Joint Forum of Financial Market Regulators

Forum conjoint des autorités de réglementation du marché financier

PROPOSED REGULATORY PRINCIPLES FOR CAPITAL ACCUMULATION PLANS

A Report by the

Joint Forum of Financial Market Regulators' Working Committee on

Investment Disclosure in Capital Accumulation Plans

April 27, 2001

Joint Forum of Financial Market Regulators

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Dear Stakeholders:

Re: Proposed Regulatory Principles for Capital Accumulation Plans

We are pleased to enclose a discussion paper from the Joint Forum of Financial Market Regulators (Joint Forum), entitled ***Proposed Regulatory Principles for Capital Accumulation Plans***, for your review and comment.

As you will recall, the Joint Forum of Financial Market Regulators was established in 1999 to proactively facilitate and coordinate the development of harmonized cross-sectoral and cross-jurisdictional solutions to financial services regulatory issues. The Joint Forum was founded by the Canadian Council of Insurance Regulators (CCIR), the Canadian Association of Pension Supervisory Authorities (CAPSA) and the Canadian Securities Administrators (CSA), and also includes representation from the Canadian Insurance Services Regulatory Organizations (CISRO) and the Bureau des services financiers in Québec.

A Joint Forum Working Committee was established to consider the adequacy of the disclosure and other regulatory protection offered to members who are entitled to make investment decisions in defined contribution pension plans and other similar types of capital accumulation plans. The enclosed discussion paper, including the proposed regulatory principles, was prepared by this Working Committee, and approved by the Joint Forum and its constituent bodies as a consultation document.

The discussion paper contains broad regulatory principles and is intended to be a concept paper for consultation purposes, not a proposal for legislation. Note that, although the recommended principles are published in all jurisdictions, the regulatory framework chosen will have to take into consideration the differences between the common law and the civil law applicable in Québec. Also, Québec is pursuing its own consultation plan about the recommended principles, in close parallel with other jurisdictions. The Joint Forum welcomes your comments on the questions posed in the report, as well as any other comments, suggestions or ideas you have on this topic.

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Information on the consultation process is set out on page 33 of the discussion paper. We look forward to receiving your comments by July 31, 2001.

Sincerely,

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JOINT FORUM OF FINANCIAL MARKET REGULATORS' REPORT ON PROPOSED REGULATORY PRINCIPLES FOR CAPITAL ACCUMULATION PLANS

April 27, 2001

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I INTRODUCTION

The regulation of capital accumulation plans (CAPs) is not harmonized across Canadian jurisdictions, nor across the insurance, pension and securities sectors in each jurisdiction. As a result, individual investors in CAPs receive varying degrees of regulatory protection depending upon the nature of the investment product and the regulatory framework applicable to that investment product.

This paper was developed by the Joint Forum of Financial Market Regulators (the Joint Forum) to address two issues:

1. The need to ensure that members of CAPs have (i) similar regulatory protection when making similar types of investment decisions, regardless of the applicable legislative regime; and (ii) the information and other tools they need to make informed investment decisions, where they are responsible for making those decisions.

2. The need of employers and administrators[1] to have their duties and responsibilities with respect to CAPs clearly defined, and harmonized across jurisdictions and products.

In this paper the term "capital accumulation plans" or "CAPs" refers to investment vehicles established by employers for the benefit of their employees that permit those employees to make investment decisions. These plans are primarily intended to ensure the financial security of employees in their retirement.

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[1] Throughout this paper, "employer" refers to an employer who offers a group registered retirement savings plan, deferred profit sharing plan or employee profit sharing plan to its employees, and "administrator" refers to an employer, board of trustees, pension committee or other statutory entity responsible for the administration of a defined contribution pension plan.

Also, in this paper CAPs specifically include four types of investment vehicles:

- Defined contribution pension plans that permit employees to make their own investment choices (ECDCPPs), as opposed to “traditional” defined contribution pension plans in which the administrator makes the investment decisions;
- Group registered retirement savings plans provided to employees by employers (group RRSPs);
- Deferred profit sharing plans (DPSPs); and
- Employee profit sharing plans (EPSPs)[2].

Traditional defined contribution pension plans in which the administrator is responsible for all investment decisions are not considered in this paper. Moreover, nothing in this paper should be construed as favouring ECDCPPs over traditional defined contribution pension plans.

The Joint Forum Working Committee on Investment Disclosure in Capital Accumulation Plans (the Working Committee) believes that it is necessary and appropriate to coordinate and harmonize the treatment of CAPs to give similar protection to investors in these different, yet functionally similar products. As a result, the paper proposes that the regulation of CAPs be harmonized to ensure that employees in these plans have a similar level of protection and investment information, regardless of the type of CAP and the applicable legislative regime.

The intent of this paper is to propose appropriate principles of regulation for CAPs regarding investment choices provided to members. The paper does not suggest how these principles might ultimately be implemented. Some options for implementation are listed at the end of the paper for discussion and comment.

[2] Currently, as set out in Section II of this paper, the vast majority of CAPs are either ECDCPPs or group RRSPs. There is a relatively small number of DPSPs and EPSPs. For this reason, the paper focuses primarily on ECDCPPs and group RRSPs sponsored by employers. Further work may be necessary to determine whether the proposed principles are appropriate for DPSPs, EPSPs and other types of CAPs.

It may be necessary to introduce legislative or other changes to implement the proposed principles. For ECDCPPs, there is jurisdiction to set disclosure and other minimum standards in pension legislation or regulations. For group RRSPs, the jurisdiction to regulate the investment disclosure provided to members currently depends on whether the products being offered are insurance or securities products.

Questions related to implementation will be addressed by the Working Committee as it continues its work.

This paper reflects the ideas of the regulators that are members of the Joint Forum and its member associations, including the Canadian Securities Administrators (CSA), the Canadian Council of Insurance Regulators (CCIR) and the Canadian Association of Pension Supervisory Authorities (CAPSA). It does not necessarily represent the views of any government. It is the first step in a process to propose new, harmonized investment disclosure rules for CAPs in Canada.

The Working Committee reviewed the regulatory environment in Canada, and the relevant law in the U.S. (ERISA). It may also be beneficial to investigate other regulatory approaches to the issue of investment choice and disclosure for CAP members before these principles are finalized.

The Working Committee welcomes comments on the proposed principles and how they might be implemented.

II PROBLEMS TO BE ADDRESSED BY THE PROPOSED PRINCIPLES

The primary issue for regulators is that plan members who have choices regarding the investment of their plan savings assume more direct responsibility for investment decisions. This is a significant change from traditional pension plans in which the employer provided either defined benefits or a managed money purchase account. Plan members should be provided sufficient information to understand the risks and implications of this responsibility, and to be able to make informed choices.

At the same time, employers and administrators have requested clarification of their duties and responsibilities in this new environment.

There is also a general need for harmonization of the rules to ensure that similar rules apply to similar products, and that adequate information and protection is provided to all members of CAPs. Currently, there is a confusing array of regulations that apply to these products, depending on which jurisdiction's laws apply to the CAP and the type of investment products offered by the CAP. There are both regulatory gaps and regulatory overlaps in the current environment. Sometimes securities rules apply to CAPs and sometimes CAPs are exempted from these rules, depending both on the applicable jurisdiction and on the nature of the investment product through which the plan is funded. It may be that securities legislation is not the appropriate regulatory framework for these employer-sponsored plans in which the employers and administrators owe fiduciary duties to members, and in which the nature of the investment decision may be different from the typical retail securities transaction. However, it is important that members in these plans receive appropriate and equivalent regulatory protection and investment information, regardless of the legislation that currently applies.

The following is a fictional pension plan scenario which points out some of the issues faced by regulators, and employers and administrators in the current environment.

(i) Scenario Facts:

The fictional pension plan is a large, single employer ECDCPP which is provincially regulated. The plan is administered by a board of trustees (the "Administrator"), whose responsibilities are set out in the trust agreement establishing the plan and in provincial pension legislation. The Administrator has a fiduciary duty to the plan members under both pension legislation and trust law. The plan has a written statement of investment policies and procedures which it must follow.

The plan offers members a small number of choices, ranging from conservative to less conservative investment funds managed by the Administrator. The Administrator provides educational materials to plan members concerning investing and asset allocation, the investment funds available to the members, the plan's annual report which includes audited financial information, and quarterly account statements describing a member's investments under the plan. Plan members do not receive a prospectus relating to these investment funds. Plan members are permitted to change their investment choices.

The plan does not have a registered advisor or registered salesperson available to provide advice to plan members about the investment options available to them. The Administrator suggests (but does not require) that individuals receive investment advice from a registrant of their choice when they join the plan and when the investment options change.

(ii) Scenario Issues:

The requirements of securities legislation to have a registered salesperson and a prospectus for the investment funds into which members invest their pension assets would apply since individual members are making investment decisions. There is no statutory exemption for such transactions. The plan itself (or the Administrator on behalf of the plan) is not making the investments and therefore cannot rely on the "sophisticated purchaser" exemptions.

The plan argues that securities law may not be appropriate in the circumstances. But the trustees are also concerned about investment choices being made by members, and whether those choices are properly informed and reasoned choices. The trustees are uncertain as to the scope of their potential liability as a result of their fiduciary responsibilities under pension legislation and trust law if a plan member experiences poor investment performance results. As well, they are concerned about the potential for liability if there has been any non-compliance with securities law.

Plan administrators are becoming increasingly aware that in most cases exemptions from securities legislation are not available to them. They have expressed concern about the cost and administrative complexity of having to comply with all of the requirements of securities legislation in addition to requirements under pension legislation. As a result, some plan administrators have applied to securities regulators for relief from prospectus and registration requirements in order to eliminate what is perceived to be unnecessary regulatory "overlap".

This scenario is just one example of the difficulties with the current regulatory system. Regulators note that investors assume greater risk in defined contribution plans than in defined benefit pension plans where members are guaranteed a certain benefit at retirement without any responsibility for the investment of their contributions. Investors assume even greater risks in ECDCPPs and other CAPs. Consequently, regulators are concerned about the adequacy of the information being provided to plan members, and whether it is a sufficient and appropriate substitute for the disclosure in a prospectus. Regulators are also concerned about the lack of advice from a registered sales representative or advisor to ensure that investment choices are suitable.

The principles proposed by this paper are designed to provide a harmonized regulatory approach to all of these issues, and to meet the needs of both plan members, and employers and administrators.

III THE MARKET REALITY: AN OVERVIEW OF THE CAP MARKET

This section contains a summary of current statistics on all defined contribution pension plans (including ECDCPPs and traditional defined contribution pension plans), group RRSPs, DPSPs and EPSPs. Statistics on money purchase plans are useful because the majority of these plans offer investment choices to members and thus, are included within the definition of CAPs for purposes of this paper.

(i) The CAP Market

According to the Benefits Canada 1999 Money Purchase Plan Report,[3] administered money purchase plans break down as set out in the following table:

	Group RRSPs	DCPPs (includes ECDCPPs & "traditional" DCPPs)	DPSPs	EPSPs & other non-registered retirement & savings plans	Total
Assets (billions)	$ 22.6	$ 16.4	$ 3.1	$ 4.1	$ 46.2
Number of Plans	30,362	10,066	1,407	_	41,835
Individual Members	1,555,410	860,791	356,092	_	2,772,293
% of Money Purchase Market	49%	36%	7%	8%	100%

[3] Kevin Press, "Money Purchase Plan Report 1999" (December, 1999), *Benefits Canada*, 33.

More recent statistics indicate that the total administered assets for the money purchase plan market was $60.2 billion for the year ending June 30, 2000.[4]

(ii) Who Administers CAPs?

- Life insurance companies administer approximately 67% of CAPs in Canada and trust companies are responsible for the administration of approximately 28% of these plans.[5]

- Most CAPs administered by life insurance companies are funded through a group insurance contract, also referred to as a group annuity contract, which is a contract of life insurance governed by the provisions of provincial insurance legislation. The investment options underlying the group annuity contract are either guaranteed options, called guaranteed funds, or segregated funds.[6]

- Based on information received from CAP providers, where their funds are administered by trust companies or investment dealers, they are generally invested in investment funds which may be subject to securities regulation.

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[4] Kathryn Dorrell, "2000 Defined Contribution Plan Report" (December, 2000), *Benefits Canada*, 45.

[5] William M. Mercer, *Survey of Defined Contribution Plans* (December, 1999). It should be noted that this survey of 206 plans covers defined contribution plans including registered pension plans (both ECDCPPs and "traditional" DCPPs), group RRSPs and DPSPs. Approximately 60% of the plans surveyed administered a defined contribution pension plan.

[6] Canadian Life and Health Insurance Association, *Defined Contribution Pension Plan Investment Disclosure Regulation* (November, 1999), 10.

(iii) How many CAP members make their own investment decisions?

- 82% of CAP members have the right to choose how to invest employee contributions and 72% of CAP members have the right to choose how to invest employer contributions.

- 90% of CAPs offering investment choices have 5 or more investment options, with an average of 12 investment options being available to members.

- 80% of CAPs allow members to change their investment selection at any time.

- Just over 50% of CAPs offer some form of investment education to all members, about 50% offer individual counselling for members generally through securities registrants and 39% offer no investment education whatsoever.[7]

From these statistics, we can conclude that the CAP market is large, with a significant number of plan members affected by the current and proposed rules. The majority of CAPs are invested in group insurance contracts. Where the group insurance contract is able to meet the requirements of specific exemptions in securities legislation, the contract issuer is not required to have a prospectus and is not required to use a salesperson registered by securities regulators. Most CAP members are provided several investment choices. The above information also suggests that most members of CAPs are in ECDCPPs or group RRSPs, which are the primary focus of this paper.

[7] The information in the last four bullet points is from the William M. Mercer *Survey of Defined Contribution Plans* (December, 1999). It should be noted that this survey of 206 plans covers defined contribution plans including registered pension plans (both ECDCPPs and "traditional" DCPPs), group RRSPs and DPSPs. Approximately 60% of the plans surveyed administered a defined contribution pension plan.

IV FUNDAMENTALS OF CURRENT REGULATORY MODELS

This section reviews the fundamentals of pension, securities and insurance regulation, and describes how these principles are currently applied to ECDCPPs and other CAPs. There is also some discussion about why these regimes may not adequately address the public policy concerns arising from CAPs. The application of trust regulation is briefly considered. As well, the fundamentals of the U.S. ERISA regulatory model are reviewed.

(i) The Fundamentals of Pension Regulation

Pension legislation is primarily intended to protect and preserve employees' pensions derived through employment. Provincial and federal pension legislation, in conjunction with the federal income tax requirements, provides the regulatory framework for employer-sponsored registered pension plans.

Pension standards are intended to ensure a minimum level of protection for members and other beneficiaries of pension plans by setting out a comprehensive set of rules governing the operation of pension plans, and establishing a regulator who has the duty and remedial authority to enforce compliance with these rules.

Pension legislation utilizes four fundamental principles to achieve the objective of protecting plan beneficiaries. For each registered pension plan:

- the plan administrator has an overriding fiduciary duty to the plan members with respect to the administration of the plan and investment of the pension fund;
- the plan must satisfy prescribed minimum standards relating to structure and administration;

- the plan must satisfy prescribed minimum requirements regarding the investment of the fund and the ongoing funding of the plan; and
- initial and ongoing disclosure about the plan must be provided to or made accessible to members and other plan beneficiaries, and certain disclosure must also be provided to the regulator to ensure compliance with pension legislation.

(a) Plan Administrators' Fiduciary Duties

Each plan must have a plan administrator, and a plan may only be administered by an administrator as defined in pension legislation. In most pension plans, the employer is the plan administrator, but the plan administrator may also be a pension committee, board of trustees (in the case of multi-employer pension plans), an insurance company if all pension benefits are guaranteed by it, or another agency or board responsible for the plan as prescribed by legislation.

The plan administrator has a statutory fiduciary duty to administer the plan and fund in the best interests of the members and other plan beneficiaries. More specifically, the plan administrator's fiduciary duty includes the obligation to invest the fund assets prudently and in the best interests of plan beneficiaries, using all relevant knowledge and skill in the administration and investment of the fund. The fiduciary duty, "prudent person", knowledge and skill standards imposed on a plan administrator are also applicable to any agents employed by the administrator.

In addition to the statutory duties imposed on a plan administrator and their agents, the common law imposes a high standard of care and overriding fiduciary obligations on a plan administrator and their agents. A plan administrator and their agents are considered fiduciaries under both pension legislation and the common law.[8]

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[8] In Québec, plans must be administered by a pension committee that acts as trustee and whose mandate is one of full administration. The fiduciary duties of the pension committee are governed by the provisions of the Civil Code of Québec. The Supplemental Pension Plans Act specifies that the pension

(b) Minimum Standards - Administration of Plan

Each pension plan must have supporting documentation which contains prescribed information including details about the appointment of the plan administrator, the mechanism for establishing and maintaining the pension fund, and how administration costs of the plan and fund are to be handled.

(c) Minimum Standards - Pension Fund

Pension legislation contains a number of rules intended to ensure plans are adequately funded. Plan administrators are required to prepare an investment policy covering the prescribed investment issues (i.e., Statement of Investment Policies and Procedures ("SIP&P")), regularly review the investment policy and invest the assets of the plan in accordance with the investment policy. Moreover, pension legislation contains a number of specific investment restrictions which are designed to ensure pension funds are adequately diversified and managed so as to avoid conflicts of interest.

Plan administrators are also required to regularly prepare and in some cases submit for filing, certain information designed to ensure the adequacy of funding and compliance with minimum standards funding rules (e.g., annual information returns, financial statements, cost certificates and actuarial valuation reports).

(d) Disclosure Standards

Pension legislation imposes several disclosure obligations on plan administrators as a means of ensuring meaningful and ongoing communication about the pension plan, and

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committee shall exercise the prudence, diligence and skill that a reasonable person would exercise in similar circumstances.

members' benefits and entitlements under the plan. These disclosure obligations include the following requirements:

- plan administrators must provide members and potential members with an explanation or summary of the plan;
- plan administrators must provide members with annual statements that disclose prescribed information, including the rate of interest credited on contributions; and
- plan administrators must make prescribed plan information available for inspection by members and others with an interest in the plan (e.g., a trade union that represents members of the pension plan), including required plan filings such as audited financial statements and annual information returns.

(e) How Pension Principles are Applied to ECDCPPs and other CAPs

The four fundamentals of pension regulation are currently applied to ECDCPPs. However, some of these principles need to be adapted in order to be relevant and useful for plan administrators and members of ECDCPPs. In particular, the disclosure obligations need to be modified to ensure an adequate level of disclosure to members of ECDCPPs to enhance investor protection and enable informed investment decisions.

Plan administrators of ECDCPPs and their agents have a fiduciary duty to administer the plan and fund in the best interests of the plan beneficiaries, and invest the fund prudently, using all reasonable knowledge and skill. However, plan administrators' fiduciary duties for ECDCPPs should be clarified in light of the fact that members also make investment decisions.

Minimum standards regarding the administration and operation of pension plans also apply to ECDCPPs. These plans must contain supporting documentation regarding the appointment of the plan administrator, the establishment and ongoing maintenance of the pension fund, and the handling of administration costs of the plan and fund. Because the various investment options in an ECDCPP may be quite different, and, among other things, the administration costs for the various options may be handled differently, there is a need to clarify the applicable principles for ECDCPPs in this area.

Minimum standards regarding pension funds also apply to ECDCPPs. Plan administrators of these plans are required to prepare a SIP&P, review the SIP&P annually and ensure each of the investment options complies with the SIP&P. Plan administrators of ECDCPPs must also ensure each investment option complies with specific investment restrictions in pension regulation, and regular funding reports in respect of the pension fund are prepared and in some instances filed, with the relevant regulator.

The disclosure principles underlying pension regulation also apply to ECDCPPs. However, current pension disclosure principles require changes to address the more varied investment options available in ECDCPPs. Plan administrators of ECDCPPs are required to provide members and potential members with an explanation or summary of the plan, including investment options, and members must also be provided with annual statements that disclose prescribed information (e.g., total contributions, interest). Members must also be given access to prescribed plan documents and notice of significant changes in the plan such as certain plan amendments, a plan conversion or a plan merger. Because members assume a greater investment risk in ECDCPPs, clear and specific disclosure obligations regarding the investment options are required.

Pension regulation is currently limited to employer-sponsored registered pension plans in most jurisdictions since other CAPs such as group RRSPs, DPSPs and EPSPs are specifically exempt from most pension laws.

(ii) The Fundamentals of Securities Regulation

Securities law governs certain investment products and the way in which such products are sold. If the products are mutual funds, securities law also governs their management.

Securities laws have four broad objectives:

- to ensure that investors have access to the information they need to make informed investment decisions;
- to provide rules of fair play for the markets;
- to establish qualifications and standards of conduct for people registered to advise investors and to trade on their behalf; and
- to protect the integrity of the capital markets and the confidence of investors.

To achieve these objectives, securities laws require that those involved in trading or advising in securities be registered, that any entity issuing securities do so by way of a prospectus, and after the security is issued, that entity must provide ongoing financial disclosure to the investor.

Securities law only addresses consumer education on investing and asset accumulation through the requirement that the registered representative fully inform the investor about their investments, and securities regulators carry out some educational activities as part of their general mandates.

(a) Registration

Unless there is an applicable exemption, anyone that trades in securities or is in the business of advising in securities must be registered. There are a number of registration requirements designed to ensure the proficiency, good character, and financial viability of those involved in trading or advising in securities. Regulators may suspend or revoke registration in appropriate circumstances, thereby removing those who are no longer fit for registration from the capital markets.

Registrants must meet prescribed educational standards, maintain prescribed books and records, maintain a minimum working capital, and comply with all other securities law requirements including rules governing conflicts of interest and disclosure to clients. In addition, registrants have certain duties. These include the duties to act honestly, fairly and in the best interests of the client, to learn all of the essential facts about the client and to recommend only investments that are suitable. In some provinces, registrants also have a positive duty to advise if they believe a proposed investment is unsuitable for a client.

In addition, certain registrants (i.e., the dealers employing the salespeople) have an obligation to supervise the activity of registered salespeople and advisors. This obligation imposes an additional “check and balance” on the system by ensuring that the activities of the individual dealing with the client are monitored not only by the regulators, but by the dealers who employ them who have more immediate control over their actions.

(b) Disclosure

Unless there is an applicable exemption, those who issue securities must provide the purchaser with a prospectus containing “full, true and plain” disclosure of all material facts about that issuer. The prospectus must be filed in advance with securities regulators, who can refuse to allow an offering of securities to proceed if the disclosure requirements of securities legislation have not been met. Securities legislation also provides investors with rights of rescission and civil remedies for material misrepresentations in a prospectus. These remedies are available whether or not the investor relied upon or even read the prospectus. The securities regime aims to ensure the investor receives a document that contains all available, relevant information about the issuer. It also makes the document's drafters responsible for that information. This enables investors to make informed investment decisions. When certain exemptions are used, the issuer is required to provide the investor with an offering memorandum. While similar to a prospectus, the disclosure in an offering memorandum is to a lower standard; this information is required to be true, and must not omit any facts which would make the information provided incorrect.

Any issuer that has filed a prospectus, including a mutual fund, is also required to provide "continuous disclosure" about its affairs including periodic financial statements and timely disclosure of changes that would affect the market price or value of its securities.[9] Mutual funds must also disclose changes that would be considered important by a reasonable investor in deciding whether to purchase or continue holding the securities of the mutual fund. This information must be disclosed generally to the public, and not only to investors. This public disclosure means that both existing investors and potential investors have information that they can use to decide whether they want to either buy the security or continue to own the security.

(c) Structure and Operation of Investment Funds

Securities legislation generally does not govern how a security or a security issuer must be structured or how they operate. The regulation of "retail" mutual funds is an exception to this general principle. This exception was created because: (i) retail mutual funds are primarily sold to investors who may not have the expertise or interest

[9] Specific continuous disclosure requirements vary depending on the jurisdiction. The information provided here is what a "reporting issuer" as defined in various province's securities legislation must generally provide to the public.

in doing hands-on investing; (ii) mutual funds are in "continuous distribution"; (iii) mutual funds have the unique characteristic of being redeemable on demand; and (iv) mutual funds engage in a form of advising or investment management, and are not simply security issuers.

As a result, the regulation of mutual funds focuses on:

- ensuring the fund is liquid so that it can meet demands for redemption;
- ensuring the fund has diversified investments so that overall risk is reduced and liquidity is increased;
- conflict of interest rules for fund managers (e.g., prohibition against dealing with parties related to the fund manager); and
- a legislated standard of care that a mutual fund manager must satisfy in its operation of a fund.

(d) How Securities Principles are Applied to ECDCPPs and other CAPs

These fundamentals of securities regulation are currently applicable to ECDCPPs, group RRSPs, DPSPs and EPSPs that offer securities as investments. In particular, the requirement for a prospectus and to sell the security through a registrant apply unless there is an applicable exemption.

In most cases, CAPs are funded by group insurance contracts (i.e., group annuities) or individual variable insurance contracts (IVICs). Where these products meet specific requirements described in securities legislation, they may either be exempt from the definition of security so that securities legislation generally does not apply, or they may qualify for a specific exemption from the requirement to provide a prospectus and sell the product through a registrant.

In some jurisdictions there are other exemptions[10] that may, depending on the facts, be applicable to some ECDCPPs and CAPs. These exemptions are quite narrow; some employers and administrators may have been relying on the exemptions in error.

It has been suggested that ECDCPP investment transactions are exempt from the prospectus and registration requirements of securities legislation since the total amount of the investment is greater than the minimum required under securities legislation. However, investments from a number of investors can be aggregated to meet these thresholds only if a portfolio manager has full managerial discretion over the individual accounts. This is not the case for ECDCPPs because the employee makes the investment decision. Therefore, to the extent that an ECDCPP or other CAP relies on the minimum "sophisticated investor" exemptions and the assumptions of this discussion apply, that reliance is misplaced.

The existing securities regime requires non-exempt transactions to be conducted through a registrant and the member must be provided with a prospectus for the securities that they purchased within two days of the trade.

At present, it appears that some plan administrators, employers and other third parties who offer investments that fall within the above assumptions, do not comply with these requirements when offering ECDCPPs and other CAPs to members. As a result, members are receiving securities without the protection provided by securities legislation. As well, in most cases, the employee members of these plans do not meet the requirements in the available exemptions. Accordingly, investment transactions involving some ECDCPPs are not in compliance with securities legislation.

[10] For example, the "private mutual funds" exemption in some jurisdictions provides a narrow exemption for certain mutual funds. As well, Ontario Securities Commission Rule 32-503, *Registration and Prospectus Exemption for Trades by Financial Intermediaries in Mutual Fund Securities to Corporate Sponsored Plans,* applies to certain trades in securities where the security is sold to a CAP. The latter exemption is technical and narrow, and it should be reviewed carefully before being relied upon.

(iii) The Fundamentals of Insurance Regulation

Insurance products are contracts between the insurance company and the policyholders. In some cases, the contracts relate to one person (the insured), who may be the policyholder, but the policyholder can be another person that has an insurable interest in the insured person. These are known as individual insurance policies. In other cases the contracts are structured as group insurance policies.

In the case of group insurance, people who benefit from the contract are not the policyholder. An example would be employees under a policy owned by their employer. The contract in this example is under the control of the employer, and the employees are only entitled to benefits under the contract. The employees are considered insured persons and enroll for coverage under the group insurance policy. There are no individual contracts between the employees and the insurance company. The employees are entitled by law to receive a certificate of coverage that must disclose certain information. Licensed agents are not required in order to enroll the employees. Accordingly, there should be some relationship between the policyholder and the insured persons in group insurance to ensure a congruence of interests and stability of the group.

There are advantages and disadvantages of both individual and group insurance. The principal advantage of group insurance is that it can be lower in cost since there are administration and distribution savings. The principal advantage of individual insurance is that the individual controls the contract and it can be more tailored to individual circumstances.

Insurance regulation is largely intended to protect purchasers of insurance contracts. Provincial insurance legislation, and in certain instances, the federal insurance requirements, provide the regulatory framework applicable to insurance companies and insurance contracts.

Insurance legislation ensures a minimum level of protection for purchasers of insurance by setting out detailed rules governing the solvency of insurance companies, and specific requirements regarding the conduct of insurers and their agents during the selling and claims process. Also, insurance legislation establishes a regulator who has the duty and remedial authority to enforce compliance with these rules.

In a typical insurance transaction, a purchaser of insurance enters into a contract with the insurer which sets out the obligations of the insurer and the insured. Insurance regulation uses three fundamental principles to achieve the objective of protecting the insured:

- a level of financial security is associated with the insurance promise;
- purchasers of insurance must be treated fairly during the selling process and claims process; and
- insurance advisors must satisfy certain educational and conduct requirements.

(a) The Insurance Promise

The insured party in an insurance contract has the security of knowing that the insurer will make a payment under the contract as long as the insured fulfills its obligations, including the payment of premiums. Through prudential regulation, insurance regulators try to ensure financial viability of insurers so that they have the financial resources to meet the promise to pay. In the event of the failure of an insurance company, there are industry funded compensation plans to pay the obligations to the insured parties, up to set limits.

(b) Fairness

Insurance regulation requires that purchasers of insurance must be treated fairly both in the selling process and the claims process. There are regulations prohibiting unfair, misleading, deceitful and discriminatory acts by insurance companies and insurance advisors.

(c) Competence of Insurance Advisors

Insurance advisors are required to complete educational programs before obtaining a license to ensure they have a minimum level of knowledge about the products they are selling. Complaints against advisors are investigated by regulators and disciplinary action taken where warranted.

(d) How Insurance Principles are Applied to ECDCPPs and other CAPs

There are no provisions in insurance legislation, policies or guidelines in Canada that specifically regulate group ECDCPPs or other group CAPs. Such plans which are administered by life insurance companies must comply with applicable pension standards in the case of ECDCPPs, and where these plans meet specified requirements described in securities legislation, they may either be exempt from the definition of security so that securities legislation generally does not apply, or qualify for a specific exemption under securities legislation from the requirement to provide a prospectus and sell the product through a registrant.

The insurance regime may, however, be applicable to single member ECDCPPs that are funded by way of an individual variable investment contract (IVIC). The requirements for IVICs are incorporated into insurance legislation by way of reference to the IVIC guideline developed by the Canadian Life and Health Insurance Association.

This guideline contains detailed provisions to ensure the plain disclosure of material facts, and presumes that the member will understand the meaning of those facts. These disclosure requirements are not intended to be a source of consumer education on asset accumulation. The IVIC guideline is not applicable to the majority of ECDCPPs which are funded by way of a group insurance contract.

The insurance regime also requires that both individual and group insurance policies contain certain information, including disclosure of the amount or method of determining the amount of insurance money payable, and the conditions under which it becomes payable. Insurance legislation also provides that certificates under group policies disclose the amount or method of determining the amount, of insurance on the group life.

(iv) Trust Regulation

The regulatory regime applicable to trust companies does not specifically deal with the regulation of CAPs. The pension, securities and insurance regimes discussed above, plus any applicable common law fiduciary duties, govern the regulation of CAP funds and the investment information provided to members of CAPs, including those CAPs which are administered by trust companies.

(v) The Fundamentals of the U.S. *Employee Retirement Income Security Act of 1974* ("ERISA")

In the U.S., there have been rules in place regarding investment disclosure to members of defined contribution pension plans for some time. It is useful to examine the ERISA model for purposes of this discussion because:

- U.S. plan administrators in circumstances similar to those of Canadian CAPs have been following ERISA, and their experience could be relevant and useful; and

- Several Canadian CAP providers, particularly insurance companies, currently follow ERISA's lead and provide the same type of information to members of CAPs (including both ECDCPPs and group RRSPs) that is required of U.S. sponsors of defined contribution pension plans under ERISA.

ERISA only deals with defined contribution pension plans, and does not cover other types of CAPs in the U.S.

ERISA provides protection to members through fiduciary duties and minimum standards for investment disclosure. ERISA also provides relief to plan administrators from potential liability for the investment choices of their members, if they follow ERISA section 404(c) rules. The following is a summary of those rules:

- Plan administrators, agents, advisors and anyone else exercising discretion over the assets or administration of a plan, have a fiduciary duty to invest and manage plan funds as a prudent person with the appropriate expertise would do, in the best interests of plan participants and beneficiaries, for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries must also diversify plan investments to minimize the risk of losses, follow the terms of plan documents which are consistent with ERISA and avoid conflicts of interest. (These rules are similar to Canadian pension standards regarding plan administrators' fiduciary duties).

- If the plan participants or beneficiaries exercise independent control over their assets as set out in section 404(c), the plan fiduciaries will be relieved of liability for any losses or breaches that result from the participants’ or beneficiaries’ investment choices. Fiduciaries are still responsible for selecting and monitoring investment alternatives to ensure that they are prudent and adequately diversified, and monitoring fees and expenses for reasonableness.

- In a plan that does not meet 404(c) standards, fiduciaries do not receive any specific relief from liability for participants' asset allocation decisions.

Detailed regulations under ERISA establish standards to determine whether employees are deemed to have effective control over the investment of their assets under 404(c). For example, in qualifying 404(c) plans, administrators are required to offer at least three diversified core investment alternatives with materially different risk and return characteristics in a reasonable range for the members. Administrators are also required to permit switching between investment options at least quarterly for each core alternative, and more frequently for more volatile funds.

With respect to investment disclosure, administrators must automatically provide members with certain information prior to investment, including:

- an explanation that the plan is intended to be a 404(c) plan and fiduciaries may be relieved of liability;
- a description of each investment option, including the investment goals, risk and return characteristics;
- information about investment managers;
- information about when participants may give investment instructions, restrictions and penalties relating to fund transfers;
- a description of the type of fees that may be charged to the participants' account; and
- a copy of the most recent prospectus provided to the plan if the investment is

subject to securities legislation (this can be given immediately before or after investment).

Administrators must also provide certain information to members upon request, including the following:

- information on the annual operating expenses of each designated investment alternative;
- copies of prospectuses, financial statements or other reports on the investment alternatives which have been provided to the plan;
- asset lists, share or unit values (past and present) and fixed rate investment contract details (if applicable) relating to the investment alternatives; and
- the value of the shares or units held in the particular participant's account.

V THE PROPOSED REGULATORY PRINCIPLES

This section sets out the proposed principles that could form the basis for a regulatory model for CAPs. These principles are largely derived from the current pension, insurance and securities models, and the U.S. ERISA model, as set out in Section IV.

The fundamental principles for the proposed regulatory model are:

(i) Obligations with respect to the establishment and maintenance of a CAP;

(ii) A minimum level of disclosure for new CAP members and continuous disclosure;

(iii) CAP members may either rely on advice provided by a registered sales representative or advisor, or receive and rely upon appropriate investment information from a party that owes fiduciary duties to the members; and

(iv) The investment products or funds must comply with minimum standards (e.g., investment restrictions and practices, valuation/redemptions, and fundamental changes).

The proposed principles seek to clarify some of the fiduciary duties of employers and administrators, creating more certainty for those responsible for CAPs. It is not proposed that plan administrators and employers would be held harmless for investment losses of members, if the principles were followed. The principles are designed to meet the legitimate concerns of employers and administrators that their responsibilities are currently unclear, while ensuring members are reasonably protected. Under the proposals, plan fiduciaries will have clearer obligations, while still having the general duty to act reasonably and prudently with respect to members.

(i) Plan Administrators' or Employers' Fiduciary Duties Regarding the Establishment and Maintenance of a CAP

Plan administrators' or employers' fiduciary duties should specifically include the duty to:

1. Select investment options for members which offer a reasonable range of options with different risk and return characteristics, each of which is diversified;

2. Prudently select, using all relevant knowledge and skill, the investment managers for each investment option;

3. Prudently monitor the performance of the investment managers for each investment option, including setting and monitoring benchmarks for investment performance according to the type of fund, and taking appropriate action where performance is unsatisfactory;

4. Where no prospectus is provided, ensure contracts with a third party provider or investment manager allow the plan administrator or employer to pursue an action on behalf of members for any misrepresentation about the investments; and

5. Allow members reasonable opportunities to switch between investment options without penalty.

(ii) Plan Administrators' or Employers' Fiduciary Duties re: Initial and Continuous Disclosure

Plan administrators' or employers' fiduciary duties include an obligation to provide members and potential members with a summary of the CAP outlining its terms and provisions, and explaining members' rights and obligations under the CAP. The initial disclosure should include:

1. An explanation of the nature of the CAP, and the liability of the plan administrator or employer and members for investments;

2. A description of the investment options available and instructions on how to make investment choices;

3. Information on transfer options, and any applicable transfer penalties or fees;

4. Management and investment fee information for each investment option;

5. Details of fund performance including a discussion of performance against the established benchmarks;

6. The default option if a member fails to make any investment choices;

7. A standardized consumer guide including a “retirement income profile” to educate members about investments; and

8. Directions as to how the member can obtain additional investment information.

Specific information on each investment option should be included in the initial disclosure to CAP members and made available to CAP members during their participation in the plan. This information is necessary to ensure informed investment decisions at the outset and when CAP members switch their investment options. The disclosure for each investment option should include the objective and strategy of the investment option, risk and return characteristics, details on diversification, the name of the investment manager, historical returns, and any other relevant investment information such as voting rights. Alternatively, existing prospectuses (simplified or full) may be provided with a wrapper modifying the terms of the prospectus as appropriate for the particular CAP (e.g., stating that the sections regarding the payment of commissions by purchasers do not apply). Given that CAP members are making investment decisions which are similar to decisions made by mutual fund investors (i.e., on average they have 12 possible investment options to choose from), simplified prospectuses may serve as a useful guide regarding the type of information expected to assist members in making investment decisions.[11]

Continuous disclosure should include:

1. Annual statements containing information such as the total contributions in each

[11] Part B of the simplified prospectus, which must be provided to mutual fund investors, includes the following information: organization and management details, fund details, fundamental investment objectives, investment strategies, top ten holdings, risks, suitability, past performance, distribution policy and financial highlights.

member's account, share/unit value information for each member's account, interest and investment income earned, a listing of transactions in each member's account during the year and any associated fees, annual operating fees for each investment option, share/unit value information for each investment option, and details on how to access other information on the CAP or the investment options;

2. Access to specific information on each investment option, and material change reports on changes in investment options including members' rights or options in respect of the change;

3. Financial statements for each investment option and asset lists of the portfolio of each investment option; and

4. Details of fund performance including a discussion of performance against the established benchmarks.

(iii) Plan Administrators' or Employers' Fiduciary Duties to provide Appropriate Investment Decision-Making Tools to CAP Members

Plan administrators' or employers' fiduciary duties should include the duty to:

1. Ensure that members deal with a registered sales representative or advisor; or

2. Take reasonable steps to ensure members (i) are provided with the recommended initial and continuous investment information discussed above, which should be presented in a manner appropriate for the members; and (ii) receive appropriate assistance with making investment decisions. For example, this may involve reviews of members' investment choices for suitability based on

their 'Know Your Client' profile, surveys of members' investment knowledge, or creating a process to allow members' to communicate their investment information needs to the plan administrator or employer, for the purpose of ensuring the effectiveness of the investment material and other assistance provided to members.

(iv) Investment Rules

Each investment option should comply with minimum investment rules designed for CAP investment options, to ensure, among other things, adequate diversification of funds, the avoidance of conflicts of interest and an acceptable level of risk.

Minimum investment rules will ensure that CAP members will be able to withdraw their retirement funds at any time, or change their asset allocation by moving some or all of their funds to other investment options under the CAP. Also, since CAPs are primarily intended to be long term savings vehicles for retirement, there should be minimum standards to ensure that the investment options presented to members are not subject to excessive risks such as those associated with a highly leveraged investment portfolio.

Minimum investment rules should not prevent members of CAPs from having access to a reasonable range of investment options with different investment objectives. On the contrary, a range of investment options is necessary and should be provided. However, given the purpose for which they are investing, CAP members should not be subject to any greater risks than investors in retail mutual funds or segregated funds.

VI CONCLUSION

This paper discusses perceived problems with the current rules, or lack of rules in some cases, regarding investment disclosure to members of CAPs. It then proposes a set of principles that, if implemented, would:

1. Provide similar protections for all members of CAPs, regardless of the investment vehicle (e.g., ECDCPP, group RRSP, and others) and regardless of the type of investment product (e.g., insurance contracts, mutual funds, and others); and

2. Harmonize rules across regulatory jurisdictions.

The proposed principles include new investment rules to apply to investment options not currently regulated under securities law, to ensure an equivalent level of protection for members in all CAPs.

These principles were developed after reviewing the existing legislation applicable to CAPs, and the ERISA investment disclosure rules applicable to defined contribution pension plans in the U.S. The proposed regulatory principles are published here for comment and discussion.

(i) Implementation of the Proposed Regulatory Principles

The paper does not address the method of implementing the proposed principles. As part of the consultation process, and to determine not only appropriate principles but also the most effective method of implementation, the Working Committee is asking for specific comments on this issue. To facilitate this discussion, the following are some possible implementation options for consideration and comment:

1. The industries involved in CAPs could develop harmonized guidelines, together with the Joint Forum, which are then adopted by the applicable regulatory authorities through regulation or rules.

2. Best practices guidelines could be issued by the Joint Forum through its various member regulators. These could be similar to the various best practices guidelines for pension plans issued by the federal Office of the Superintendent of Financial Institutions.

3. The Joint Forum could use the finalized principles to develop stand-alone model legislation for CAPs, or model regulation which could be adopted into regulations, rules, or national policies under the applicable pension, securities and insurance regimes in each jurisdiction.

The Working Committee is also interested in receiving comments proposing any other implementation option that could be utilized by all relevant regulators to create a harmonized regulatory regime.

(ii) Consultation Process

The Joint Forum invites written comments and suggestions regarding any aspect of this consultation paper. In particular, the Joint Forum hopes to hear from interested parties on the following questions:

1. Are the statements in the paper about the existing regulatory environment accurate, in your experience?

2. Are the proposed regulatory principles appropriate and adequate to address the needs of CAP members, plan administrators, employers and regulators?

3. What would be the most effective and practical method of implementing the regulatory principles that emerge from this process?

4. What are the anticipated short-term and long-term costs (in $ and in plan coverage) of implementing the proposed regulatory principles?

Written submissions regarding this report should be sent to:

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The Working Committee will consider all submissions received by July 31, 2001.

Questions arising from this consultation paper may be directed to any of the members of the Working Committee, as set out in Appendix A.

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