components of all stages in the product design cycle.
An extensive regulatory framework establishes standards for both the assessment and management of risk in the design of the product and the disclosure of risk during the sale of the product to the retail consumer. The former is provided primarily through OSFI Guidelines and the latter is provided primarily through CLHIA Guideline G2 which is adopted as a regulation by the Province of Ontario.

In the corporate governance structure of life insurance companies, policies associated with the assessment and management of risk are approved by the Board of Directors and senior management is responsible for understanding and implementing these policies. The performance measures of all company officers include risk management measures. As a final check in the product development cycle, a Chief Risk Officer with responsibility to assess products purely from a risk perspective has the power to stop development of a product at any stage.
Managing Risk in Product Development

A Description of Practices in the Life Insurance Industry

1. INTRODUCTION

1.1 About CLHIA

Established in 1894, the Canadian Life and Health Insurance Association (CLHIA) is a voluntary trade association that represents the collective interests of its member life and health insurers. Its members account for 99 per cent of the life and health insurance in force in Canada and contribute to the financial well-being of millions of Canadians by providing a wide range of financial security products.

The industry protects more than 26 million Canadians, as well as over 45 million policyholders in other countries around the world, with products such as life, health and disability insurance as well as savings and lifetime income solutions, including Individual Variable Insurance Contracts (IVICs) and annuities.

In 2010, Canada’s life and health insurers paid out $64.1 billion in payments to policyholders and beneficiaries. The value of assets under management in segregated funds was approximately $196 billion.
1.2 Purpose

This report describes product development practices used by the life insurance industry to manage risk in IVICs.

It builds on an information session for members of the Joint Forum Product Disclosure and Regulation Committee that was held in March 2012. It also addresses specific questions posed by the Joint Forum after that session.

For convenience, the product development cycle is divided into four discrete stages: idea development, assessment, roll-out and post-release monitoring. It is important to keep in mind, however, that the practices described in this report actually meld into a more seamless, iterative process with specific steps at each stage informing decisions in all the other stages.

Also for convenience, this report will shift between insurance terminology and investment or banking terminology. While insurance terminology is more precise and more accurately reflects the legal nature of the product, oftentimes it is neither familiar nor economical. For example, consumers (and many in the industry) talk about buying a seg fund or investing in a segregated fund but this transaction is more accurately described as paying premiums into an IVIC and allocating these premiums to a segregated fund available in the contract.
1.3 Overview of IVICs

An IVIC is an insurance product designed to protect consumers against certain risks associated with financial investments. Like all insurance products, IVICs pool the risk of multiple clients and share this risk between the clients and the insurer. Also in common with many other life insurance products, the IVIC establishes certain rights for the client and creates obligations for the insurer that often extend well beyond a decade.

A client who purchases an IVIC and invests in segregated funds receives the benefits of guarantees on the capital investment. Additionally, some IVICs allow the client to select guarantees on income produced by these investments.

There are two guarantees on the capital, a maturity benefit and a death benefit. The maturity benefit guarantees that the client will get back at least 75 percent of his or her investment at the end of a period of time specified in the contract, usually ten years. Some IVICs allow the client to increase the guarantee to 100 percent. The 75 percent guarantee is the minimum required to exempt the product from securities legislation. In the Ontario Securities Act, the definition of "security" exempts "a contract issued by an insurance company licensed under the Insurance Act which provides for payment at maturity of an amount not less than three quarters of the premiums paid by the purchaser for a benefit payable at maturity."
This guarantee applies if the market value of the investment has gone down. If, at the maturity date, the market value is higher than the amount that was invested, the client receives this higher amount. Thus IVICs provide consumers with a means of protecting against downside risk in the market while still having the opportunity to enjoy the upside benefits of a rising market.

It should be noted that the amount of the guarantee may be reduced if the client makes withdrawals before the maturity date. As well, the maturity date may be extended if the client resets the guarantee during the period.

The death benefit works in a way that is similar to the maturity benefit. The primary difference is that the guarantee is payable upon the death of the named insured (usually the investor) whenever that occurs. As an example, if a client purchased an IVIC in 2006 and died in 2009 when the markets were depressed, the client (actually his or her estate or beneficiary) would get back 75 or 100 percent of the investment, less any withdrawals that might have been made after the initial purchase.

To obtain these benefits, the client pays an insurance fee. This fee is generally embedded in the management fee associated with the funds the client selects for investments. The insurance fee will vary depending on the level of guarantee (75% vs 100%) and, in some cases, the riskiness of the fund.
The guarantees on income work differently than the maturity and death benefits that protect capital. The Guaranteed Withdrawal Benefit (GWB) comes in two forms. The Guaranteed Minimum Withdrawal Benefit (GMWB) is the more common and essentially guarantees that a client will get back all of his or her investment in equal payments over a specified period of time, typically 15 years. The Guaranteed Lifetime Withdrawal Benefit (GLWB) guarantees that a client will receive equal payments, based on the amount invested in the IVIC, for life.

The GWB feature in IVICs is intended to shield the client against the risk that required income will be reduced because the underlying investments intended to produce this income have gone down in value. With a GWB, even in the worst-case scenario where the nest egg is entirely wiped out, the insurer will continue to make the guaranteed income payments that the investment would have produced.

The central feature of IVICs is that they offer clients the upside potential of investing in market-linked funds with protection against the down-side risk of market declines. The specific features of the product that provide this protection are set out in a contract that imposes long-term obligations on the insurer. If any of the assumptions the insurer uses to design the product are mistaken or if conditions relevant to these assumptions change, the insurer cannot vary the terms of its contracts with existing clients. This inability to change the terms of the contract represents a substantial risk to the insurer and helps explain the rigour in the product design processes for IVICs.
The general exception to this restriction on insurers relates to the segregated funds provided as investment options in the contract. According to CLHIA Guideline G2, enacted by Ontario Regulation 132/97 *Variable Insurance Contracts*, insurers are permitted to make the following fundamental changes provided they give the contractholder at least 60 days notice in writing: increase the management fee, change the fundamental investment objective, decrease the frequency of valuation and increase the insurance fee within specified limits. If an insurer makes one of these fundamental changes to a fund, the client has the right to switch to another fund without affecting other rights or obligations under the contract or, if a similar fund is not available, redeem the units of the fund without incurring any deferred sales charges or other similar fees. In addition to these fundamental changes, insurers can also reserve the right to make changes such as adding or deleting funds.

1.4 **Nature of Risk**

Like most retail investors, clients who purchase IVICs are hoping that the markets will perform well and that their capital (i.e., the value represented by the premiums they have paid into the contract) will appreciate or go up in value. What distinguishes IVICs from other retail investment products is the fact that the insurer who manufacturers the IVIC has a similar stake in its performance.

It is true that insurers charge an insurance fee to offset the cost of the guarantees. But the insurance fee may not fund the entire cost of the guarantees for
an individual client. An important factor in the design and pricing of an IVIC is the pooling of risk. Maturity dates and deaths will occur at various times. Some of these will coincide with down-markets, others with up-markets. Since the life insurer only realizes risk in down-markets, pricing of the IVIC is based on assumptions about how the markets will perform and the behaviour of clients. More specifically, the insurer is exposed to risk by prolonged market declines that increase the likelihood that deaths or maturity redemptions will coincide with depressed market values and trigger the need to pay out on guarantees. This risk is further compounded by the fact that these declines may reduce the insurer's capital reserves that help fund these guarantees.

For clients who purchase IVICs, the risks associated with market performance are mitigated but not entirely eliminated. They still face a risk, similar to that faced by insurers in down markets, if they have unexpected expenses that create needs to access capital in the short-term. As well, they face the risk of not receiving the financial benefit of the guarantee if the market performs well. Of course, this is similar to the risk of not needing home insurance if your house does not burn down. In both cases, the client has still received the less tangible benefit of peace of mind and, in the case of an IVIC, may benefit from other life insurance features such as creditor protection and bypass of probate.

One factor that complicates financial planning is the fact that risk is affected by individual circumstances. For individuals who are saving for retirement or otherwise accumulating assets, prolonged declines in the market increase risk because they
increase the likelihood that the need to access capital will coincide with depressed investments. For these same individuals, however, market declines in the early years are not especially troubling. In fact, they may be a good thing because they enable investors to purchase more shares or mutual fund units with a given investment. For individuals who have retired and begun drawing down on their nest egg, however, even short-term declines in the early years of retirement pose a much greater risk as they reduce the amount of capital that is available to produce the desired income.

One of the primary consumer risks or trade-offs associated with the GWB feature lies with investment constraints that insurers design into the product. Because early declines expose the life insurer to considerable risk, most IVICs limit the client to relatively conservative investment options when a GWB is selected. Thus a client with a GWB may trade off the ability to fully enjoy the benefits of strong markets in exchange for the security of a guaranteed income stream.

The other primary risk lies with contractual restraints on withdrawals. Because the GWB is designed to provide a predictable flow of income, any additional withdrawals by the client to increase this income will affect the guarantees. The liquidity risk created by this inflexibility means that the GWB is generally best suited to form only a part of a client's comprehensive income planning strategy.
1.5 Comparison with Mutual Funds

The primary investment option provided by IVICs is segregated funds. These funds, which were introduced in 1961, were originally developed to provide a higher rate of return in pension products offered by insurers. The use of segregated funds expanded throughout the 1960s. In 1970, after extensive discussions among insurers and securities and insurance regulators, the Ontario Securities Commission (OSC) agreed that contracts that offer a minimum 75 percent guarantee on capital at death and maturity are exempt from the Securities Act. The rationale for this exemption is that the 75 percent threshold provides a "guaranteed obligation of substance which does not vary with fluctuations in the securities market" (see the OSC Reasons dated August 20, 1970, In The Matter Of The Securities Act, 1966 and In The Matter Of Equity Based Variable Contracts Issued By Insurance Companies Listed Under The Insurance Act).

By the mid-1990s, segregated funds available in IVICs had become a mainstream retail product for asset accumulation.

As an investment product, segregated funds share many similarities with mutual funds. Both types of funds provide consumers with a convenient way to diversify their portfolio. In fact, for small investors, these funds may be the only practical way to enjoy the benefits of investing in equities while avoiding the risks of investing in a single or small number of companies. As well, actively managed segregated funds and mutual funds both provide customers with an economical way to get professional advice about stock selection.
These features of segregated funds and mutual funds -- diversification and advice -- are very attractive to consumers and relatively easy to understand. As a result, during the 1990s there was a tendency to focus on these similarities and market segregated funds as "mutual funds with guarantees." Unfortunately, this way of referring to the insurance product tended to obscure the insurance features in the contract and the legal nature of the product. Over the past five or six years, however, two developments in the marketplace have helped to correct this perception. The first was the introduction of GWB features in 2006. The second was the collapse of the markets in 2008.

Both of these developments focussed attention on the guarantees provided in the contract, how they operate and the value they represent for the client. This effect has applied to both the basic death and maturity benefits in the traditional product used for asset accumulation and the GWB features in the newer product used for payout of income. For clients who purchased IVICs in the late 1990s, deep declines in the markets coincided with the ten-year maturity dates in many contracts so, while the market gains of the past decade may have been lost, the contract preserved the original capital. A similar story can also be told for retirees who, in 2006 or 2007, purchased an IVIC with a GWB and then saw their nest egg substantially diminished. More generally, consumers deciding to buy an IVIC with a GWB feature tend to focus on the income guarantees. It is these guarantees, not the investment options, that is the main reason for purchasing an IVIC with this feature. In fact, many such IVICs limit the specific investment options that are available when a GWB option is selected.
1.6 Regulatory Framework

IVICs are subject to three regulatory frameworks specific to the product. As was discussed above, the legal nature of the product is established in securities legislation. The prudential requirements related to the insurer’s contractual obligations are established by the Office of the Superintendent of Financial Institutions (OSFI). And the distribution and disclosure requirements are established in industry guidelines and provincial insurance statutes. In addition, as an insurance product, IVICs are subject to provincial market conduct legislation that applies generally to all life insurance. Of these, the prudential and disclosure requirements bear the most relevance to management of risk.

OSFI's requirements are based on the recognition that insurers "accept funds from the public and often deal in long-term financial commitments, which are predicated on a high degree of confidence in the long-term stability and soundness of the institutions making these commitments." (Corporate Governance Guideline, January 2003, p. 5) Through its guidelines, OSFI provides principles-based advice to companies on various matters such as governance, capital and liquidity, and stress testing.
Over the past decade, OSFI has developed an extensive framework of guidelines and other advice related to sound business and financial practices. The most relevant guidelines for risk management are:

- Corporate Governance Guideline, January 2003
- E-13 Legislative Compliance Management, March 2003
- E-14 Role of the Independent Actuary, February 2002, revised January 2010
- E-15 Appointed Actuary: Legal Requirements, Qualifications and External Review, August 2003, revised November 2006
- E-18 Stress Testing, December 2009

Along with these guidelines, the Supervisory Framework explains how OSFI assesses an institution's safety and soundness by "evaluating its risk profile, financial condition, risk management processes, and compliance with applicable laws and regulations." (Supervisory Framework, p. 4)

CLHIA Guideline G2, Individual Variable Insurance Contracts Relating to Segregated Funds, establishes industry standards for:

- advertising disclosure;
- pre-sale disclosure requirements, including Key Facts and Fund Facts;
- contract disclosure, including minimum contractual terms;
- contractholder rights;
- audit and accounting requirements;
- investment disclosure;
• minimum investment standards;
• corporate governance of segregated funds;
• partitioning of assets held in segregated funds;
• closing of segregated funds; and
• fundamental changes to, and mergers of, segregated funds.

Guideline G2 is adopted as a regulation in the Province of Ontario.

More generally, provincial statutory requirements related to the sale of life insurance and life insurance agents apply to IVICs. Among other things, these establish prohibitions against unfair and deceptive acts, proficiency standards for life insurance agents and the agency relationship between the insurer and the life agent.

2. RISK MANAGEMENT AND PRODUCT DEVELOPMENT

2.1 The Product Development Cycle

On the surface, the product development cycle is quite generic. Most industries go through similar stages in conceiving and bringing new products to market. These stages are:

• idea generation;
• assessment;
• roll-out; and
• post-release monitoring.

Having said that, the life insurance industry and the development of IVICs is distinguished from other financial services and other industries by two fundamental factors. The first of these is that the product is intended, and is designed, to protect consumers against risk by guaranteeing their financial investments. The second is that the protection provided to consumers is a long-term contractual obligation that is frequently measured in decades.

Like companies operating in any industry, life insurers want to design products that will be attractive to consumers and offer competitive advantages in the marketplace. The unique challenge for the life insurance industry, however, is that almost anything that enhances the attractiveness or competitiveness of an insurer’s product also increases its risk. Striking the right balance of benefits and risks is critical to an insurer’s long-term viability and, thus, central to its product development practices.

2.2 Roles and Responsibilities of Chief Actuary

Guiding Principle No. 1 of the Canadian Institute of Actuaries states, “In carrying out its activities and programs, the Institute holds the duty of the profession to the public above the needs of the profession and its members.”
As noted above, a balance of benefits and risks forms the foundation for the product development practices of life insurers. The role of the Chief Actuary, a professional with a duty to the public, is to ensure that reasonable and accurate assumptions are made in the assessment of both benefits and risks. OSFI Guideline F-1, an Introduction to OSFI's Standards of Sound Business and Financial Practices, explains that the Appointed Actuary "identifies and quantifies the risks to which a company's financial condition is sensitive" and expresses "an opinion on the results of the valuation of the policy liabilities." These responsibilities and the requirement for an independent external review of the work of the Appointed Actuary are described in more detail in Guideline E-15 Appointed Actuary: Legal Requirements, Qualifications and External Review.

3. IDEA GENERATION

For insurers, idea generation is, at its core, a process of separating the wheat from the chaff. Insurers employ a variety of metaphors (e.g., gates, funnels, pipelines, etc.) to describe this process but the objective is always the same, that is to take a large number of ideas and, on the basis of a number of criteria, narrow these down to those that show the most promise.

The primary criterion that most types of manufacturers use to evaluate new ideas is whether or not the product will sell. It's actually a bit more complicated than this but the general idea is that success is mainly tied to sales volume. For insurers, however,
the competitive attractiveness of the product is only one of several criteria that is used to evaluate a potential product. Equally important is how the product will perform and the level of risk it will create for the insurer.

The use of these criteria to evaluate the "finalists" in the idea generation stage will be described in the next section, Assessment. This section will describe the sources of ideas and the preliminary assessment.

Common to all industries that manufacture retail consumer products, insurers engage in on-going market research, both primary and secondary, to track trends and identify emerging consumer needs. This information plays an obvious and important role in finding opportunities and assessing the potential demand for possible products.

In addition to this research, ideas for new products and modifications of existing products come from a variety of other sources. Product specialists monitoring trends or changes in tax law may come up with ideas for addressing these opportunities. Those who are assessing the performance of existing products may come up with ideas for improving these products. Insurers also rely on getting insights and suggestions from their distribution channels and individual advisors who are experts at matching products to clients. In addition, because it is impossible for everyone to be first all the time, a frequent source of innovation is old-fashioned copying. This is usually referred to as "improving on" the competition.
In most industries, idea generation in the product development cycle focuses exclusively on identifying a consumer need and a product to address that need. But the development of life insurance products is complicated by the fact that any product that mitigates risk for the consumer, by its very nature, exposes the insurer to risk. An IVIC that guarantees an income stream for a client, for example, imposes an obligation on the insurer to provide that income even if the funds that were intended to generate the income are depleted. To put this in another way, the fact that a consumer's risk is assumed by the insurer does not mean it disappears, it simply means it has been shifted to a person who is in a better position to manage it.

For this reason, the identification and quantification of risk is engrained even in the earliest stages of idea generation. To achieve this, the process is carried out by a cross-functional team. While different insurers may use slightly different terminology to describe each specific function, these teams generally include: client strategy, compliance, finance, information technology, investment, legal, marketing, operations, pricing, product, risk management, sales and valuation.

The introduction of GWB features in Canada illustrates some of the practices involved in idea generation and the checks and balances. As the 21st century began, the fact that the first Canadian boomers were approaching retirement was well documented and there was plenty of research about their attitudes and concerns, including worries about retirement income. South of the border, variable annuities (the U.S. counterpart to IVICs) had been offering a Guaranteed Minimum Living Benefit
along with a death benefit since the 1990s. The U.S. product offered an obvious way to address an emerging consumer need in Canada. But Canada is not the United States. Savings rates are different. Pension plans and social entitlements are different. Longevity and mortality are different. Interest rates and the performance of equity markets often differ. Regulatory requirements are different. And corporate cultures and appetite for risk can be different. The job of the cross-functional teams contemplating the introduction of GWBs was to satisfy themselves either that the differences were not material or that they could be accommodated by modifications in the design or pricing of the product.

While the individuals on this cross-functional team each have specific responsibilities delegated to them by senior managers, ultimate accountability for decisions made by the team rests with senior management reporting to the Board of Directors.

There is no precise way to describe how decisions are made and who makes them, it will depend on the circumstances. For a new product that might fundamentally alter the competitive marketplace, final decisions are likely to be made at the most senior level with close attention being paid to each of the steps leading up to that decision. At the other end of the continuum, a tweak to a relatively minor feature in a mature product is likely to attract less senior attention, even though ultimate accountability remains with senior management.
No cross-functional team can be entirely immune from the inevitable pressures of a competitive marketplace. To avoid or mitigate potential conflicts of interests, accountabilities are separated and, as a final check, a Chief Risk Officer, with responsibility to assess products purely from a risk perspective, has the power to stop development of a product. As a further safeguard, the compensation of company officers in control functions is delinked from sales volume and, more generally, OSFI expects the Board of Directors to ensure that the CEO and senior management are compensated in a way that is consistent with appropriate prudential incentives. Finally, risk management measures are incorporated in the performance measures of all company officers.

4. ASSESSMENT

The process of assessment involves identifying risks, developing criteria to evaluate those risks and gathering information to determine whether or not each risk falls within a target range that is appropriate for the insurer. Risk management is a pervasive element in the corporate culture of all Canadian insurers. OSFI's 2003 Corporate Governance Guideline is worth quoting at length on this matter.

"Financial institutions' choices of business objectives and strategies are intimately tied to decisions about the particular risks the institution is prepared to take and what means it will use to manage and mitigate these risks."
"The types of risks assumed and the relative importance of particular types of risks in the institution's risk management process will differ based on the institution's business mix and risk tolerance. Risk management means, in part, understanding the quality of assets and the nature of associated liabilities.

"Risk management systems and practices will differ, depending on the scope and size of the institution and the nature of its risk exposures. But whatever the particular approach, every institution should have integrated policies that, taken together, apply to the organization's significant activities regarding the corporate philosophy on risk management, the institution's permissible exposure to risk, objectives of risk management, delegation of authorities and responsibilities, and processes for identifying, monitoring and controlling/managing risk. This process should be tailored to the particular nature of the institution and can, for example, have different degrees of centralization or decentralization and be organized in various ways. It should enable the board and senior management to meet their organization-wide responsibilities. Comprehensiveness is a key attribute of effective risk management." (pp. 8-9)

There are a couple of key points about risk management that emerge in this commentary. The first is that, as a way of advancing identified business objectives and strategies, insurers make conscious decisions about the risk they are prepared to assume and how they manage this risk. In other words, risk management is not a reactionary practice that is implemented only when it is necessary. Rather, it is central
to each insurer’s business plan. The second point is that each insurer will develop risk management practices that are specific to its circumstances. This means that there are few questions about risk management that have inherently right or wrong answers.

In practical terms, these two points mean that an individual insurer may design a product in ways that, to an outsider, appear to expose the insurer to unnecessary risk. The only way to understand the individual insurer's assessment of this design is to understand a wide range of decisions that the insurer has made about that product, including how it will be marketed, and all its other products.

The Board of Directors is responsible for reviewing and approving the insurer's risk philosophy and risk tolerance. It should also understand the types of risk to which the insurer is exposed and how these risks are measured and managed. Any changes to policies related to accepting, monitoring, managing and reporting risk should be approved by the Board. Senior management is responsible for understanding the insurer’s risk tolerance and the factors that can have an effect on this risk. Senior management participate in reviewing and identifying assessment practices and contribute to the development of risk management strategies. Two OSFI guidelines, Corporate Governance Guideline and Stress Testing, describe the roles of the Board and senior management in more detail.

Guideline E-18 Stress Testing also sets out OSFI's expectations for how life insurance companies conduct stress testing. Stress testing is a technique used to
determine the effect that various events could have on the risk factors that have been identified by the insurer. For example, if the design of the product makes certain assumptions about the mortality of clients, stress testing determines what happens if the mortality changes (an event that could arise if the people who actually purchase the product are older or younger, on average, than expected).

The guideline states that the board and senior management need to be involved in a program that is "embedded in enterprise wide risk management." It goes on to state that "the board must ensure its senior management has in place a "fit for purpose" program" and that "senior management should be able to identify and clearly articulate the institution's risk appetite and understand the impact of stress events on the profile of the institution" (p. 3).

Four key considerations are central to an effective stress testing program.

- It should take into account views from across the organization and cover a range of perspectives.
- Policies and procedures governing the program should be documented and the assumptions should be evaluated regularly in light of changing external conditions.
- The institution should have a sufficiently robust and flexible infrastructure to accommodate different and possibly changing stress tests at an appropriate level of granularity.
• The testing framework should be updated on a regular basis and its effectiveness should be evaluated regularly and independently.

In OSFI's view, stress testing should be comprehensive and applied consistently to the insurer's most material and significant risks. This includes credit risk, market risk and insurance risk. As part of a complete stress testing program, insurers are expected to contemplate a situation that threatens the viability of the organization and work backwards to identify an event or combination of events that could result in this situation. As well, stress testing is not limited to reasonably foreseeable events. Rather, it needs to take into account extreme events that are plausible.

The guideline provides a detailed description of methodology and scenario selection and includes a discussion of risks that require specific attention in light of recent financial market turmoil. On this point, the guideline, which was released in 2009, notes that "stress testing is especially important after long periods of benign economic and financial conditions, when fading memory of negative conditions can lead to complacency and the underpricing of risk" (p. 2).

5. ROLL-OUT

In designing products, insurers make assumptions about how the product will be marketed and used once it is in the marketplace. To ensure that actual behaviour aligns as closely as possible with these assumptions, the release of a product is
accompanied by a wide range of supports. This includes detailed, technical information about the product, sales and marketing materials, advisor training and general consumer information.

Life insurance products generally, and IVICs in particular, are designed to be used by consumers in specific ways. These intended uses are referred to as sales concepts (i.e., how the product can be used in certain circumstances for certain purposes). Sales concepts are reviewed and signed off by market conduct, legal and compliance officers. Because they help the advisor understand how the product can relate to consumer needs, they often form the backbone of training for advisors.

With the introduction of GWB features, the use of illustrations became widespread in the sale of IVICs. Illustrations use concrete numerical examples to show how the product can perform, how this performance might be affected by changing conditions and how specific uses or sales concepts operate. Like sales concepts, illustrations are reviewed and signed off by market conduct, legal and compliance officers. As well as complying with the statutory requirements related to disclosure noted below, illustrations are expected to comply with CLHIA Guideline G15 Guaranteed Withdrawal Benefit Illustrations.

All product information is tested to ensure it is accurately understood by the intended audience and effectively communicates the intended message. This testing typically involves focus groups of advisors. In addition to wanting to make sure advisors
are taking away the appropriate understanding, advisors are viewed as an effective proxy for the consumers with whom they interact on a daily basis. Where the insurer wishes to confirm the impressions of its advisors, focus group testing might be broadened to include consumers. As is done for sales concepts and illustrations, all product information is also reviewed and signed off by market conduct, legal and compliance officers. Among other things, this review is intended to ensure that the information complies with statutory requirements that apply generally to all life insurance products (e.g., Ontario Regulation 7/00 Unfair and Deceptive Acts and Practices) and to IVICs in particular (i.e., CLHIA Guideline G2 which is incorporated by reference in Ontario Regulation 132/97 Variable Insurance Contracts).

Insurers provide training to the sales force, either directly or through trainers in distribution channels such as national accounts and managing general agencies, to build awareness of the product and to ensure advisors understand the product and its intended market. Again, this goes back to the insurer’s fundamental need to balance benefits and risks. On the one hand, training is used to make sure advisors are familiar with the product and will sell it. On the other hand, because assumptions of client behaviour are central to assessing and managing risk, training is also used to make sure that the sale and use of the product is matched to its intended purpose.

CLHIA Guideline G2 describes the information that insurers must provide to consumers at the point of sale to help them understand the product and make informed purchase decisions. While G2 applies broadly to any printed or electronic information
used to market IVICs, it provides detailed requirements specific to the Information Folder.

The Information Folder provides information about the contract features, the segregated funds available in the contract, the fees and sales incentives, restrictions and risk factors. While it is intended to be written in plain language, Information Folders tend to be long and detailed. This was identified as a challenge for effective disclosure to the consumer so the life insurance industry worked with regulators to develop brief, easy to read descriptions of the contract features and segregated funds. By January 2011, all insurers were required to include these descriptions, known as Key Facts (for the contract) and Fund Facts (for the segregated funds) in the Information Folder.

The Key Facts document provides a brief (i.e., two pages), plain language description of the guarantees, the different levels that are available and the costs associated with this added protection, other key features such as resets and bonuses, and the key limitations and how these affect the guarantees. The Fund Facts document describes the underlying investments in the fund, its past performance and risk, who it is intended for and its cost. Both documents outline the consumer's rescission rights and where additional information can be obtained.

As with any complex life insurance product, disclosure documents and other consumer information prepared by the insurer are generally intended the complement the role of the advisor in ensuring the consumer is able to make an informed purchase
decision and use the IVIC appropriately. In addition to helping direct the client towards
the most relevant information, the interactive two-way dialogue between the advisor and
his or her client is often the best indication of the client's understanding.

Insurers typically go to considerable lengths to make sure advisors are aware of
products, understand their features and know how to relate these to consumer needs.
In part, training advisors and arming them with technical information and sales support
is intended to build the advisor's comfort with the product and encourage sales. But at
the same time, for a number of reasons, it is also a critical part of risk management.

As noted in the discussion under Assessment, assumptions about the behaviour
of clients play an important role in identifying the risk factors for a product. Once the
product is in the marketplace, it is the advisor who exercises the greatest influence over
whether or not these behavioural factors line up with the insurer's assumptions. Thus
insurers have a strong interest in making sure advisors understand the target markets
for the IVIC and its intended uses within these markets.

As well, two of the insurance risks that insurers need to manage are risks to
reputation and regulatory (i.e., non-compliance) risk. Both of these risks can be
affected by improper selling of the product. For life insurers, these risks are amplified
by deemed agency provisions in provincial Insurance Acts. These provisions (e.g.,
*Ontario Insurance Act*, sec. 222) stipulate that advisors will be deemed to be
representing the insurer in any questions arising out of a contract.
6. **POST-RELEASE MONITORING**

Post-release monitoring is a critical part of the measurement of risk related to the specific product. As well, as part of an enterprise wide risk management strategy, it provides important insights that can be used for the assessment of any new product under development. This enterprise wide function arises in two separate and quite distinct ways. One relates to how the product is sold, the other relates to how it performs.

Generally post-release monitoring and reporting practices all fall within clearly defined parameters and can be carried out with a minimum of senior oversight. Any results that fall outside accepted tolerances, however, receive heightened attention and, depending on the circumstances, could be reported to senior management for review.

6.1 **Sales Practices**

It has been noted more than once in this paper that an insurer's decisions in the product development cycle rest on a number of assumptions about how the product will be sold to consumers and, eventually, used by them. A clothing manufacturer is not generally around when its clothes are being worn so it need not care that a man wears a striped shirt with checked pants or a size ten woman squeezes into a size eight dress. By agreeing to accept at least some of the client's risk, however, an insurer is around.
Insurers generally take a risk-based approach, monitoring trends or patterns at a macro level to determine if additional investigation is required at a micro level. This approach has the advantage of often being a more cost-effective means of monitoring sales practices. But more importantly, the fact that IVICs can be used in different ways, in varying combinations with other financial products, to address any given need means that it is often the only workable approach. Short of being in the room with the advisor and peering over his or her shoulder, there is usually no way to assess the appropriateness of individual decisions about IVICs.

In this macro approach, there are a number of "red flags" that provide evidence that sales or subsequent client decisions are not conforming to the insurer's assumptions for its product. These include:

- high taxes and/or DSC due to early surrenders (or withdrawals);
- surrenders within six (6) months;
- product switches, i.e., from mutual funds to segregated funds;
- movement between internal policies and/or external organizations within a short period of time, typically six (6) months, one (1) and two (two) years;
- large transactions;
- frequent transactions (excluding those in systematic plans);
- leveraging;
- concentration limits; and
- deviations from normal patterns of business.
Some of these indices may trigger additional scrutiny in a single instance. For example, insurers will routinely follow-up on any transaction over a specified dollar amount. All of these indices can be monitored to detect patterns that are used to identify advisors who require heightened scrutiny such as a review of the advisor's client files.

6.2 Product Performance

Common to manufacturers in all industries, insurers try to learn from past experience. Knowledge of what worked and what didn't work gives direction to idea generation and helps ground assessment in real-life empirical data. What sets IVICs apart, however, is the fact that a contract can't be recalled and modified once it's been issued. Each contract creates liabilities for the insurer that it cannot avoid. So if these liabilities end up being greater than expected, this becomes a new variable in the insurer's broader risk management strategies.

Recent developments related to the GWB features of IVICs illustrate this role of post-release monitoring.

As was discussed earlier, Guaranteed Lifetime Withdrawal Benefits have been available in variable annuities in the United States since the 1990s. So prior to the
introduction of the GWB feature in Canada, there was roughly a decade of experience with a similar feature in the United States during which it provided clients with the peace of mind of downside protection without creating unexpected liabilities for insurers. A little over a year after insurers began rolling out the feature in Canada, however, the economy and markets around the world began to change dramatically. For the consumer, the risk that GWB customers were protecting against (i.e., having their nest egg wiped out or substantially depleted in the early years after retirement) became a reality and the protection they'd purchased assumed very real financial value. For the insurer, the depth, breadth and duration of the downturn in the markets meant that the risk mitigation measures they had built into their products were facing exposures that showed signs of exceeding insurers' assumptions.

For existing contracts, insurers were (and are) obliged to fulfill their obligations. This means making the guaranteed payments and allowing clients to take full advantage of resets and bonuses to increase these payments. (The fundamental change rules allow the insurer to make modest and finite increases in the insurance fees it charges. As explained earlier, however, because the pricing of the product relies on pooling of risk, this fee does not cover the entire cost of the insurance.)

For new contracts being offered, insurers began making modifications intended to balance the need to mitigate their risk with their desire to preserve the competitive attractiveness of their product. Over the past six months (this report was written in May 2012), however, as financial uncertainty continues and more and more commentators
question the prospects for a return to "normal" (see, for example, OSFI's March 2012 paper, *Evidence for Mean Reversion in Equity Prices*) this balance has begun to show signs of tilting towards risk mitigation. Less abstractly, while the early decisions focussed on minor modifications like reducing the frequency of resets or limiting investment options available with certain guarantees, more recent decisions have, in some cases, been central to the product.

The example of GWB features represents something of an extreme case. Most of the time, post-release monitoring does not involve gathering economic and investment data that stands in such stark contrast with the assumptions that were used in the design of the product. Rather, the data tends to be more varied and subtle. And quite often it points, not to the product itself, but to supports such as unclear or misunderstood explanations or gaps in advisor training.

7. CONCLUSION

The Joint Forum asked specifically whether processes have changed as a result of the financial crisis and changing consumer expectations.

The life insurance industry operates in a principles-based regulatory environment. The general principles for effective risk management in product development have been well established since the 1990s when OSFI, in consultation
with the industry, began developing Standards for Sound Business and Financial Practices. By 2005, in further consultation with the industry, these standards evolved into the current framework of guidelines.

At the same time, individual companies, on their own and cooperatively through CLHIA, and OSFI continue to look at specific practices with a view to improving their sensitivity and enhancing their effectiveness. In Guideline E-18, OSFI identified a number of risks that require specific attention based on the turmoil and uncertainty in the financial markets. These include risk mitigation, risks to reputation and risk concentrations. One of the consequences of this turmoil is that insurers have adjusted their assumptions about market performance that are used to determine capital requirements. For some, this has led to increasing their reserves.

The guarantees in IVICs provide financial security to individual clients and help maintain stability in financial markets. In Corporate Governance Guideline, OSFI recognized the special nature of financial institutions in general and insurers in particular. The trust that consumers place in insurers to protect substantial portions of their life savings is a trust that imposes both moral and legal obligations on insurers. Carefully maintaining a robust risk management strategy and continually looking for ways to improve the practices covered by that strategy are both recognized and accepted by insurers as being central to fulfilling those obligations.
REPORT OF THE INVESTMENT FUNDS INSTITUTE OF CANADA TO THE
JOINT FORUM OF FINANCIAL MARKET REGULATORS

RISK ASSESSMENT AND MANAGEMENT
DURING THE MUTUAL FUND PRODUCT DEVELOPMENT AND
DISTRIBUTION PROCESS

JUNE 2012
EXECUTIVE SUMMARY

The Canadian mutual fund industry well understands the concept of risk, and the value of market risk to investors as the primary driver of growth in their investment fund assets. Very few investments are without risk. Risk is therefore a concept that is to be understood by market participants. Those whose objective is the preservation of capital without much need for growth should be directed to investments or savings products that are stable and not exposed to much market risk, recognizing that there will be a risk that the investment may not generate returns in excess of the rate of inflation. Those investors who are interested in growth can be directed to mutual funds that have significant market exposure. Those investors who would like to have some elements of growth and stability can be offered products that offer a blend of these attributes.

The mutual fund industry has comprehensive risk assessment and management processes that are used during the life cycle of a mutual fund, from its ideation to its manufacture and distribution, and through its lifetime as a publicly-offered mutual fund. These processes ensure that the risks are measured, understood and found to be appropriate for the type of fund it is supposed to be. These processes ensure that those risks are disclosed to investors and understood by distributors and their advisors to ensure that suitable product recommendations are provided to investors. These processes also ensure that as the product, or the environment in which the product is offered, changes in a way that alters the risks to which the fund is exposed, that those changes are known and, if appropriate or possible, that necessary changes are made to restore the product to its appropriate risk levels.

In this report, the investment fund industry will provide a detailed review of those processes, and other risk management and investor protection attributes of mutual funds.

INTRODUCTION

The Joint Forum has embarked on a review of the manner in which competing investment product manufacturers assess and manage risk in the product development process, and disclose risk to investors. This stage involved reports from the industry about, and description of, the processes and practices in the manufacturing of mutual funds and IVICs that help ensure the suitability of the products and ensure that consumers are able to make informed decisions.

IFIC created a group of Member firms, both managers and distributors, to provide the content and to present the mutual fund industry report. The report demonstrates that risk assessment and management is embedded within all aspects of mutual fund manufacturing and distribution.

OVERVIEW OF MUTUAL FUNDS

Mutual funds are investment products which enable investors to pool their money with other investors and hold diversified investments at relatively low cost. Funds have ‘democratized’ investing by providing investors with only limited amounts to invest access to capital markets and professional
money management, access which prior to the development of mutual funds had been available only to institutional and high net worth investors.

Investors benefit from the values that mutual funds deliver:

**Reduced risk.** The pooling concept, an essential element of an investment fund, allows for diversification across sectors and securities that individual investors with limited capital are less able to achieve on their own.

**Reduced cost.** Pooling also spreads the research, time and effort required to invest in individual securities over a larger asset base, thus reducing the cost per dollar for each participant in the fund.

**Easy access.** Mutual funds are available through a broad range of investment providers in Canada including banks, brokerage firms, credit unions, financial planning firms and other investment firms.

**Professional portfolio management.** Mutual funds provide cost effective access to professional money management and the underlying research, asset allocation, tax planning and other services that comprise a fund.

**Liquidity.** Mutual funds are easy to purchase and redeem on demand with minimal cost, and therefore suitable to meet any of the wide-ranging savings goals that Canadians may have over their lifetimes.

**Choice and Flexibility.** Mutual funds are available to meet the widest variety of needs and types of investor.

**Investor Protection.** Mutual fund companies and their distributors maintain the highest standards of care for their clients’ interests, in accordance with the stringent rules and regulations of Canadian securities regulators.

Mutual funds are available in a wide variety of ways through numerous channels. They can be purchased from a registered representative at any branch of a bank or a securities dealer; directly from a fund company; online at a discount brokerage; or through payroll contributions to a group registered retirement plan.

As much as 85% of mutual fund purchases¹ are assisted by an advisor or a professional salesperson. Often this is through face-to-face meetings or over the phone – comprising literally millions of conversations between individual Canadians and their advisors over the course of a year. As of June

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2011, $1.85 trillion of Canadian household savings were gathered through advice-driven networks\(^2\), and of this, close to one half, or $871 billion, was placed in investment funds.\(^3\)

**Investor Protection**

A good part of the popularity of funds is related to the security of the investments and the highly regulated nature of the product and its distribution.

Each province and territory in Canada, through its securities regulator, regulates the operations, distribution and sale of mutual funds. Investment fund managers, portfolio managers, dealer firms and their advisors, and many of their employees, as well as other market participants, are required to be registered with regulators in order to do business, and are subject to regular compliance reviews to ensure adherence to regulatory requirements. Retail mutual funds themselves are offered via simplified prospectuses which must be filed and receipted in each province where the funds’ units may be sold. Other disclosure requirements, and the practices to be followed by managers and distributors and their advisors, are all prescribed and subject to regulatory oversight.

More particularly, distributors of mutual funds are overseen by the following Canadian regulators: the Mutual Fund Dealers Association (MFDA); the Investment Industry Regulatory Organization of Canada (IIROC); or, in Quebec, L’Autorité des marchés financiers (AMF) and La Chambre de la sécurité financière (CSF). The regulators perform audits of the dealer/advisor members and monitor their compliance with securities laws. Requirements for Know Your Client (KYC) and suitability reviews, the Canadian Investor Protection Fund, the Investor Protection Corporation, on-going financial reporting, capital and insurance requirements all provide for a very deep level of confidence in mutual funds and their distributors.

Mutual fund distributors are responsible to ensure that investors purchase products that are consistent with their risk tolerance. Distributors are required to Know the Client and Know the Product. Dealers have two levels of account supervision (Branch and Head Office) to ensure product suitability.

Rules governing the disclosure of information about a fund, its custodian, trustee, the use of external auditors and the management of conflicts are some of the investor protections built into the product. These provide for and govern: an Investment Review Committee overseeing decisions involving all actual or perceived conflicts of interest faced by the Fund Manager; a Custodian responsible for the safekeeping of the cash and securities that belong to the mutual fund; a Registrar responsible for maintaining the record of issued units or shares; a Transfer Agent responsible for maintaining investor records, including all transactions; a Trustee which holds title to the investments on behalf of the unit holders and is responsible for the proper administration of the trust; and Auditors who provide independent verification of the financial information produced by management.

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\(^2\) Advice driven networks include: Branch Advice, Full Service Brokers, Financial Advisors, Private Investment Counsel, and Estates & Trusts.

\(^3\) Investment Funds refer to a broader base which encompasses mutual funds, segregated funds, ETFs and insurance company group pooled funds. Mutual funds assets at June 2011 totalled $803 billion.
UNDERSTANDING RISK

Much is currently being made of the concept of risk. There is not one “risk”, but rather many sorts of risk that result in different outcomes in different circumstances. One key point to be borne in mind in the context of investment funds is that prudential risk and market risk is not the same thing.

Prudential Risk

Prudential risk is the risk that a failure of the financial institution will result in a financial loss to the stakeholders in that institution. In the case of banks, a bank failure would expose bank deposits to loss, were it not for the mandatory deposit insurance coverage which covers such losses up to a dollar limit. Although there is an inherently high prudential risk for mutual funds, as a product where investors entrust their money to third-party entities, the regulatory and product structure and the stringent policies and regulations governing mutual funds minimizes or removes much of that risk. For example, a failure of the investment fund management firm does not by itself expose the funds (which are separately held with a third party custodian) to financial loss. The funds would simply need to retain a successor fund management firm to continue managing its portfolios and perform administration services. This report describes these structures and policies as part of the broad mutual fund risk assessment and management system.

Market Risk

As pooled vehicles which invest their portfolio assets in the capital markets, mutual funds are exposed to market risk. This is the risk that the funds (and therefore the investors in those funds) might decline in value when the markets decline, which is the inescapable flip-side of the primary objective of having asset values increase when the markets increase. Market fluctuations are unavoidable, but they are what provide the potential for gains in the value of one’s investments. There is a broad spectrum of mutual funds ranging from those that seek higher growth opportunity (and therefore are likely to be exposed to more market risk) to those with a primary objective of preservation of capital (and therefore will seek to minimize the degree of market risk). The processes, controls and reviews that are applied as part of the mutual fund risk assessment and management system are described in more detail in this report.

Specifically on client risk exposure, advisors are required to understand their client’s objectives and risk tolerance, so as to recommend suitable funds in each case. Investors seeking preservation of capital without much growth are encouraged to consider funds that hold stable market assets, whereas those interested in growth are able to invest in funds that offer more exposure to market movement.

What are the risks of investing in mutual funds?

As noted above, the primary risk impacting mutual funds is market risk. From an investor’s point of view, the typical concern is about the chance of losing money in an investment, whether it is a mutual fund, segregated fund, GIC or other asset. The main risks that investors are likely to encounter in their investments are in the form of capital loss or inflation. A capital loss risk is the risk that the investment
will decline in value. Investors are protected from capital losses with Guaranteed Investment Certificates (GICs) because at maturity they receive back what they invested. Most mutual funds, however, fluctuate in price on a regular basis and at times can experience a loss of capital.

However, the longer the period which investors invest their money, the less likely it is that they will suffer a net capital loss. Economists acknowledge a general relationship between risk and return that implies if an investor seeks higher returns, the investor must be prepared to take on more risk of capital loss. It should be remembered that even a GIC carries risk - the risk that the investors’ money will not grow enough to cover the long-term increase in the cost of living (inflation risk).

Mutual fund prospectuses contain a section entitled *What are the Risks of Investing in a Mutual Fund* which provides detailed descriptions of the types of risk to which an investment in a fund may be exposed.

Some of the most common market risks associated with fund investments are:

- **Currency risk** – if an investor’s assets are held in another currency, then movements in the value of a currency can affect the value of the investment.
- **Liquidity risk** – the risk that it may not be easy to sell an investment on the open market when the investor wishes to do so.
- **Concentration risk** - A lack of diversification in an investor’s investments may increase concentration risk.
- **Political risk** - the potential for losses caused by political decisions made by or forced upon governments.

Accordingly, it is critical that investors understand that they cannot completely avoid risk in their investing or saving activity. However they can and should understand and manage it, and be encouraged to review the detailed information about such risks contained in the prospectus.

Investment fund managers also produce public information on a number of topics related to investing generally, and investing in mutual funds specifically. Given the importance of clients understanding risk associated with mutual fund investing, there is useful information on this subject posted on their websites.

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4 See, for example, pages 14 to 16 of the online resource provided by Dynamic Funds, *Mutual Funds 101*, available at http://docmgt.dynamic.ca/documentdownload/getdocument/3700.
RISK ASSESSMENT / MANAGEMENT DURING THE PRODUCT DEVELOPMENT AND DISTRIBUTION PROCESS

As noted pictorially by the diagram, prudential and market risk assessment and management components are integrated into the investment fund product development and distribution processes of investment fund managers, dealers and advisors. There is no particular order to these components, which will be described below, as many occur simultaneously and continuously with other components. These components are applicable however, in various combinations through all stages of the product lifecycle, including idea generation, product manufacture, product roll-out and ongoing product monitoring.

A. INTERNAL CONTROLS

Fund Manufacturers assess risk during the product development process through a number of measures, either required by regulation, or by prudent business practice.
A fundamental degree of risk assessment is necessitated by the Canadian Securities Administrators general “C-SOX” requirements. These rules require that Canadian companies perform a high level of care and diligence in reviewing and documenting their internal controls so that the controls provide a reasonable assurance that the risk of material misstatement will be prevented; controls extend to review of procedures governing the business of fund operations. Certification is provided by the CEO of each company to provide reasonable assurance that there are no material misstatements.

Fund managers also employ internal control systems which extend to a variety of internal review and product development processes and fund operations to ensure compliance with the regulatory environment as well as corporate governance standards. Examples of such controls include:

- Product Committees (to review and assess products) and Product Review Committees (to review product integrity)
- Financial Review Committees
- Audit Committee along with reporting directly to the Board of Directors (both of the funds and of the management company)

Product Committees for example, usually include representation from all areas of the organization: Legal, Compliance, Operations, IT, Marketing and Product Development, Investment Management, Client Service and Dealer Services. Internal Controls in the Product Development Process are managed and communicated through reporting to various boards, including sub-committees of the various boards and to executive levels of management within the firm.

A broader set of measures are included within a manager’s Enterprise Risk Management (ERM) process. ERM reviews span the entire organization, representing an attempt to assess the risk of unexpected outcomes across a variety of dimensions including product failure risk and market risks, among others. These reviews include reviews of product development processes and internal controls. ERM reviews also include safeguards to mitigate risk.

To demonstrate the product development process in operation, the decision to launch a product is typically made by an “Operating Committee” which consists of the senior business leaders of each business unit of the organization. The Operating Committee is advised by the Product Committee which reviews and assesses each product development opportunity (whether triggered by investor demand, risk or compliance assessment, consistency with firm strategy or financial viability) and provides its recommendation as well as provides operational resources to implement those activities which are approved.

Key information used to make the decision include (but are not limited to):

- description of opportunity
- sponsor
- summary of opportunity
- reasons to act now
- strategic alignment
- preliminary market assessment
- preliminary technical assessment
- preliminary business assessment (including legal, compliance and risk assessment)
- key stakeholders
- alternatives considered and rejected

One investment fund manager, for example, employs safeguards that include a formalized “staged” product development” process, with various checkpoints for product review and approvals. Examples of such checkpoints include Document Review Certificates and “Rate Sheets” as part of the prospectus filing and fund set-up process to ensure formalized sign-off on product changes, prospectus filings, and to ensure transfer agency set-up is in accordance with prospectus filings.

In addition to the assessment of risk, risk management requires that employees acknowledge and sign a variety of compliance and review certifications including Document Review Certificates throughout the product development process as part of prospectus filing and fund set-up. As an added measure of control, ERM is reviewed by the Senior Executive level of the investment fund manager.

It is also imperative in each of these components that risk is properly communicated. This is achieved through reporting to Board of Directors of the fund manager, and, if applicable, to the Board of Directors of corporate funds.

B. DEFINED PROCESSES

Fund Manufacturers and Distributors also use defined processes to assess and manage product risk. Product concepts are tested for “consumer experience” through focus groups and informal surveys with the investor groups and the distribution channels. Product Review Committees exist at fund managers to ensure product integrity. Product manufacturers also perform rigorous analysis and financial modeling to ensure the product is likely to perform as expected. Fund Distributors also use Product Review Committees to ensure products have been assessed for appropriateness for sale to the distributors’ typical customers, and to ensure there is a level of product knowledge within the dealer firm and with the advisors. In addition, there are required Know Your Client (KYC) and suitability assessment procedures that must be performed by advisors to ensure the suitability of their product recommendations.

For every recommendation that results in a purchase transaction, each transaction is reviewed within the dealer firm for compliance with the KYC and suitability requirements. In certain cases (high dollar-value transactions and when higher-risk funds are being recommended) the dealer compliance process undertakes a more thorough review of the KYC and suitability process that was performed.
C. INDEPENDENT REVIEW

Through a robust independent review process, fund manufacturers have another tool to assess, manage and communicate product risk both during the development process and throughout the life of the fund.

The assessment is performed mainly by Oversight Committees and Fund Board of Directors that routinely review absolute and relative fund performance and volatility vs. benchmark and category peers. These findings are used to make continuous determinations about existing funds, and their attributes, as well as future funds which may be under contemplation or development. Fund oversight committee reviews any product changes as part of the committee’s fiduciary obligations to unitholders.

Management falls more to Independent Review Committees (IRC) which have become an integral part of the overall product development and product change process. The IRC approves or recommends a course of action to resolve conflicts of interest in order to achieve a “fair and reasonable result for the Fund(s)”

At least annually, the IRC also reviews and assesses the adequacy and effectiveness of the fund manager’s policies in respect of the funds, and the results of these reviews are publicly posted on fund company websites.

The communication of risks identified through the independent review process can emanate from the IRC which provides an annual report of its activities that is published by the fund company.

In addition, the fund manager must, through its MRFPs communicate fund risk and performance. These reports also show investment performance versus benchmark and provide attribution of over- or under performance. MRFPs are reviewed by a variety of internal boards as well as external committees to ensure integrity of information and process.

REGULATORY FRAMEWORK

It is beyond dispute that, in a highly regulated environment, mutual funds are subject to a very thorough set of rules and regulations, many of which have been touched on elsewhere in this report. These rules govern the attributes and authorization for sale of the funds, the authorization, business and compliance practices and oversight of investment fund managers and fund distributors and their individual advisors.

Regulation Overview

In Canada, publicly offered mutual funds are highly regulated investments that are subject to the jurisdiction and oversight of the provincial and territorial securities regulators. All firms associated with the operation and distribution of mutual fund securities must be registered with the provincial securities regulators. Registration imposes insurance and capital requirements, among others, including minimum education and proficiency requirements for individuals who must be registered to perform certain
functions such as portfolio management and compliance. Fund manufacturers are subject to regulatory compliance reviews.

Funds themselves are governed by the various provincial Securities Acts and by a host of specialized rules contained in the “81-series” National Instruments. In addition, the rules require a variety of mandatory disclosure documents be made available to investors when purchasing mutual funds, namely: the simplified prospectus, the annual information form and the fund facts document. Additional continuous disclosure documents such as financial statements, MRFPs and other materials are also required to be made available to investors in mutual funds at various time intervals. These documents provide a useful communication tool for information about funds and their activities. All of these documents must be filed with the securities commissions, posted on the SEDAR website and in many cases also posted on the manager’s website for ease of access by prospective and current investors and analysts.

Material contracts are also required to be posted on SEDAR, which makes them publicly available.

Specific Restrictions

As noted, many of the risk-reduction protections for mutual funds are the result of the tight controls imposed on funds by National Instrument 81-102 Mutual Funds (“NI 81-102”). This rule contains the restrictions on investments that can be made by mutual funds. These investment restrictions must be kept in mind during the product development process.

By virtue of the investment restrictions contained in NI 81-102, mutual funds are prevented from:

- Becoming too concentrated in the securities of any issuer
- Purchasing securities in order to exercise control over any issuer
- Purchasing (subject to certain exceptions)
  - real property
  - a mortgage
  - physical commodities
- Becoming too concentrated in illiquid assets
- Borrowing cash or providing a security interest over any of its portfolio assets (subject to certain limited exceptions)
- Other restrictions on investment exist, such as rules governing investment in other mutual funds and restrictions on the duplication of fees
- Strategies such as short selling, securities lending, and investments in derivative instruments, which may be considered “riskier” are permitted under NI 81-102 but it also puts many safeguards in place
- NI 81-102 requires that the portfolio assets of a mutual fund be held by a custodian
- Only certain types of entities are permitted to act as custodian/sub-custodian
- Specific custodial provisions relating to short sales and specified derivatives

NI 81-102 also imposes certain requirements regarding:

- The handling of redemptions / redemption orders, including transmission and receipt of orders, price and payment as well as setting out the limited circumstances when redemptions may be suspended
- Separation of assets into trust accounts (prevention of commingling)

**Unique Regulations Applicable to Fund Distributors**

In addition to the regulations governing authorization to act as product distributors, and for compliance and senior management personnel to perform their duties, discussed above, fund distributors are also subject to the rules and policies of their self-regulatory organizations (SROs) such as the MFDA, IIROC and, the AMF and CSF for Quebec distributors and advisors who are not IIROC members.

By way of example of such SRO rules, MFDA Rules and Policy provide for:

- Product due diligence
- KYC
- 2 levels of account and trade supervision
- Suitability review of account holdings at time of trade or revision of KYC

**DEALER COMPLIANCE**

The compliance process performed by fund distributors is another significant risk assessment and management tool, as it is the point at which the product’s risk characteristics are considered and aligned to the investors’ risk tolerance, objectives and product expectations.

Product risks are properly assessed through a dealer firm’s Know Your Product due diligence and review process. This KYP review begins with the Product Review Committee and involves policies and procedures from the Compliance area to ensure that the advisors are familiar with the products’ characteristics and the types of investors for whom products may or may not be suitable. From time to time, distributors may receive additional, more technical information in order to discharge their own “shelf management” due diligence obligations. Typically, this information may take the form of back-tested performance information, more detailed performance holdings data and attribution information of the particular mandate relative to benchmark.

The risks are properly managed through a combination of processes, beginning with the requirements for advisors to obtain information about their clients through account opening forms as well as interview on the clients’ objectives, to help the advisor understand the client and his/her expectations. The suitability requirements will allow the advisor to assess the clients’ risk tolerances in order to assess
which funds may be suitable to meet the clients’ objectives in light of that tolerance. Risk assessment is often reviewed in the context of the requisite disclosures of the prospectus as well as those required by the distributor.

As mentioned earlier in this report, the account and trade supervision processes also ensure there is ongoing monitoring of a client’s account and portfolio of investments. For every recommendation that results in a purchase transaction, the trade is reviewed within the dealer firm for compliance with the KYC and suitability requirements. In certain cases (high dollar-value transactions and when higher-risk funds are being recommended) the dealer compliance process undertakes a more thorough review of the KYC and suitability process that was performed.

The dealer firm also performs an ongoing account supervisory function for all clients. This process ensures that any changes to funds held by clients, or their performance or other environmental or market conditions are discussed with each client to discuss appropriate changes or rebalancing to ensure the portfolio continues to be suitable and appropriate for the client.

An annual portfolio review with the client to discuss any changes in the client’s objectives or circumstances also ensures the client’s portfolio continues to meet their objectives and remains suitable for the client.

Product risks are properly communicated through the distribution process initially through provisions of the Fund Facts and simplified prospectus. As noted, continuous disclosure documentation is also provided by the manager for any ongoing information about each fund. The dealer must also provide each client with confirmation of each purchase of a security, within a few days of the completion of each transaction. The dealer firm also provides each client with a statement about their portfolio on a regular basis. The statement must contain transaction and holdings information, including number of securities held, when purchased, book value and current market value. This information provides clients with a regular reminder about their account situation. The Canadian Securities Administrators are currently proposing more detailed portfolio performance and cost data to be included in such statements.

**DISCLOSURE**

In this section we will provide more detail about the risk disclosure requirements that are imposed on fund manufacturers and distributors. The documentary requirements are grouped by the investment stages – at time of purchase, on occurrence of an event or during the term of the investment.

The use of plain language is mandated for the Fund Facts and Simplified Prospectus, and is often used in the preparation of marketing materials and sales presentations so as to facilitate comprehension of the product by both distributor and investor audience. Depending on the nature of the investment fund, standardized fund profile sheets are often prepared so as to ensure a consistency of presentation to both audiences.

**Risk Disclosure at Point of Sale**

The Fund Facts discloses the investment risk level of the fund and the type of investor for whom the fund may, in general, be suitable.
The simplified prospectus (the form and content of which is prescribed in National Instrument 81-101 – Mutual Fund Prospectus Disclosure) must describe in some detail the risk factors and other investment considerations that an investor should take into account that are associated with investing in mutual funds generally and the investment risk level of each mutual fund described in the prospectus. The simplified prospectus also must:

- describe the methodology used by the manager for the purpose of identifying the investment risk level of the mutual fund and how frequently it is reviewed
- disclose the fundamental features and investment strategies of the fund, including whether the fund may sell short, use derivatives etc. and what exemptions the fund may have received from securities laws
- disclose material risks associated with each fund
- provide a brief description of the type of investors/portfolios for which the fund may be a suitable investment

Event Disclosure

Any material change to the business operations or offerings to a fund (such as mergers, terminations, and changes in fees or investment objectives) would require a material change report to be filed with the regulator and a press release and a prospectus amendment. Often such changes will require that a meeting of unitholders be convened so that unitholders may vote to approve or reject change proposals.

Continuous Risk Disclosure

The risks associated with mutual fund investments are set out for investors in a variety of continuous disclosure documents:

Management reports of fund performance, required by National Instrument 81-106, Investment Fund Continuous Disclosure must be filed and delivered twice each year. These reports must discuss how changes to the mutual fund over the financial year affected the overall level of risk associated with an investment in the fund. They must also, in relevant part, discuss risks that had a material effect on past performance, as well as unusual or infrequent events or transactions, economic changes and market conditions that affected performance or that are expected to affect the fund going forward.

Financial Statement & Quarterly Portfolio Positions

Each investment fund manager is required to produce for each prospectus qualified mutual fund, semi-annual unaudited and annual audited financial statements which must be filed with regulators and made available to fund investors. Financial statements must include a Statement of Investment Portfolio showing each portfolio holding. Funds must also, in each calendar quarter, publish their top 25 portfolio positions.

For their part, fund distributors are required to provide the simplified prospectus for each fund to an investor upon request, and within 2 business days of the completion of a purchase transaction. In addition, for each investor account with the dealer, it is required to provide to its clients statements
which contain mandated disclosure. The CSA is consulting on changes to that disclosure in its Relationship Disclosure Document project.

HUMAN CAPITAL

The value of human capital in the risk assessment and management process cannot be overlooked or understated. Fund manufacturers seek to ensure their staff is comprised of seasoned management and employees. Registration requirements for personnel in particular positions include minimum education and experience. Fund managers ensure their staff is guided by clear operational policies and procedures. Lastly, a program of continuing education is essential to ensure employees’ knowledge and training in their areas of expertise remains current and relevant.

Similarly, fund distributors also have an interest in ensuring their staff consists of seasoned management and personnel. Just as with fund managers, certain staff at dealer firms must meet registration requirements which include minimum education and experience. Clear operational policies and procedures are also necessary to ensure minimal compliance concerns. Continuing education programs are used to maintain the highest level of expertise and knowledge, in many cases beyond the requirements imposed by SROs.

Dealer firms also employ complaint handling processes which will allow early identification of problems in established practices or policies which can be rectified before they become major concerns. In addition dealer staff assesses trends and other events that may impact their clients or the securities in which they invest. Dealers regularly communicate such information to clients to keep them fully informed about their investments and events that may impact them, to ensure they maintain comfort with their portfolios, or that they are informed and prepared to make any necessary rebalancing or adjustment transactions to stay on track with their investment objectives.

The assessment and analysis of trends is also an important part of the iterative product development process. Input from advisors and dealers often generates new products or other innovations that address clients’ objectives. One example of this is the creation of the portfolio fund – one fund that functions as if it were a portfolio of individual funds – offering investors diversified and efficient market exposure in a simpler all-in-one product having a lower overall risk level that is known to the investor.
The contents of this report were prepared by the Product Development Task Force of The Investment Funds Institute of Canada, the members of which are:

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