

Research Study

**Implications of the Use of
Investment Wrappers**

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All opinions expressed in this report are my sole responsibility, as are all errors and omissions.

A.F.

1. Executive Summary

i. Mandate

We were initially mandated by the Task Force to Modernize Securities Legislation in Canada (“Task Force”) to make recommendations on a Canadian framework for hedge fund regulation. Our findings and recommendations are contained in the report entitled *A Canadian Framework for Hedge Fund Regulation*.

In the course of our research project on hedge funds, we found that structured products are used to transform the legal but not the economic nature of hedge funds. Our research also revealed that hedge funds are only one among many types of investment being wrapped or packaged within other investment vehicles. We also found that structured products are not the only forms of wrappers available. Life insurance products are also used for this purpose.

As a complement to the hedge fund project, we were mandated to assist the Task Force by documenting investment wrappers used in Canada, assessing the implications of their use, examining approaches taken by other jurisdictions in regulating wrapped investment products, and making such recommendations as we deem appropriate.

ii. Structured Products

In the broadest sense, structured products are investment vehicles designed to meet specific investment objectives. They are constructed with building blocks or components in a manner similar to a Lego set. The building blocks include derivatives that are financial instruments whose value is derived from that of another asset known as the underlying asset. Through the use of derivatives, the return on a structured product can be linked with that on the underlying asset.

The building blocks are packaged or wrapped within an investment vehicle which constitutes the wrapper and through which the structured product is offered to investors. Wrappers may take several forms, e.g., notes, bonds, and special-purpose vehicles. A note is the wrapper of choice for principal-protected products because it is a simple, easily understood instrument whose principal is normally repaid in full at maturity.

a) Structured Notes

In Canada, most, though not all, structured products aimed at retail investors are principal-protected. As expected, the wrapper consists of a note. The note is usually issued by a bank, a credit union, or a Crown corporation.

The building blocks of a structured note are a zero-coupon bond and a derivative in the form of a call option. The zero-coupon bond provides the principal protection. The call option provides the exposure to the return on the underlying investment.

The distribution of a security in all jurisdictions of Canada normally requires the filing of a prospectus with the securities commissions and the involvement of a registered dealer in the trade. There is an exemption from these requirements in respect of a trade in a debt security issued or guaranteed by certain entities, including banks, credit unions, and Crown corporations. Structured notes are usually distributed under this exemption.

b) Issues with Structured Notes

Structured Notes Are Complex and Difficult to Understand

Conventional bank deposits such as Guaranteed Investment Certificates (“GICs”) are straightforward and easily understood investments with virtually no risk. Structured notes are more complex and difficult to understand. Certain features of structured notes give rise to special difficulty.

- Structured notes are not standardized products. Features such as the nature of the underlying investment, the term of the note, and management fees vary from product to product. This makes product comparison difficult.
- The nature of the principal protection is widely misunderstood. Many investors are under the mistaken impression that they are protected by the zero-coupon bond and the call option. In actual fact, the investor has an interest only in the note. In the worst case scenario, which is the bankruptcy of the issuer, the investor will rank as an unsecured creditor with no preferential access to the zero-coupon bond or the call option.

- Some structured notes claim that investors will participate in 100 per cent of the return on the underlying investment. This claim may be true only initially and not throughout the life of the note.
- Some structured notes aim at enhancing yield rather than protecting principal. The principal of these products is not protected, yet they are characterised as notes. This characterization may be confusing. Most people expect that the principal of a note, especially when issued by a bank, will be repaid in full at maturity.
- With certain structured notes, the final return is path-dependent, i.e., it depends on the history of prices of the underlying asset throughout the term of the note. This may mean that there is no return even if the price of the underlying asset at maturity is higher than the price on the date of issue. The investor may be surprised at this result.

Due Diligence on Structured Notes Is Complex

Prior to purchasing an investment product, the investor should carry out a due diligence exercise. In practice, this is done on his behalf by the intermediary. In the case of structured notes, certain aspects of the due diligence are complex.

- The investor should evaluate whether the structured note has been fairly priced. When the issuer and the product structurer are related parties, there is a possibility of conflict of interests and due diligence on the pricing of the structured note becomes particularly important. The fair value of a structured note is simply the sum of the fair values of its component parts, i.e., a zero-coupon bond and a call option.
 - The zero-coupon bond is fairly priced when the interest rate charged to the issuer is appropriate in the light of the issuer's debt rating and the terms of the bond. It may not be easy for an investor to evaluate the appropriateness of the interest rate.
 - In order to price the call option, it is necessary to estimate future values for various parameters, e.g., the interest rate, the dividend yield, and the volatility in the price of the underlying asset, and feed them into a model. This may be beyond the capabilities of most investors.
- Under certain protection structures, the proceeds of issue of the note are invested in a feeder fund, which in turn allocates its assets among the underlying investment and money market instruments. A weak performance of the underlying investment will cause

more money to be allocated to money market instruments. There is a pre-determined point at which all the money will be switched to the money market, in which case the investors will probably get only their principal back with no return. The safety margin is the amount that the fund is allowed to lose before all the money is switched to the money market. When the safety margin is low, the fund is particularly vulnerable to a weak performance of the underlying asset, especially in the first few months following the issue of the note. It is not easy to evaluate whether the safety margin is adequate.

Other Issues

Structured notes give rise to a number of other issues:

- The brokerage arm of the product structurer usually operates a secondary market, which constitutes the only source of liquidity to investors wishing to sell their notes prior to maturity. These markets are less liquid than exchanges where several brokers are active. In addition, the difference between the buying and selling prices may be wider.
- Structured notes are normally distributed with a disclosure document known as an information statement. The contents of information statements are not prescribed by securities regulations, and they are not reviewed by the securities commissions. As a result, the quality of information statements varies widely.
- Structured notes usually have terms of six to eight years. The longer the period of time for which an investment is held, the less likely it is that it will lose money. This is particularly true of diversified investments such as most of those that underlie structured notes. If so, why pay for protection? The question assumes its full significance when the investor is unable to buy the underlying investment separately, as is the case for retail investors wishing to buy hedge funds. In this case, if the investor wants hedge fund exposure, he has no choice but to also buy and pay for principal protection which he may not need.
- Structured notes cost more than equivalent non-protected products because of the cost of the guarantee.

c) Possible Regulatory Approaches

These issues echo the regulatory concerns in the foreign jurisdictions that we examined. Regulatory action on structured products in the United States and the United Kingdom has mainly focused on the following objectives:

- Ensure that they are sold only to investors for whom they are suitable;
- Ensure that they are fairly priced in situations of potential conflict of interests; and
- Ensure that the investor understands the product.

We would add a fourth objective. We need to balance investor protection with the legitimate need of product structurers to seize business opportunities and launch new products expeditiously.

In order to meet these objectives, proper disclosure by issuers and structurers of all material facts about the product is vital. Under the existing regime, it is not possible to enforce a uniformly high standard of disclosure. Proper supervision of intermediaries, enforcement of the suitability requirement, investor education, and the management of conflicts of interests are also essential.

Appropriateness of Exemption

The appropriateness of the exemption under which structured notes are currently distributed must be questioned. At least four approaches are possible.

One obvious possibility is to maintain the status quo. Given the numerous concerns discussed above, this approach is difficult to defend.

Another approach would be to make structured notes ineligible to use the exemption. This would effectively subject these products to the normal prospectus filing and dealer registration requirements in securities legislation. If applied across the board, this approach will give anomalous results. For instance, many structured notes are wrapped around mutual funds. It would be anomalous for mutual funds to be eligible to use simplified prospectuses and be distributed by mutual fund dealers while the equivalent protected product requires a long-form prospectus and the involvement of an investment dealer.

Yet another approach would be to set up a new regime for structured notes. However, we are loath to recommend a solution that would further complicate the regulatory framework.

Our preferred approach would be to regulate structured notes according to the underlying investment. For instance, if the underlying investment is a mutual fund, the structured note would be subject to the same requirements regarding simplified prospectus disclosure, continuous disclosure, and sales practices as mutual funds.

Structured notes with more exotic underlying investments would become subject to prospectus filing and dealer registration requirements. To reduce the delays inherent in the review and approval of prospectuses, it would be open to issuers to use shelf registration, provided they are so qualified. Consideration should also be given to fast-tracking the processing of structured notes by the regulatory authorities.

In all cases, structured notes will become subject to regulatory disclosure requirements. This will ensure that all material facts about the product are disclosed in all cases.

Intermediaries Must Be Properly Equipped

Intermediaries have the onerous duty of ensuring that all products sold to investors pass the suitability test. In order to discharge this responsibility adequately, they require knowledge not only of the client but also of the product.

The due diligence on a structured note is complex and requires nothing less than professional expertise. There is no alternative but to ensure that all intermediaries that sell structured notes are properly equipped to do so. This may be achieved by requiring that all such intermediaries employ staff with certain qualifications, such as the Charter Financial Analysts or similar designations. In addition to conducting the due diligence, these employees would be responsible for supervising the trades in structured notes.

The maintenance of investor confidence also requires the strictest enforcement of the suitability rule.

Investors Must Be Educated

Investor education can take the form of brochures demystifying structured notes and explaining the main factors that an investor should take into account in deciding whether to buy the product. We believe that investor education is best achieved with the collaborative efforts of regulators, issuers, product structurers, and intermediaries.

Conflicts of Interests Must Be Addressed

In the US, a fairness opinion is required from a qualified, independent third party when the issuer and lead underwriter are affiliated to one another. The opinion is to the effect that the pricing of the structured product is fair to the investor. There is no such requirement in Canada.

Consideration should be given to requiring a fairness opinion from a qualified, independent third party when the issuer and product structurer are related parties.

iii. Life Insurance Wrappers

For many years now, life insurance companies have been driven by demographic considerations to expand their offering of investment products. The most common investment products offered by life insurers are segregated funds and universal life insurance policies.

a) Segregated Funds

Segregated funds are variable annuities and are so called because they are segregated from the general fund of the life insurer. The investment risk is borne by the client, not the life insurance company. However, the latter does guarantee a minimum value for the segregated fund at maturity or at the death of the holder, whichever happens earlier. Products with 75 per cent protection of principal at maturity are now the norm. If the holder redeems his investment prior to maturity, the guarantee does not apply.

From a legal perspective, a segregated fund is a life insurance contract with a life insurer. From an economic perspective, it is an investment fund around which a life insurance contract offering

certain guarantees has been wrapped. Often, the investment fund is a mutual fund managed by a third party and available for purchase on a stand-alone basis.

Harmonization of Segregated Fund and Mutual Fund Regulations

Given the close similarity of segregated funds and mutual funds, it would make sense for the regulation of the two products to be harmonised.

As a matter of fact, the securities and insurance regulators have, through the Joint Forum of Financial Market Regulators (“Joint Forum”), been working for some time now on projects to harmonise the regulation of segregated funds and mutual funds.¹

We believe that the areas where harmonisation would be most beneficial are as follows:

- Disclosure;
- Investment rules applying to the funds; and
- Distribution.

In 2003, the Joint Forum published a consultation paper on harmonising point of sale disclosure for segregated funds and mutual funds. The Joint Forum saw this as an opportunity not only to harmonise but also to modernise the disclosure requirements. The most significant proposal was to adopt a “layered” approach to disclosure, whereby the material would be made available to investors in components. Investors would decide for themselves how much information they want to receive. We fully support the layered approach to disclosure.

The investment rules governing segregated funds are less restrictive than those applicable to mutual funds. As a result, segregated funds are able to offer a wider choice of investment strategies. The Joint Forum has a project to identify the problems resulting from differences in investment rules and develop appropriate recommendations. We support this project. We believe

¹ The Joint Forum was founded in 1999 by pension, securities, and insurance regulators. It seeks to coordinate the development of harmonised approaches to financial services regulation across sectors as well as across jurisdictions. Its members are the Canadian Council of Insurance Regulators (“CCIR”), the Canadian Securities Administrators (“CSA”), the Canadian Association of Pension Supervisory Authorities (“CAPSA”), and the Canadian Insurance Services Regulatory Organizations (“CISRO”).

that the exercise should be taken as an opportunity to broaden the investment powers of mutual funds rather than to restrict those of segregated funds. For instance, leverage and short selling allow the implementation of absolute return investment strategies, which enhance the efficiency of investors' portfolios.² At present, these techniques are available to segregated funds but not to mutual funds generally.

Mutual fund managers have long recognised that segregated funds compete with mutual funds. In their view, the playing field is not level because life insurers can offer to intermediaries various inducements to sell their products, whereas mutual fund managers are not allowed to offer such. There is some justification in this view. The Joint Forum has a project to examine the regulation of intermediaries and recommend ways to promote equivalent consumer protection, focusing initially on intermediaries that sell mutual funds and segregated funds. We recommend that this project be assigned high priority.

b) Universal Life Insurance

Universal life insurance combines permanent insurance protection with an investment vehicle. The investment component may be invested, at the holder's choice, in a range of investments which may include daily interest accounts, term deposits, mutual funds (including third-party funds), and even hedge funds. The holder may change the investment mix as he wishes.

Similarity of Segregated Funds and Universal Life Insurance

Because segregated funds and universal life insurance are life insurance products, a life insurance agent is not required to possess a mutual fund licence when selling these products. This is the case even when the underlying investment is a mutual fund. This approach values form ahead of substance and appears anomalous to us. The project to harmonise distribution practices should take this into account.

² For an explanation of absolute return strategies and their impact on portfolio efficiency, see the companion report *A Canadian Framework for Hedge Fund Regulation*.

As investment wrappers, segregated funds and universal life insurance policies work in much the same way. The major difference is that the life insurance component is relatively minor in a segregated fund whereas it plays an important part in a universal life insurance policy.³

If one accepts that the regulation of segregated funds and mutual funds should be harmonised, then it requires but one small step to suggest that the harmonisation efforts should extend to the investment component of universal life insurance policies.

³ The life insurance component of a segregated fund consists of the guarantee of a minimum value in the event of the holder's death.

2. Summary of Key Recommendations

We summarise our key recommendations below:

Recommendation #1: Structured notes should be subject to the same disclosure and sales practices' requirements as the underlying investment (Section 5(i)).

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Recommendation #2: A fast track should be available for the processing of structured notes by the regulators (Section 5(i)).

Recommendation #3: Intermediaries wishing to sell structured notes should be required to employ staff with certain qualifications, such as the CFA or similar designations (Section 5(i)).

Recommendation #4: joint initiatives involving regulators, issuers, structurers, and intermediaries should be implemented to educate investors on the subject of structured notes (Section 5(i)).

Recommendation #5: Consideration should be given to requiring a fairness opinion on the pricing of the product from a qualified, independent third party when the issuer and the structurer of a structured note are related parties (Section 5(i)).

Recommendation #6: The proposed harmonization of investment rules applicable to mutual funds and segregated funds should be taken as an opportunity to broaden the investment powers of mutual funds rather than to restrict those of segregated funds (Section 6(ii)(f)).

Recommendation #7: The project to examine the regulation of intermediaries, focusing initially on intermediaries that sell mutual funds and segregated funds, should be assigned high priority (Section 6(ii)(g)).

Recommendation #8: The same project should address the anomaly whereby life insurance agents may sell segregated funds and universal life insurance policies without a mutual fund licence even when the underlying asset is a mutual fund (Section 6(iii)).

Recommendation #9: Consideration should be given to extending to universal life insurance policies the current initiatives to harmonize the regulation of segregated funds and mutual funds (Section6(iv)).

3. **Mandate**

i. **Mandate**

We were initially mandated by the Task Force to Modernize Securities Legislation in Canada (“Task Force”) to make recommendations on a Canadian framework for hedge fund regulation. Our findings and recommendations are contained in the report entitled *A Canadian Framework for Hedge Fund Regulation*.

The Task Force was set up by the Investment Dealers Association of Canada (“IDA”) in June 2005 in order to examine issues related to investor protection, access to capital, enforcement, governance, and regulatory burden, while drawing on the latest regulatory thinking in Canada and abroad.

In the course of our research project on hedge funds, we found that structured products are used to transform the legal but not the economic nature of hedge funds. This is done by wrapping a hedge fund within a debt instrument of certain institutions such as banks and Crown corporations. The debt instrument is exempt from the usual prospectus and dealer registration requirements in Canadian securities legislation. However, since the return on the debt instrument is linked to that on an underlying hedge fund, the debt instrument has some of the economic characteristics of a hedge fund.

Our research also revealed that hedge funds are only one among many types of investment being wrapped within other investment vehicles.

We also found that structured products are not the only forms of wrapper available. Life insurance policies are also used to wrap investment products.

As a complement to the hedge fund project, we were mandated to assist the Task Force by:

- Documenting the types of investment being wrapped within other investment vehicles;
- Documenting the types of wrapper used;

- Examining the benefits of wrapped products to investors, issuers, and product structurers;
- Assessing the implications of the use of wrappers from the point of view of investor protection and fair competition (level playing field);
- Examining approaches taken by other jurisdictions in regulating wrapped investment products;
- Making such recommendations as we deem appropriate.

ii. Previous Canadian Studies

In the performance of our mandate, we benefited from a number of previous Canadian studies both on structured products and on life insurance wrappers.

a) Structured Products

Report of the Task Force on Debt-Like Derivatives

The Task Force on Debt-Like Derivatives (“Derivatives Task Force”) published its report in 1999.⁴ The Derivatives Task force was set up by the Ontario Securities Commission (“OSC”) with a mandate to review the application of the existing securities regulatory regime in Ontario to the distribution of debt-like derivative securities and to make recommendations on the regulation of these securities at the retail level. A debt-like derivative is basically a structured product. However, the product was less developed in 1999 than it is today, for instance, in the range of underlying assets available.

The Derivatives Task Force took the position that investors are entitled to expect the same minimum standard of disclosure in connection with all debt-like derivative instruments, whether the instrument takes the legal form of a security, a deposit, an insurance contract, or otherwise. In other words, substance should prevail over legal form.

⁴ Report of the Task Force on Debt-Like Derivatives, January 5, 1999.

The Derivatives Task Force also took the position that debt-like derivatives should be regulated according to the same “disclosure-based” approach as conventional securities, as opposed to a “merit-based” approach. In other words, the role of the regulator should be to ensure that all relevant facts about the debt-like derivative have been disclosed to the investor. Its role should not be to pass judgement on the merits of the investment, this being the prerogative of the investor.

The Derivatives Task Force recommended that the prospectus and dealer registration exemptions in the Securities Act (Ontario) should not be available to debt-like derivatives. It then made a distinction between two types of debt-like derivative.

Debt-like derivatives that met certain conditions would be qualified to use an “alternative disclosure regime”. It was intended that the alternative disclosure regime would include a simple term sheet describing, among other things, the economic terms and risks of the instrument and a generic form of risk disclosure statement. Debt-like derivatives would be qualified to use this regime if the initial purchase price was not at risk, all amounts payable were due no later than 10 years after issuance, and the amounts payable were based on underlying instruments that were widely known and not subject to manipulation by the issuer of the instrument.

Debt-like derivatives not meeting these conditions would need to comply with the prospectus and registration requirements of the Securities Act (Ontario).

IDA Report on Hedge Funds

In 2005, the IDA published a report on hedge fund activities in Canada and the involvement of IDA member firms or their affiliates in such activities.⁵ The report deals, among other things, with principal-protected notes, which are a structured product. Principal-protected notes are commonly used to offer hedge funds to retail investors. The IDA observed that hedge funds, including principal-protected notes, are exempt from most regulatory requirements such as the filing of a prospectus and the involvement of a registered dealer.

Besides internal recommendations to be dealt with by the IDA itself, the report recommended a review of provincial laws, regulations, and approaches and, if necessary, the development of

amendments to bring hedge fund products offered to the retail investor fully within the regulatory system.

b) Life Insurance Wrappers

The harmonization of the regulatory regimes applying to segregated funds and mutual funds has been the subject of several reports and studies since at least 1999.

In May 1999, the CSA and the CCIR jointly published a comparative study of segregated funds and mutual funds.⁶ The study includes a helpful comparative table that compares certain features of both products and their regulation.

Building on the May 1999 study, the Joint Forum recommended in December 1999 fifteen topics where harmonisation could be undertaken.⁷ These topics relate to the areas of product regulation, disclosure, manufacturer regulation, and distribution regulation.

With a view to implementing its recommendations relating to disclosure, the Joint Forum published in 2003 a consultation paper on harmonising point of sale disclosure for segregated funds and mutual funds.⁸ At the same time, the Joint Forum released a background research report summarising the legal research conducted by the staffs of the OSC and the Financial

⁵ Investment Dealers Association of Canada, Regulatory Analysis of Hedge Funds, May 18, 200

⁶ Canadian Securities Administrators and Canadian Council of Insurance Regulators, A Comparative Study of Individual Variable Insurance Contracts (Segregated Funds) and Mutual Funds, May 7, 1999.

⁷ Joint Forum of Financial Market Regulators, Recommendations for Changes in the Regulation of Mutual Funds and Individual Variable Insurance Contracts, December 15, 1999.

⁸ Joint Forum of Financial Market Regulators, Consultation Paper 81-403 – Rethinking Point of Sale Disclosure for Segregated Funds and Mutual funds, February 13, 2003.

Services Commission of Ontario (“FSCO”) while preparing the consultation paper.⁹ Subsequently, the CSA and the CCIR published a summary of comments on the consultation paper together with the Joint Forum’s responses.¹⁰

⁹ Joint Forum of Financial Market Regulators, Regulation of Point of Sale Disclosure for Segregated Funds and Mutual Funds, February 13, 2003.

¹⁰ Canadian Securities Administrators and Canadian Council of Insurance Regulators, Summary of Comments and Responses, April 30, 2004.

4. Types Of Wrappers

i. Structured Products

In the broadest sense, structured products are investment vehicles designed to meet specific investment objectives. Indeed, in many cases, structured products are created to meet the investment objectives of a single client. Examples of investment objectives are:

- Protection of capital;
- Enhancement of yield;
- Exposure to an asset that would otherwise be inaccessible for regulatory or other reasons, e.g., hedge funds;
- Exposure to foreign markets; for instance, prior to the abolition of the foreign-property rule in 2005, structured products were used in Canada to achieve foreign market exposure beyond that allowed by the rule; and
- Reduction of transaction costs.

Structured products are constructed with building blocks or components that include derivatives. Because of the common use of building blocks in their construction, some observers have drawn a parallel between structured products and Lego sets.

a) Derivatives and Their Underlying Assets

A derivative is a financial instrument whose value is derived from that of an asset or variable known as the “underlying asset”. Examples of underlying assets are:

- Individual stocks or bonds;
- Baskets of stocks or bonds;
- Indices, e.g., stock market indices;
- Commodities;
- Interest rates;
- Inflation rates;

- Currencies;
- Mutual funds; and
- Hedge funds and funds of hedge funds.

The use of a derivative as a building block or component allows the return on a structured product to be linked with that on the underlying asset.

b) Types of Wrapper

The building blocks or components are packaged or wrapped within an investment vehicle, which constitutes the wrapper. Wrappers may take several forms, including:

- Notes;
- Bonds;
- Mutual funds;
- Closed-end funds;
- Swaps;
- Warrants; and
- Special-purpose vehicles.

The choice of wrapper is dictated by financial as well as by legal, regulatory, and tax considerations. For instance, a note is the wrapper of choice for principal-protected products. A note is a simple, easily understood instrument whose principal is normally repaid in full at maturity. Investors are thus readily able to understand the protection features of the product.

The importance of regulatory considerations in the choice of wrapper may be illustrated by reference to mutual funds. In Canada, it is not possible to use mutual funds as a wrapper because mutual funds are not allowed to use derivatives for investment purposes.

On the other hand, mutual funds may be used as wrappers in Europe, where the regulatory regime for mutual funds is different. The so-called UCITS III Directive, which aims at modernising the regime governing cross-border retail investment funds in the European Union, became effective

in February 2004.¹¹ The Directive gives broader investment powers to UCITS schemes, including the ability to use derivatives for investment purposes. By investing in structured products that use a UCITS scheme as wrapper, investors are able to combine the benefits of structured products with the regulatory protections associated with mutual funds.

c) Global Development of the Structured Products Industry

The tools to price derivatives became available in the 1970s. Market participants in Europe and the United States soon realised that it was possible to combine derivatives with other assets to create products with entirely new characteristics. The first modern structured products were designed in the 1980s. The industry grew rapidly throughout the latter half of the eighties, during which time structured products acquired most of the characteristics by which they are now recognised. By the 1990s, structured products had become well established in the capital markets. After a short period of slowdown in the mid-nineties caused by high-profile failures¹² attributed to the improper use of derivatives, the industry gradually recovered and subsequently resumed its growth.

d) Retail Structured Products in Canada

In Canada, most, though not all, structured products aimed at retail investors are principal-protected. As expected, the wrapper consists of a note. To be specific, it consists of a note issued by a bank, credit union, or Crown corporation, because of regulatory considerations.

Structured notes will be discussed in detail in section IV.

ii. Life Insurance Wrappers

Life insurance products, when used to wrap an investment, are sometimes regarded as structured products. For the purpose of this report, life insurance products are treated as a separate category of wrapper.

¹¹ UCITS stands for “Undertakings for Collective Investment in Transferable Securities”. A UCITS scheme may be likened to a mutual fund.

¹² The most notable examples are perhaps the bankruptcy of Orange County in California in 1994 and the failure of Barings Bank in 199

Life insurance companies have long offered investment products, in addition to protection products. Traditionally, these investment products carried a fixed rate of return. Fixed annuities constitute an example. The investment risk in respect of these products is borne by the insurer, and the liabilities form part of the insurer's general fund. Since an insurer's general fund is mostly invested in bonds, the fixed rate of return promised to the client is driven by bond returns.

For many years now, life insurance companies have been expanding their offering of investment products beyond fixed-rate investments. This strategic initiative was driven by demographic changes. The majority of individual life insurance purchasers are between 25 and 44 years of age. The baby-boomer generation, which accounts for about a third of the Canadian population, is now mostly past this age group. This important client segment is now in a phase where protection products are relatively less important. Instead, it is actively investing for the retirement years.

The most common investment products offered by life insurers today are segregated funds and universal life insurance policies. These products differ from the traditional products because they are usually invested in equities rather than bonds and the investment risk is borne by the holder and not the life insurer.

Segregated funds are variable annuities. The principal is protected to a certain degree at maturity or on the death of the holder, whichever occurs earlier.

Universal life insurance policies are a bundled product, combining permanent life insurance with an investment product.

Life insurance wrappers will be discussed in detail in section 6.

5. Structured Notes

Structured notes were originally developed to meet institutional investors' appetite for enhanced yields. Subsequently, structured notes focusing on principal protection were developed for retail investors. This market is now the larger one. Structured notes have proved popular not only in Canada but also in the United States., Asia, and Europe. Europe constitutes the most developed market for structured notes.

i. Structured Note Fundamentals

A structured note consists of a zero-coupon bond and a call option, both wrapped within a note. Structured note fundamentals are reviewed in Appendix 1.

The appendix discusses:

- The characteristics of zero-coupon bonds and the factors determining their price; and
- The different types of option, the risks to the holder of an option, the differing characteristics of exchange-traded and over-the-counter options, and the factors determining the price of an option.

The appendix also identifies the steps involved in the construction of a structured note:

- The choice of issuer;
- The choice of the note's characteristics, including a discussion of the concept of participation rate;
- The protection of the principal; and
- Hedging the equity risk.

The mechanics involved in each step are illustrated.

Readers unfamiliar with the above concepts may wish to refer to the appendix before proceeding further.

The Classic Case

The type of structured note illustrated in the appendix is the classic one where the return on the note is equal to the percentage increase in the price of the underlying asset between the issue and maturity dates, net of fees and expenses.

ii. Flexibility of Structured Notes

Besides the classic case, a wide range of variants may be found in practice. All of the variants involve a trade off. Some examples will be provided to illustrate the flexibility of structured notes and demonstrate how they may be tailored to meet different investor preferences.

In the classic case, the return on the note depends on a straightforward comparison of the initial price of the underlying asset with the price at maturity. This approach makes sense because, over the long term, markets usually trend upwards. However, if the price of the underlying asset rises steadily over time then drops sharply just before maturity, this will reduce the return on the note.

There are strategies that avoid this drawback. Since there is no such thing as a free lunch, there will always be a trade off.

Simple Average

Instead of using the price of the underlying asset at maturity, one strategy uses the average of prices at the end of each period (for instance, each month, each quarter, or each year). With this approach, the investor is not penalised in the event of a sharp drop just prior to maturity. However, if the price of the underlying asset rises steadily throughout the term of the note, this strategy will yield a lower return than the classic strategy.

In this approach, the return is said to be path-dependent because it depends on the path taken by the price of the underlying asset over the term of the note. Path-dependency sometimes yields results that may be counterintuitive to the investor. Suppose the underlying asset price remains steadily below the initial price, then rises sharply just before maturity. Since the average reflects all the lower prices, the return may be nil. The investor may be surprised at this result, given that the final price of the underlying asset has risen above the initial price.

Protected Average

To avoid the problem just mentioned, another strategy calculates the average using only period-end prices that are higher than the initial price. If a period-end price is lower than the initial price, the initial price is used in the computation of the average. This approach avoids the problem of the Simple Average but this normally comes at the cost of a lower participation rate.

Look Back

“Look back” strategies provide another way to avoid the return being dependent on a single day’s price of the underlying asset. One approach is to look back over, say, the six months prior to maturity and pick the highest price which prevailed over that period to serve as the final price.

An alternative is to look back over, say, the six months following the date of issue and pick the lowest price over that period to serve as the initial price.

“Look back” strategies avoid the market timing risk involved when the initial and final prices are those on a single day but, again, this normally comes at the cost of a lower participation rate.

iii. Capital Protection Structures

a) Zero-Coupon Bond Plus Call Option

The classic protection structure combines a zero-coupon bond and a call option. This structure has the advantage of simplicity and still being used in practice. However, it suffers from a couple of drawbacks.

The first drawback is its static nature. Once the proceeds of issue of the note have been split between the zero-coupon bond and the call option, the split is never adjusted. If the underlying investment performs very well, the value of the call option will rise. Indeed, it may rise to a point where it is more than sufficient to ensure the repayment of the principal.¹³ If this is the case, there is little point in continuing to hold the entire zero-coupon bond with its relatively low yield, since

¹³ This argument assumes that it is possible to sell the call option or a portion thereof.

this will limit the overall performance of the note. Yet, the protection structure does not allow any portion of the zero-coupon bond to be reinvested in a riskier instrument with a potentially higher yield.

The second drawback is that, in periods of low interest rates, as in the past few years, the zero-coupon bond ties up a large portion of the proceeds of issue of the note. This leaves less money with which to buy the call option and gain exposure to the performance of the underlying asset.

To overcome the drawbacks of static structures, dynamic structures have been developed. Examples of dynamic structures are described in sections 5(c)(ii) and 5(c)(iii) below. These structures are based on portfolio insurance techniques that provide the rules for monitoring the risk of a portfolio and deciding when to switch from more risky to less risky investments to ensure the protection of the principal.

b) Constant Proportion Portfolio Insurance (“CPPI”)

Under CPPI, the proceeds of issue of the note are invested in a feeder fund, which in turn invests a portion of its assets in the underlying investment and the remainder in money market instruments.

How CPPI Works

The portion invested in the underlying investment is adjusted over time depending on its performance. This is the reason why this strategy is said to be dynamic. The adjustment is calculated by comparing the value of the fund at various points in time with that of a nominal zero-coupon bond that would repay the principal at maturity.

Simply stated, when the value of the fund lies above that of the nominal zero-coupon bond, a portion of the money market instruments is sold and reinvested in the underlying investment. Here, the objective is to allow greater participation in the performance of the underlying investment. On the other hand, when the value of the fund lies below that of the nominal zero-coupon bond, a portion of the underlying investment is sold and the proceeds reinvested in money market instruments. Here, the objective is to protect the capital. If the net asset value of the feeder fund falls to a pre-determined level, the entire position in the underlying investment is liquidated

and the assets become fully invested in money market instruments. In this case, it is likely that the investors will only get their principal at maturity with no return.

This structure is more efficient than the zero-coupon bond plus call option in the sense that it potentially provides investors with a higher participation in the return on the underlying investment.

Drawbacks of CPPI

However, CPPI does have certain drawbacks. It involves buying more of the underlying investment after a period of strong performance, i.e., when the investment has become expensive. In addition, it involves selling some or all of the underlying investment after a period of weak performance, in other words, when the investment has become cheap.

The structure is vulnerable to a weak performance of the underlying asset in the first few months following the issue of the note. Once assets have been switched from the underlying investment to money market instruments, it is very difficult to reverse this. In fact, further switches in the same direction are likely.

Where the underlying investment is a fund, such as a fund of hedge funds, the type of investment that may be held in the fund is subject to the approval of the product structurer. This is normal because the latter will have to compensate the issuer if there are insufficient assets at maturity to repay the principal. In order to minimize its exposure, the product structurer will insist on relatively low-risk investments. It will also insist on relatively liquid investments in order to facilitate the switch to money market instruments if necessary. This may not be what investors want. Since they have a promise of principal protection, they will probably want the fund to be invested in riskier, less liquid assets with a higher return potential. Thus, there is a conflict between the interests of the structurer and those of the investors. If the fund consists of low-risk, liquid investments, investors may wish to ask themselves if the protection is worth paying for.

At the systemic level, the simultaneous use of CPPI by a large number of market participants may exaggerate market movements. This is a concern particularly in down markets. Furthermore, there may not be enough buyers to accommodate all the sellers. Indeed, in extreme cases, bids for

certain investments may evaporate altogether. In such circumstances, CPPI will not provide the requisite protection.

c) Recent Developments in Protection Structures

New protection structures are constantly being devised. Two recent structures are:

- Variable proportion portfolio insurance (“VPPI”); and
- Multi-level portfolio insurance (“MLPI”).

VPPI is similar to CPPI. The main difference is that, whereas CPPI targets a constant level of risk in the fund, VPPI allows the level of risk to be adjusted in cases of market turbulence.

Both CPPI and VPPI use pre-determined rules to allocate the assets of the fund between the underlying investment and money market instruments. The fund’s adviser has no discretion to depart from these rules.

Under MLPI, the adviser is responsible for determining the asset allocation. However, its activities are monitored by means of a model. The model takes into account the value of the fund, the time to maturity, the value of a nominal zero-coupon bond as well as other factors. When the model determines that the fund has become too risky, the adviser is required to invest a higher proportion of the fund in money market instruments.

iv) Market Participants

The main participants in the market for structured notes are:

- The investor;
- The issuer; and
- The product structurer.

a) The Investor

Flexibility of Structured Notes

Perhaps the greatest benefit to the investor relates to the flexibility of structured notes. This flexibility enables the investor to enjoy risk-return characteristics that are not possible with other investments. For instance, an equity investment provides a possibility of high returns but there is no principal protection. A GIC provides principal protection but the return is low. A structured note allows investors to participate in equity-like returns, net of fees, and expenses, while at the same time benefiting from principal protection.

Enhanced Yields

Rather than protect capital, structured notes may be engineered to enhance the yield that would otherwise be available. This may appeal to certain investors.

Indirect Access to Certain Products

Structured notes provide investors with access to investment products that would otherwise not be available to them. In certain jurisdictions, including Canada, retail investors are unable to purchase hedge funds directly. They can, nevertheless, obtain indirect exposure to hedge funds by purchasing a structured note whose return is linked to that of a hedge fund or a fund of hedge funds.

Retail investors are not the only ones to benefit from access to a wider range of investments. In certain countries, institutional investors are constrained from investing in certain types of asset or from transacting in derivatives. These investors can invest in structured notes as a way of gaining exposure to these assets.

Drivers of Investor Motivation

Although structured notes have been available in Canada since the 1990s, it was not until the bear markets of 2000 to 2002 that principal-protected notes really took off. It is clear that investor

interest in structured notes is to some extent driven by the market environment. Of course, this is true of all investments.

Behavioural finance is a branch of finance that uses psychology-based theories to explain the behaviour of market participants. It has been used to explain the growth of structured notes. The argument is that investors perceive the risk to their capital differently from the risk to their return. They are much less willing to risk their capital than their return. Principal-protected notes fit well into this asymmetrical approach to risk because they allow investors to secure their principal while exposing their return.

Risks to the Investor

The investor shoulders the equity risk, which is the risk related to the performance of the underlying asset.

The investor also shoulders credit risk, which is the risk of default on the part of the issuer. At first, this might seem strange, given that the principal is protected. It is important to realize that the principal is protected only to the extent that the issuer is able to honour his commitments. To manage the credit risk, structured notes are usually issued by creditworthy issuers whose debt instruments carry a rating of at least “A”. Where the issuer is a government agency such as a Crown corporation, the risk of default is virtually non-existent.

The credit rating of an issuer evolves over time. Structured notes have lengthy terms to maturity. The lengthier the term, the more likely it is that the credit quality of the issuer will deteriorate prior to maturity.

b) The Issuer

A Cheaper Source of Financing

In Canada, structured notes are usually issued by banks, credit unions, and Crown corporations. This is in order to benefit from certain regulatory exemptions, as discussed in section 5(viii)(b) below.

Issuers are willing to lend their name and credibility to structured notes because they often constitute a cheaper source of financing than other financial instruments.

The classic structure involves investing a portion of the proceeds of issue of the note in a zero-coupon bond. Rather than invest in a bond issued by a third party, it may make more sense for the issuer to retain the portion of the proceeds and repay the face value of the zero-coupon bond from its own funds at maturity. From the point of view of the issuer, this is equivalent to borrowing at the rate of interest used to calculate the discounted value of the bond.

The rate of interest charged to the issuer is negotiated between the issuer and the product structurer. This rate of interest will be lower than that on a conventional debt instrument of the issuer. The reduction in the issuer's borrowing costs is at the expense of the investor. When conducting the due diligence on the product prior to purchase, the investor should evaluate whether the interest rate charged to the issuer is reasonable in the light of its debt rating and the terms of the bond. In practice, this exercise may not be easy.

Ease of Issue

Another benefit to the issuer is the ease and speed with which a structured note may be issued compared with other instruments. In Canada, structured notes issued by banks, credit unions, and Crown corporations are exempted from the prospectus filing requirement.

Risks to the Issuer

The issuer does not face any equity risk related to the increase in the price of the underlying asset. This risk is eliminated by purchasing a call option on the underlying asset.

However, the issuer does face counterparty risk, which is the risk of default on the part of the party from which the call option was bought.¹⁴ This risk is managed by ensuring the creditworthiness of the counterparty. This is done by a careful analysis of the financial condition of the counterparty, including its capital, the composition of its assets and liabilities, and its off-

¹⁴ In the UK, there are products where the counterparty risk is borne by the investor rather than the issuer. See Financial Services Authority, Consultation Paper 188 -- Clarification and Revision of Financial Promotion Rules and Guidance, July 2003. We have not come across similar products in Canada.

balance sheet exposures. Financial institutions worldwide have taken steps to improve the management of counterparty risk in the wake of the near-failure of the hedge fund Long-Term Capital Management in 1998.

The issuer also faces reputational risk in the event that the product does not live up to investors' expectations or the product is mis-sold by intermediaries.

c) The Product Structurer

Structured notes are usually structured by an investment bank or a broker-dealer. The product structurer, together with its related entities, is responsible for:

- Identifying the investment opportunity and determining investors' requirements;
- Structuring the product;
- Making arrangements with the issuer;
- Hedging all relevant exposures;
- Committing capital where relevant;
- Distributing the product; and
- Maintaining a secondary market for the note.

Sources of Revenue to the Product Structurer

The main sources of revenue to the product structurer and its related entities are:

- Sales charges on the sale of the product;
- Management fees, which are usually calculated as a percentage of assets under management;
- The bid-ask spread on maintaining a secondary market for the product; and
- The profit on the pricing of the product.

The product structurer makes a profit on the pricing of the product by selling the option component of the product to the investor for more than the price at which it was purchased. This

is not to suggest that the investor is being gouged. There may be valid reasons for the investor to be willing to pay a higher price for the option, such as:

- Gaining access to a product that meets the investor's specific objectives;
- Gaining indirect access to the derivatives market;
- Being able to buy an option in small denominations; and
- Benefiting from the credit enhancement provided by the issuer.

Ease of Issue

The product structurer values the ease and speed with which a new product may be brought to market once a business opportunity has been identified.

New products are designed and brought to market on the basis of a perceived investment opportunity, such as the current weakness of an industrial sector or a currency. An opportunity may also arise as a result of natural disasters, such as hurricanes, which are unpredictable by nature. Since the window of opportunity is typically narrow, time is of the essence when designing and bringing new structured products to market.

Risks to the Product Structurer

The product structurer may incur significant costs in structuring new products. If, for some reason, the issue of a new product is not closed, the product structurer will be unable to recoup its costs.

The product structurer faces operational risk, for instance if a mistake is made while discharging its responsibilities, such as while hedging all relevant exposures. This risk is managed through proper systems of control.

The product structurer also faces reputational risk in the event that the product does not live up to investors' expectations or the product is mis-sold by intermediaries.

v. Structured Notes as a Distribution Channel for Asset Managers

So far, we have looked at structured notes from the point of view of the investor (as an investment that may meet his specific objectives), from the point of view of the issuer (as a cost-effective way of raising capital), and from the point of view of the product structurer (as a potentially profitable line of business).

Sometimes, the initiative for a structured note is taken by an asset manager. In this case, the return on the note will be linked to that on an investment fund managed by the asset manager, and the proceeds of issue of the note partly invested in the investment fund. Here, the structured note effectively serves as a distribution channel for the fund.

A mutual fund manager may wish to wrap a structured note around its products because it makes them more attractive to conservative investors who want exposure to mutual fund returns but are unwilling to risk their capital.

A hedge fund manager has even more to gain from the use of structured notes. In many jurisdictions, retail investors are unable to purchase hedge funds directly. By wrapping a structured note around its products, a hedge fund manager gains indirect access to a market that would otherwise be out of reach.

vi. Regulation of Structured Products in Other Jurisdictions

a) United States

Distribution of Structured Products

In the US, offerings of structured products generally take the form of public offerings of securities registered under the *Securities Act of 1933*. In most cases, issuers use shelf registration.

Shelf registration procedures were introduced in the United States some 25 ago as a way to speed up the regulatory approval process. These procedures involve the filing of a base shelf prospectus that contains all the relevant information about the issuer except for the terms of the offering. In

order to provide maximum flexibility, the base shelf prospectus normally specifies that the issuer may use a variety of instruments. The base shelf prospectus is filed, and reviewed by the Securities and Exchange Commission (“SEC”), ahead of the distribution of the product. When a product is actually distributed, the issuer files a shelf prospectus supplement that provides the specific terms of the offering. In the case of an offering with no novel features, a new product may be brought to market within a matter of days. Shelf registration allows a product to be brought to market more quickly while at the same time providing investors with the legal and regulatory protections associated with offerings under prospectuses.

Fairness Opinion

In certain circumstances, the National Association of Securities Dealers requires a Qualified Independent Underwriter to issue a written opinion to the effect that the pricing of the structured product is fair to the investor. This opinion is required in circumstances where potential conflicts of interest could arise because the issuer and lead underwriter are affiliated to one another.

Suitability Concerns

In a recent Notice to Members, NASD staff expressed its concern that broker-dealers may not be fulfilling their sales practice obligations when selling structured products, especially to retail customers.¹⁵ NASD provided the following guidance:

- Particularly in cases where there is no principal protection, broker-dealers should consider limiting purchases of structured products to accounts which have been especially approved for this purpose or which have been generally approved for options trading.
- Before recommending a product to investors, broker-dealers should perform a “reasonable basis suitability determination” aimed at ensuring the general suitability of the product. This involves passing judgement on the merits of the product as an investment.
- Additionally, broker-dealers should ensure the suitability of the product for the particular investor buying the product. This customer-specific determination involves consideration

¹⁵ NASD, Notice to Members 05-59 -- NASD Provides Guidance Concerning the Sale of Structured Products, September 200

of the financial and tax status and investment objectives of the customer and other relevant information.

- Broker-dealers should establish written supervisory procedures designed to ensure that sales of structured products comply with applicable regulations.
- Broker-dealers should train personnel about the characteristics, risks, and rewards of each structured product before they allow their representatives to sell the product to investors.

b) United Kingdom

2006 Financial Risk Outlook

Every year, the Financial Services Authority (“FSA”), the integrated financial services regulator in the UK, publishes its *Financial Risk Outlook* to raise awareness of the key risks in the operating environment and to increase understanding of its actions. As part of the 2006 review, the FSA assessed the risks of structured products to both issuers and investors.¹⁶

From the perspective of the issuer of structured products, the FSA identified the following main risks:

- Legal risks may be greater where the products are innovative, precedents have not been set, and standardised product documentation has not been developed.
- The risk of mis-selling or of customer complaint may be greater than with conventional products.

There have already been cases in the United Kingdom where substantial damages have been awarded against the issuer because the latter could not demonstrate that it had properly explained to the investor the risks involved in complex products.

Where the products are sold through intermediaries, the issuer is additionally exposed to reputational risk if the intermediary gives incorrect advice to the investor.

¹⁶ Financial Services Authority, *Financial Risk Outlook*, 2006.

From the investor's perspective, the FSA opined that while more complex products may offer significant benefits to some investors, their complexity makes it difficult for other investors to understand the risks associated with the product. This could lead to unsuitable higher-risk products being sold to investors with low tolerance for risk.

The FSA identified certain product characteristics that it believes investors may have difficulty understanding:

- The nature of the underlying investment;
- The potential return they are sacrificing in exchange for the capital guarantee;
- The proper significance of past performance and the targeted return, with undue emphasis being placed on these factors;
- The appropriate holding period for the investment, given that any guarantee will be honoured only if the investment is held to maturity;
- The impact of fees and expenses on the performance of the product; and
- How the product compares with others on the market.

The FSA's concerns point to certain drawbacks of structured products: aggressive marketing by issuers and intermediaries (though this is by no means exclusive to structured products), the impact of high fees (including the cost of the guarantee) on the return to the investor, and the requirement for a long-term commitment on the part of the investor in order to benefit from the principal guarantee.

Regulation of the Promotion of Structured Notes

The FSA launched a consultation on the regulations relating to the promotion of structured notes in 2003.¹⁷ The concern was that investors were often unable to determine whether a structured note was suitable for them.

At the time, structured notes were not subject to any requirements in the United Kingdom beyond the basic principle that promotions for financial products must be clear, fair, and not misleading.¹⁸

¹⁷ Financial Services Authority, Consultation Paper 188 – Clarification and Revision of Financial Promotion Rules and Guidance, July 2003, and Policy Statement 04/3 – Feedback on CP188, January 2004. The FSA refers to structured notes as “structured deposits”.

As a result of the consultation, the FSA subjected structured notes to a limited number of rules that already applied to the promotion of other investment products, namely:

- The rule requiring a fair and adequate description of the nature of the investment, the commitment required and the risks involved, as well as the name of the product provider;
- The rule requiring that information about past performance must use suitable text and must make it clear that past performance will not necessarily be repeated. The rule also requires a sufficient and relevant period of past performance information to be provided to give a fair and balanced picture; and
- The rule requiring that information about past performance should not be presented in a way that suggests it is a projection of the possible future value of an investment.

The result was that the promotion of structured notes became subject to more requirements than traditional bank deposits but nevertheless remained subject to fewer requirements than most other investment products.

vii. The Canadian Market

a) Development of the Structured Note Industry in Canada¹⁹

Structured products first became available to Canadian retail investors in the 1990s.

The first large-scale issue of structured notes linked to an equity instrument occurred during the 1994 RRSP season. The issuer was a Schedule I bank and the proceeds of the issue exceeded \$500 million. There had been previous issues of structured notes listed on the Montreal Exchange but on a smaller scale. The same Schedule I bank issued the first structured note without principal protection in 2000.

In 2002, independent (i.e., non-bank) asset managers began to sponsor principal-protected notes. These asset managers work in partnership with banks or Crown corporations. The notes are

¹⁸ Financial Services Authority, Handbook COB 3.8.4R.

¹⁹ This overview of the development of the industry in Canada is largely based on a presentation made by Alain Pelchat at the 2004 IDA Annual Private Client Conference, Mont-Tremblant, June 12, 2004.

sponsored by the asset manager but issued by a bank or Crown corporation. A product structurer is also involved.

b) Market Participants

Investors

In addition to the general factors discussed in section 4.4.1 above, there are certain factors specific to Canada that make structured notes attractive to investors.

Structured notes may be held in registered accounts such as Registered Retirement Savings Plans (“RRSPs”). This allows the deferral of taxes on gains and income until such time as money is withdrawn from the registered account.

Prior to the elimination of the foreign-property rule in 2005, structured notes held in registered accounts qualified as Canadian content even when the underlying asset was clearly foreign.

Outside of registered accounts, if a structured note is held to maturity, the return will generally be taxed as income in the year of maturity. It appears to be the administrative practice of the Canada Revenue Agency that there will be no deemed accrual of interest on a structured note prior to maturity.

If a structured note is sold prior to maturity, it appears that the gain on the sale is taxed as a capital gain rather than as income, although there is some doubt about the tax treatment. Because capital gains are taxed at a lower rate than income, this enhances the tax efficiency of the investment.

Issuers

Issuers of structured notes include Schedule I banks (i.e., Canadian banks), Schedule II banks (i.e., Canadian subsidiaries of foreign banks), credit unions, and Crown corporations.²⁰ Where the

²⁰ We use the expression “Crown corporation” to include agencies such as the Canadian Wheat Board, which are not Crown corporations proper but whose debt is irrevocably and unconditionally guaranteed by the Government of Canada.

issuer is the Canadian subsidiary of a foreign bank, the note is usually guaranteed by the foreign parent.

There is a reason why the issuers of structured notes are banks, credit unions, and Crown corporations. Under securities legislation in the jurisdictions of Canada, the distribution of a security normally requires the filing of a prospectus with the securities commissions and the involvement of a registered dealer in the trade. There is an exemption from these requirements in respect of a trade in a debt security issued or guaranteed by certain entities, including the Government of Canada and certain financial institutions.²¹ Structured notes issued by a bank, credit union, or Crown corporation are distributed under this exemption.

The use of the exemption has two main advantages. Since time is of the essence when designing and bringing new structured products to market, the absence of a requirement to file a prospectus with the securities commissions means that structured notes may be brought to market with little delay. In addition, since there is no need for a registered dealer to be involved in the trade, this broadens the distribution of structured notes.²²

Deposit Insurance and Issuers' Debt Ratings

Structured notes are not covered by deposit insurance. This means that the investor is only able to look to the issuer (or guarantor, if there is one) for the repayment of the principal and the payment of any return. The financial strength of the issuer may be assessed by referring to the rating of its debt.

In Canada, issuers of structured notes usually have debt ratings ranging from “AAA” to “A”. In general, Crown corporations hold an “AAA” rating, the larger banks an “AA” rating, and the smaller banks an “A” rating.

²¹ See, for instance, s. 34(2) of National Instrument 45-106 *Prospectus and Registration Exemptions*.

²² In Ontario and in Newfoundland and Labrador, a person trading as an intermediary under an exemption must be registered as a limited market dealer.

Structurers

The main product structurers in Canada are banks and credit unions. Some mutual fund companies and independent dealers also have in-house product structuring capabilities.

The banks and credit unions are both structurers and issuers of structured notes. There are advantages when the structurer and the issuer are the same entity. This makes it possible to bring a new product to market more quickly and to keep any proprietary features within the entity. On the other hand, this situation may give rise to conflicts of interests.

c) Product Characteristics

Underlying Investment

There is a wide diversity of underlying investments. Among others, they include baskets of stocks, mutual funds, funds of hedge funds, indices, and commodities.

The range of underlying investments is a positive feature of structured notes. By providing retail investors with access to investments that would otherwise be out of their reach, structured notes enhance the efficiency of their portfolio.

Coupon

Certain products pay a periodic coupon, which is normally taxed as interest in the hands of the investor.

In some cases, the periodic coupon is paid in the form of a return of capital. This is tax effective because the coupon is not taxed immediately as interest. Instead, it is taxed as a capital gain when the investor sells the note.

Principal Protection

Most structured notes are 100 per cent principal-protected, although there are some non-protected products. Non-protected products have advantages of their own. In exchange for surrendering principal protection, the investor can expect an enhanced yield.

In order to benefit from the exemption discussed in section 5(vii)(b), a structured note must be fully principal-protected. Non-protected products require the filing of a prospectus with the securities commissions. This may explain their relative rarity.

Ranking

Most structured notes are unsubordinated. Again, in order to benefit from the exemption discussed in section.2, a structured note must be unsubordinated.

Term

The term is usually six to eight years, although we have seen a note with a term as long as 13.5 years.

The term is influenced by the level of interest rates. When interest rates are low, as has been the case in the past few years, this requires a longer term.

The investor depends entirely on the creditworthiness of the issuer for the repayment of the principal and the payment of the return. The longer the term, the more likely it is that the credit quality of the issuer will deteriorate prior to maturity.

Participation Rate

Most structured notes feature a participation rate of 100 per cent , at least initially.²³

²³ There may be less in a 100 per cent participation rate than meets the eye. See section .1 for a discussion of this concern.

Cap on the Return

A cap on the return is not unusual.

Minimum Investment

Since structured notes are aimed at retail investors, the minimum investment is usually modest and can be as little as a few hundred dollars.

Management Fees

Most structured notes carry management fees of around 3 per cent per annum.

Some products do not carry management fees. As noted in section 4(iv)(c) above, the remuneration of a product structurer can take many forms and is not limited to management fees.

Secondary Market

In most cases, the product structurer or a related entity maintains a secondary market in the product, although it usually disclaims any obligation to do so.

d) Distribution

Structured notes are usually distributed in the branch networks of banks and credit unions as well as through investment and mutual fund dealers. Bank channels usually sell in-house products only, whereas third party intermediaries such as investment and mutual fund dealers sell products from several structurers. Generally, as is the case for investment products, structurers have to vie for scarce shelf space.

When investment products are distributed by intermediaries, this is often done through FundSERV. The latter operates like a clearinghouse for purchase and redemption orders. The intermediary submits clients' orders to FundSERV, which then routes the orders to the appropriate structurer. This avoids the need for the intermediary to interface with each structurer individually.

A small number of structured notes are listed on the Toronto Stock Exchange.

Sales Charges

Just like for mutual funds, investors may purchase structured notes with a front-end load or a back-end load. Both loads may not be available in respect of the same product.

In the case of a front-end load, the investor negotiates the amount of the commission with the intermediary and pays the commission from his own funds.

In the case of the back-end load, a fixed commission, normally amounting to 5 per cent of the amount of transaction, is paid by the product structurer to the intermediary. The hitch is that, if the investor decides to “redeem” his notes by selling them on the secondary market in the first few years following the date of issue, he must pay the equivalent of a redemption fee or deferred sales charge. Deferred sales charges operate on a sliding scale. For example, they may amount to 5 per cent of the sales proceeds in the first year after issue, dropping to 1.5 per cent in the third year and thereafter to zero. There is some diversity in the rates of deferred sales charges and the length of time for which they apply.

viii. Issues

a) Structured Notes Are Complex and Difficult to Understand

Conventional bank deposits such as GICs are straightforward, easily understood investments with virtually no risk. The repayment of principal is assured and the return (in the form of a rate of interest) is known in advance. Structured notes are more complex and difficult to understand. The principal is usually protected, provided the note is held to maturity. However, the return is not known in advance but is linked to the performance of an underlying investment. There is a risk that there may not be a return at all.

Some features of structured notes are particularly difficult to understand. In particular, they can be described as follows

- Structured notes are not standardized;
- The nature of the principal protection is often misunderstood;
- A 100 per cent participation rate may be less than it seems;
- Unprotected notes are a confusing concept; and
- Path dependency can yield counter-intuitive results.

Structured Notes Are Not Standardized Products

Unlike GICs, structured notes are not standardized products. Product features such as the nature of the underlying investment, the size, frequency and nature of the coupon (if any), the term of the note, the participation rate, the existence of a cap on the return, and management and other fees vary from issuer to issuer. Different issues from the same issuer may have different product features. This makes it difficult to compare products.

The Nature of the Principal Protection Is Often Misunderstood

The nature of the principal protection seems to be widely misunderstood. The principal is protected only to the extent that the issuer is able to honour its commitments. In the course of our research, it became clear that many people are under the mistaken impression that the protection structure, e.g., a zero-coupon bond and a call option, provides protection to the investor. In actual fact, the investor has an interest only in the note. In the worst case scenario, which is the bankruptcy of the issuer, the investor will rank as an unsecured creditor with no preferential access to the zero-coupon bond or the call option.

A 100 Per Cent Participation Rate May Be Less Than What It Seems

It was noted in section 5(c)(ii) above that, under portfolio insurance techniques such as CPPI, the proceeds of issue of the note are invested in a feeder fund, which in turn invests a portion of its assets in the underlying investment and the remainder in money market instruments. Assets may be switched between the underlying investment and money market instruments after comparing the value of the fund with that of a nominal zero-coupon bond that would repay the principal at maturity. If the value of the fund falls below a pre-determined level, all the assets of the fund are switched into money market instruments.

It was also noted that CPPI is vulnerable to a weak performance of the underlying asset in the first few months following the issue of the note. This may result in all the assets becoming invested in money market instruments, which means that at maturity the investor will only get his principal back and no return.

The bottom line is that the claim of a 100 per cent participation rate may only be true at the time of issue. There is a risk that the investor will get no return. We believe that product structurers could do more to explain this risk to investors. Here is an excerpt from the marketing document of a structured note structured by a major Canadian financial institution:

“Dynamic Allocation

The Notes provide 100 per cent initial exposure to the Target Portfolio with the potential for up to 200 per cent exposure when the Target Portfolio performs well.”

The word “dynamic” informs us that the protection structure is CPPI or a variant thereof. However, the key word is “initial”. This informs us that the 100 per cent exposure holds true on Day 1 but may not be true subsequently.

The disclosure of the potential for up to 200 per cent exposure when the underlying investment performs well is certainly helpful to the investor. However, in the interest of balanced disclosure, we believe that investors should also have been informed that there is a potential for zero exposure when the underlying investment performs poorly.

Unprotected Notes Are a Confusing Concept

Some structured notes aim at enhancing yield rather than protecting principal. The principal of these products is not protected, yet they are characterized as notes. This characterization may be confusing. Most people expect that the principal of a note, especially when issued by a bank, will be repaid in full at maturity. In all fairness to one of the products concerned, the base shelf prospectus states clearly that the principal is not protected. Whether investors actually delve into 51-page prospectuses is another matter.

Path Dependency Can Yield Counter-intuitive Results

With certain structured notes, the final return is path-dependent. In other words, it depends not only on the price of the underlying asset at maturity but on the history of prices throughout the term of the note. This may lead to results that the investor may find counter-intuitive. For instance, if the price of the underlying asset remains below the price on the date of issue for most of the term then rises sharply just before maturity, there may well be no return. The investor may be surprised at this result, given that the price of the underlying asset at maturity is higher than the price on the date of issue.

b) Due Diligence on Structured Notes Is Complex

Prior to purchasing an investment product, the investor should carry out a due diligence exercise. In practice, this is done on his behalf by the intermediary. In the case of structured notes, due diligence can be complex.

The following aspects of the due diligence may be particularly complex:

- The pricing of the structured note, including
 - The pricing of the zero-coupon bond;
 - The pricing of the call option;
 - Considerations of conflicts of interests;
- The evaluation of the safety margin.

Pricing of the Structured Note

The fair value of a structured note is simply the sum of the fair values of its component parts, e.g., a zero-coupon bond and a call option. The investor should evaluate whether each component of the structured note has been fairly priced.

Pricing of the Zero-Coupon Bond

As regards the bond component, fair pricing means that the interest rate charged to the issuer is fair in the light of the issuer's debt rating and the terms of the bond. The interest rate is negotiated between the issuer and the product structurer and will be lower than what the issuer would pay on

conventional borrowings. Indeed, issuers are willing to lend their name and credibility to structured notes because they can thereby raise capital more cheaply. The reduction in the cost of capital is at the expense of the holder of the note. The investor should evaluate whether the interest rate charged to the issuer is fair but this is by no means easy.

Pricing of the Call Option

The option is usually arranged over-the-counter by the product structurer, and the price is negotiated between the issuer and the product structurer. In order to price an option, it is necessary to estimate future values for various parameters, e.g., the interest rate, the dividend yield, and the volatility in the price of the underlying asset. The volatility is usually the most difficult parameter to estimate. The investor will need to be particularly well equipped to figure out whether the option has been fairly priced.

Conflict of Interests Situations

Sometimes, the issuer and the product structurer are related parties. This gives rise to potential conflicts of interests. It was pointed out in section 5(vi)(a) that, in similar situations in the United States, a fairness opinion is required from a Qualified Independent Underwriter. There is no such requirement in Canada.

Safety Margin

We have already noted that, under CPPI, when the value of the feeder fund drops below a pre-determined point, all the assets will be switched to the money market, in which case the investors will probably get only their principal back with no return.

The amount that the fund is allowed to lose before all the assets are switched to the money market constitutes a safety margin. The lower the safety margin, the more vulnerable the fund will be to an initial weak performance of the underlying asset. Vulnerability is highest in the first few months following the issue of the note.

When constructing a structured note, product structurers sometimes accept a lower safety margin because it enables them to shorten the term to maturity. Unlike the safety margin, which is hidden deep in the bowels of the protection structure, the term to maturity is very visible to investors.

The investor should heed the safety margin because, when the safety margin is low, there is a relatively high risk that the return will turn out to be zero. It is not easy to evaluate whether the safety margin is adequate.

c) Lack of Liquidity and Related Problems

The brokerage arm of the product structurer usually undertakes to use its best efforts to operate a secondary market, which usually constitutes the only source of liquidity to investors wishing to sell their notes prior to maturity. These secondary markets are less liquid than exchanges where several brokers are active. In addition, the bid-ask spread, or difference between the buying price and selling price, may be wider. This operates, of course, to the detriment of the investor.

d) The Quality of Disclosure Varies

Because structured notes are distributed under an exemption, there is no need to file a prospectus. This allows a new issue to be brought to market quickly. This feature of structured notes is valuable to issuers as well as to product structurers.

The downside is that the investor is less well protected. When products are sold under a prospectus, the latter is reviewed by the securities commissions to ensure compliance with all regulatory requirements. In addition, recourses are available to investors in the event of misrepresentation in a prospectus.

The distribution of a structured note is normally accompanied with a disclosure document known as an information statement. The contents of information statements are not prescribed by securities regulations, and they are not reviewed by the securities commissions.²⁴ As a result, the quality of information statements varies widely. Some information statements are of prospectus-like quality and include all the information necessary to enable an investor to decide whether to

buy the investment. At the other end of the spectrum, there are information statements that do not even disclose the size of the remuneration paid to intermediaries.

e) Possible Redundancy of the Protection

Structured notes usually have terms of six to eight years, with at least one product carrying a 13.5 year term. The longer the period of time for which an investment is held, the less likely it is that the investment will lose money. This is particularly true of diversified investments such as most of those underlying structured notes. If so, why pay for protection?

The question is less significant when the investor is able to buy the underlying investment separately without principal protection. In this case, if the investor chooses to buy the principal-protected version, it presumably makes him better off. No one may question his choice although one would want to make sure that he has been properly advised.

The question assumes its full significance when the investor is unable to buy the underlying investment separately, as is the case for retail investors wishing to buy hedge funds. In this case, if the investor wants hedge fund exposure, he has no choice but to also buy and pay for a principal protection which he may not need.

f) No Free Lunch

The cost of structured notes, as measured by the management expense ratio, is higher than that of equivalent non-protected products because of the cost of the guarantee.

Structured products where the underlying asset is a fund of hedge funds are particularly expensive. This is because these products carry costs at three levels: the stand-alone hedge funds underlying the fund of funds, the fund of funds, and the structured note. Costs at the level of the stand-alone hedge funds and the fund of hedge funds include performance fees in addition to asset-based management fees.

²⁴ When the issuer is a bank, the Bank Act and regulations thereunder apply.

(g) Possible Regulatory Approaches

The issues identified above echo the regulatory concerns in the foreign jurisdictions that we examined. Regulatory action over structured products in the United States and the United Kingdom has mainly focused on the following objectives:

- Ensuring that they are sold only to investors for whom they are suitable;
- Ensuring that they are fairly priced in situations of potential conflict of interests; and
- Ensuring that the investor understands the product.

We would add a fourth objective. Investor protection must be balanced with the legitimate need of product structurers to seize business opportunities and launch new products expeditiously.

In order to meet these objectives, proper disclosure by issuers and structurers of all material facts about the product is vital. Under the existing regime, it is not possible to enforce a uniformly high standard of disclosure. Proper supervision of intermediaries, enforcement of the suitability requirement, investor education, and the management of conflicts of interest are also essential.

Appropriateness of Exemption

It is necessary to question the appropriateness of the prospectus and dealer registration exemption under which structured notes are currently distributed. At least four approaches are possible:

- Maintaining the status quo;
- Removing the exemption for structured notes;
- Devising a special regime for structured notes; and
- Regulating according to the underlying investment.

Status Quo

One obvious possibility is to maintain the status quo. Given the numerous concerns discussed above, this approach is difficult to defend.

Removal of Exemption for Structured Notes

Another approach would be to remove the exemption under which structured notes are currently distributed. This would effectively subject these products to the normal prospectus filing and dealer registration requirements in securities legislation.

If applied across the board, this approach will give strange results. For instance, many structured notes are wrapped around mutual funds. It would be anomalous for mutual funds to be eligible to use simplified prospectuses and to be distributed by mutual fund dealers while the equivalent protected product requires a long-form prospectus and the involvement of an investment dealer.

A Special Regime for Structured Notes

Yet another approach would be to set up a new regime for structured notes. However, we are loath to recommend a solution that would further complicate the regulatory framework.

Regulation According to the Underlying Investment

Our preferred approach would be to regulate structured notes according to the underlying investment.

Recommendation #1: Structured notes should be subject to the same disclosure and sales practices requirements as the underlying investment.

For instance, if the underlying investment is a mutual fund, the structured note would be subject to the same requirements regarding simplified prospectus disclosure, continuous disclosure, and sales practices as mutual funds.

Structured notes with more exotic underlying investments would become subject to prospectus filing and dealer registration requirements. To reduce the delays inherent in the review and approval of prospectuses, it would be open to issuers to use shelf registration, provided that they

are so qualified. Consideration should also be given to fast-tracking the processing of structured notes.²⁵

Recommendation #2: A fast track should be available for the processing of structured notes by the regulators.

In all cases, structured notes will become subject to regulatory disclosure requirements. This will ensure that all material facts about the product are disclosed in all cases.

Intermediaries Must Be Properly Equipped

Intermediaries play a key role in the distribution of investment products. They have the onerous duty of ensuring that all products sold to investors pass the suitability test. In order to discharge this responsibility adequately, intermediaries require knowledge not only of the client but also of the product.

Structured notes are a complex product. In the future, it can be expected that increasingly complex products will be brought to market. A key concern is ensuring that, no matter how complex the product, it is only sold when it passes the suitability test.

Knowledge of the product can be gained by performing a due diligence exercise. The due diligence on a structured note is complex and requires nothing less than professional expertise.

There is no alternative but to ensure that all intermediaries that sell structured notes are properly equipped to do so. This may be achieved by requiring that all such intermediaries employ staff with certain qualifications, such as the CFA or similar designations. In addition to conducting the due diligence, these employees would be responsible for supervising the trades in structured notes.

Recommendation #3: Intermediaries wishing to sell structured notes should be required to employ staff with certain qualifications, such as the CFA or similar designations.

²⁵ The regulations concerning shelf registration in Canada are set out in National Instrument 44-101 *Short Form Prospectus Distributions* and National Instrument 44-102 *Shelf Distributions*. All base shelf prospectuses and shelf prospectus supplements relating to specified derivatives or asset backed securities with novel features need to be reviewed by the regulators.

The maintenance of investor confidence also requires the strictest enforcement of the suitability rule.

Investors Must Be Educated

It will be easier for intermediaries to ensure that the suitability requirement is satisfied if their clients are well informed on the subject of investing generally and structured notes in particular. A well-informed client is more likely to understand the product and the various trade offs involved.

Investor education can take the form of brochures demystifying structured notes and explaining the main factors that an investor should take into account in deciding whether to buy the product. We believe that investor education is best achieved with the collaborative efforts of regulators, issuers, product structurers, and intermediaries.

Recommendation #4: Joint initiatives involving regulators, issuers, structurers, and intermediaries should be implemented to educate investors on the subject of structured notes.

Conflicts of Interests Must Be Addressed

In the United States, a fairness opinion is required from a qualified, independent third party when the issuer and lead underwriter are affiliated to one another. The opinion is to the effect that the pricing of the structured product is fair to the investor. There is no such requirement in Canada.

Recommendation #5: Consideration should be given to requiring a fairness opinion on the pricing of the product from a qualified, independent third party when the issuer and the structurer of a structured note are related parties.

6. Life Insurance Wrappers

This section focuses on the two main investment products offered by life insurance companies in Canada:

- Segregated funds, which are variable annuities; and
- Universal life insurance policies, which are a bundled product combining permanent life insurance with an investment product.

Distribution of Life Insurance Products to the Individual Market

In Canada, there are three main channels through which life insurance companies distribute their products to the individual (as opposed to the group) market:

- Career agents;
- Independent dealers and their agents; and
- Independent direct brokers.

In all cases, an agent must be licensed to sell life insurance products. Many agents have both a life insurance and a mutual fund license.

In the 1990s, some life insurance companies abandoned the career agent system (which entails heavy fixed costs such as salaries and occupancy costs) in favour of an independent dealer system (which entails variable costs such as commissions). More recently, some life insurers have shown renewed interest in career agents.

Independent dealers do not deal directly with the life insurers. Instead, they deal through a Managing General Agent (“MGA”). The MGA’s role is to process transactions and to act as an intermediary between the dealer and the life insurer. The MGA also plays an important business development role on behalf of the life insurer.

Some life insurers also deal directly with certain independent agents known as independent direct brokers.

i. Regulatory Background

a) Regulatory Framework in Canada

Life Insurers

The federal and provincial governments share jurisdiction over life insurers.

The federal government is responsible for conducting prudential reviews of life insurers with a federal charter in order to determine their financial soundness. Federal supervision is the responsibility of the Office of the Superintendent of Financial Institutions (“OSFI”) and encompasses life and health insurers holding more than 90 per cent of the industry’s assets.²⁶

The provincial governments are responsible for the prudential regulation of life insurers with a provincial charter.

Life Insurance Products

The provincial governments also have sole responsibility for the regulation of life insurance products and their marketing as well as the licensing of life insurance agents. In Quebec and Saskatchewan, life insurance and securities are regulated by an integrated financial services regulator. In other provinces, life insurance and securities are regulated by separate regulators.

b) Regulatory Concerns in Other Jurisdictions

In Canada, variable annuities and variable life insurance products are regulated as insurance under provincial legislation. The regulatory framework is different in the United States where these products are regulated as securities under the federal securities laws and as insurance under the state insurance laws. In the United States, these products may be sold through broker-dealers as well as insurance agents.

In the United States, concerns by securities and insurance regulators over variable annuities and variable life insurance products have mainly focused on ensuring the fairness of sales practices.

This includes the product's suitability for the client, complete disclosure to the client of all material facts about the product, the supervision and training of sales representatives as well as the maintenance of proper documentation.

Joint SEC/NASD Examination of Broker-Dealer Sales of Variable Products

In 2004, the staffs of the SEC and NASD conducted a number of examinations of broker-dealers to review sales of variable annuities and variable life insurance products.²⁷ The exercise was in response to a large number of complaints received from individual investors, many indicating that the client was sold a variable product without fully understanding it or that the product was not appropriate in the light of the client's investment objectives.

The joint staff report identifies both sound and weak practices in the areas of sales suitability, disclosure, supervision, training, and records maintenance. Although there are some differences between the United States and Canadian environments, it is instructive to review the findings of the SEC/NASD staffs.

In the area of sales suitability, the joint staff report noted that recommendations were being made that could not reasonably be regarded as suitable in the light of information regarding the customer, as follows:

- Age;
- Financial or tax status (e.g., sales that exceed a pre-determined percentage of the customer's net worth; sales that require the mortgage of a home to finance the purchase; or sales that require a customer to borrow from an existing life insurance policy or annuity);
- Investment objectives (e.g., the same product is recommended to all customers, one size fits all);
- Current need for income;
- Investment sophistication and ability to understand the complexity of variable products generally, and to monitor the investment of the separate account;

²⁶ Source: Office of the Superintendent of Financial Institutions.

²⁷ Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products, June 9, 2004.

- Low risk tolerance (e.g., high-risk equity funds are recommended to an investor with low risk tolerance);
- Need for liquidity (e.g., sale of an illiquid variable product to persons who will need their funds soon, and as a result incur surrender charges to obtain their funds);
- Lack of need or desire for life insurance; and
- Ineligibility under the terms of the prospectus.

The joint staff report also identified sound practices, including:

- The proper documentation of the basis for suitability decisions;
- The existence of comprehensive policies and procedures;
- The use of exception reports; and
- The use of automated systems.

NASD Proposed Rule on Variable Annuities

At about the same time that the joint staff report was released, NASD issued a proposed rule on the purchase, sale or exchange of variable annuities.²⁸ The proposed rule was made as a result of concerns about unsuitable recommendations and inadequate supervision.

The main requirements of the proposed rule are as follows:

- Suitability. In recommending a variable annuity transaction, a registered representative would be required to determine and document that:
 - the customer has been informed of the unique features of the variable annuity;
 - the customer has a long-term investment objective; and
 - the variable annuity as a whole, and its underlying investments, are suitable for the customer, particularly with regard to risk and liquidity.
- Disclosure and prospectus delivery. The firm or its representative would be required to provide the customer with a current prospectus and a separate brief risk disclosure

²⁸ NASD, Notice to Members 04-45 -- Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities, June 2004.

- document in plain English highlighting the main features of the particular variable annuity transaction.
- Principal review. Before a registered representative could effect any transaction in a deferred variable annuity, a registered principal would be required to review and approve the transaction.
 - Supervisory procedures. Firms would be required to establish written supervisory procedures to achieve compliance with the rule's standards.
 - Training firms would be required to develop training programs to ensure that registered representatives and principals comply with the rule's requirements and that they understand the unique features of variable annuities.

NAIC Model Regulation on Variable Annuities

The National Association of Insurance Commissioners ("NAIC") has also been active.²⁹ In September 2003, the NAIC adopted a model regulation entitled *Senior Protection in Annuity Transactions*. The model regulation, which was adopted as a model for legislation by several states, requires insurers and producers to adopt standards to evaluate the suitability of recommendations when selling variable annuities to seniors. In March 2006, the NAIC adopted revisions to extend the model's protections to all consumers.³⁰

ii. Segregated Funds

Annuities are an investment product offered by life insurance companies. An annuity may be broadly defined as a contract between a life insurer and its client whereby the client makes a current payment or series of payments to the insurer in exchange for the latter's promise to make a series of future payments to the client or beneficiary.

At one time, annuities were mostly of the fixed variety, whereby the client is guaranteed a fixed rate of return. The investment risk is borne by the insurer. Fixed annuities form part of the

²⁹ The National Association of Insurance Commissioners regroups state insurance regulators in the US. It provides a forum for the development of uniform policy.

³⁰ National Association of Insurance Commissioners, *Suitability in Annuity Transactions -- Model Regulation*, March 2006.

insurer's general fund. Since an insurer's general fund is mostly invested in bonds, the fixed rate of return promised to the client is related to bond returns.

Today, variable annuities are more common. Segregated funds are variable annuities. Segregated funds are so-called because they are segregated from the general fund of the life insurer.

Segregated funds have existed in Canada for some 40 to 50 years but they only took off during the bull market of the 1990s. Segregated funds are usually invested in equities. The future payments by the life insurer to the client will depend on the performance of the fund. Thus, the investment risk is borne by the client, not the life insurance company (subject to the guarantees given by the company, as described below).

From a legal perspective, when an investor buys a segregated fund, he is entering into a life insurance contract that gives him the right to allocate his premium among a number of segregated funds.³¹ From an economic perspective, segregated funds may be thought of as an investment fund around which a life insurance contract providing certain guarantees has been wrapped. Often, the investment fund is a mutual fund managed by a third party and which is also available for purchase on a stand-alone basis. Mutual funds constitute the underlying asset of approximately 85 per cent of segregated fund assets.

The Investor Does Not Own Units of the Segregated Fund

The investor in a mutual fund owns units or shares of the mutual fund. In the case of a segregated fund, the investor does not own units or shares of the segregated fund. Instead, the investor owns an insurance contract whose value is linked to that of the segregated fund. This is analogous to a structured note where the investor owns a note whose value is linked to that of an underlying asset.

The life insurer does not bear any investment risk. It hedges the risk by investing the premium in the segregated fund.

³¹ The technical term for the life insurance contract is "individual variable insurance contract" ("IVIC").

Guarantees

The insurance company guarantees a minimum value for the segregated fund at maturity or at the death of the holder, whichever happens earlier. The maturity date must be at least 10 years from the date of the original investment. The minimum value must be at least 75 per cent of the amount invested. At one time, a minimum value corresponding to 100 per cent protection of principal was common. In 2000, OSFI introduced capital requirements in respect of the segregated fund guarantee risks borne by life insurers. A product with 100 per cent protection requires more capital on the part of the life insurer than one with 75 per cent protection and is, therefore, more expensive. As a result, products with 75 per cent protection of principal have now become the norm.

Different levels of protection may apply at maturity and at death. For instance, a product may feature 100 per cent protection at death but only 75 per cent protection at maturity.

If the holder redeems his investment prior to maturity, the guarantee does not apply.

The holder may be able to reset his principal from time to time. This enables him to lock in any increases in the value of the segregated fund. Suppose a \$10,000 investment has grown to \$15,000. The holder may decide to reset the protected amount at \$15,000. This privilege comes at the cost of extending the maturity date. The higher level of protection will only be effective if the investment is held for another period of at least 10 years or until death.

Protection from Creditors

Provided certain conditions are met, segregated funds cannot be seized by the holder's creditors. This feature makes segregated funds particularly attractive to self-employed persons. The main conditions are as follows:

- The named beneficiary must be a spouse, child, grandchild, or parent of the insured person (there are variations among the provinces) or the beneficiary must be designated irrevocably; and
- The holder must not have purchased the segregated fund for the primary purpose of shielding assets from creditors.

a) Business Model of a Segregated Fund Manager

In its capacity as a segregated fund manager, the business model of a life insurer is very similar to that of a mutual fund manager. The life insurer's sources of revenue consist mainly of management fees and redemption fees.

Management fees are charged to the fund and are normally calculated as a percentage of assets under management. Management fees are higher for segregated funds than for mutual funds because they include a fee charged by the life insurer to provide the guarantee. The guarantee fee will vary with the features of the product. Thus, a 100 per cent guarantee will cost more than a 75 per cent guarantee. Reset privileges will also add to the cost of the guarantee.

Typically, the management fee for a segregated fund with a 75 per cent guarantee will be higher than that of the underlying mutual fund by 0.5 to 1.0 percentage point. A 100 per cent guarantee will add another 0.5 percentage point to the management fee.

Redemption fees are paid by investors who purchase the segregated fund with a deferred sales charge and who redeem their investment within a certain period, say, seven years, following purchase.

The costs to the manager of operating a segregated fund consist mainly in marketing and distribution costs, including commissions and trailers to intermediaries, as well as management fees to the third-party manager of the underlying fund. There is also an opportunity cost involved in tying up capital to back the guarantee.

Commissions and trailers to intermediaries are usually similar to those paid on mutual funds.

The profit model of segregated funds may be contrasted with that of fixed annuities. In the case of segregated funds, the life insurer's revenue is fee-based and is driven by the level of assets under management. In the case of fixed annuities, the life insurer's profit is spread-based. It is represented by the difference between the return on the assets invested in the general fund and the fixed rate of return guaranteed to the client. Segregated funds involve no investment risk for the life insurer whereas fixed annuities clearly do.

b) Prudential Regulation of Life Insurers as Regards Segregated Funds

Life insurance companies in Canada are required to maintain adequate capital. The framework within which OSFI assesses whether a life insurance company maintains adequate capital is provided by the MCCSR Guideline.³² Capital requirements are determined for each of the risk components of a life insurer.

Prior to 2000, there was no capital requirement in respect of the risk of loss arising from guarantees embedded in segregated funds. Capital factors for segregated fund guarantee risks were first introduced in 2000 and are set out in section 9 of the MCCSR Guideline. The MCCSR Guideline uses a risk-based approach. For example, a 100 per cent guarantee carries more risk than a 75 per cent guarantee and, therefore, requires more capital.

There is an opportunity cost involved in tying up capital. When segregated fund capital requirements were introduced in 2000, this resulted in an increase in the management fees charged by life insurers to segregated funds.

c) The CLHIA Guidelines

The regulatory framework for segregated funds is set by the CLHIA Guidelines.³³ The CLHIA Guidelines were issued on March 4, 1997, and amended on March 7, 2001.³⁴ All the provincial and territorial jurisdictions have adopted the CLHIA Guidelines. Revised Guidelines incorporating certain minor changes will become effective on June 30, 2006.

Among other matters, the CLHIA Guidelines cover the following:

- The review of segregated fund documents in draft form by the CLHIA prior to their filing with the insurance regulators;

³² Office of the Superintendent of Financial Institutions, Minimum Continuing Capital and Surplus Requirements (MCCSR) for Life Insurance Companies, October 200

³³ The Canadian Life and Health Insurance Association (“CLHIA”) is a trade association whose membership includes virtually all the life and health insurers in Canada.

³⁴ The CLHIA Guidelines were published in the Ontario Gazette on November 3, 2001 and may be found at www.ontariogazette.gov.on.ca. The guidelines are incorporated by reference in Ontario Regulation 132/97 relating to Variable Insurance Contracts.

- The matters to be disclosed in the information folder of a segregated fund;
- A requirement on the life insurer to deliver a copy of the information folder to a prospective client prior to the signature of the contract;
- A requirement to provide the client with an annual statement containing prescribed information;
- Regulations on the advertising of segregated funds;
- The manner of calculating the management expense ratio of a segregated fund;
- The investment rules applicable to segregated funds; and
- The audit and accounting requirements applicable to segregated funds.

d) Differences in the Regulation of Segregated Funds and Mutual Funds

Given the close similarity of segregated funds and mutual funds, it would make sense for the regulation of the two products to be harmonized.³⁵

As a matter of fact, the securities and insurance regulators have, through the Joint Forum, been working for some time now on projects to harmonise the regulation of segregated funds and mutual funds.

In May 1999, the CSA and the CCIR jointly published a comparative study of segregated funds and mutual funds.³⁶ The CSA and the CCIR expressed their objective “to ensure that their respective regimes of regulation are harmonized and give similar protections to investors in these different, yet functionally similar products”. The study includes a helpful comparative table that compares specified features for both products and their regulation.

Building on the May 1999 study, the Joint Forum recommended in December 1999 fifteen topics where harmonisation could be undertaken.³⁷ These topics relate to the areas of product regulation, disclosure, manufacturer regulation and distribution regulation. Initiatives are currently under way to implement certain of these recommendations.

³⁵ For a detailed discussion of the regulatory framework applying to mutual funds, please see the companion report *A Canadian Framework for Hedge Fund Regulation*.

³⁶ Canadian Securities Administrators and Canadian Council of Insurance Regulators, *A Comparative Study of Individual Variable Insurance Contracts (Segregated Funds) and Mutual Funds*, May 7, 1999.

³⁷ Joint Forum of Financial Market Regulators, *Recommendations for Changes in the Regulation of Mutual Funds and Individual Variable Insurance Contracts*, December 15, 1999.

We believe that the areas where harmonization would be most beneficial are as follows:

- Disclosure;
- Investment rules applying to the funds; and
- Distribution.

e) **Disclosure**

The main disclosure documents provided by mutual funds are:

- The simplified prospectus;
- The annual information form;
- Financial statements and fund portfolio reports; and
- Management reports of fund performance.

National Instrument 81-101 *Mutual Fund Prospectus Disclosure* prescribes the requirements for the simplified prospectus and the annual information form. National Instrument 81-106 *Investment Fund Continuous Disclosure* prescribes the requirements for financial statements, fund portfolio reports, and the management report of fund performance.

The information folder of a segregated fund is the counterpart of the simplified prospectus and annual information form of a mutual fund. The contents of the information folder are prescribed by the CLHIA Guidelines. The latter also require segregated funds to prepare annual audited and semi-annual unaudited financial statements. Segregated funds are not required to prepare management reports of fund performance.

Harmonisation Initiatives

In 2003, the Joint Forum published a consultation paper on harmonizing point of sale disclosure for segregated funds and mutual funds.³⁸ The Joint Forum saw this as an opportunity not only to

³⁸ Joint Forum of Financial Market Regulators, Consultation Paper 81-403 -- Rethinking Point of Sale Disclosure for Segregated Funds and Mutual Funds, February 13, 2003.

harmonize but also to modernize the disclosure requirements. The most significant proposal was to adopt a “layered” approach to disclosure, whereby materials would be made available to investors in components. Investors would decide for themselves how much information they want to receive.

Four components were envisaged:

- A fund summary document;
- A foundation document;
- The continuous disclosure record; and
- A consumers’ guide.

A new document called a *fund summary document* would be given by the intermediaries to all investors before a purchase is made. The document would be one or two pages long. Besides providing the most important information about the fund, the document would inform investors that they can find additional information in other disclosure components, i.e., the foundation document, the continuous disclosure record and the consumers’ guide. We understand that a model will be made available for comment in 2006.

The *foundation document* would provide all of the relatively static information about the fund. It corresponds to the simplified prospectus and annual information form of a mutual fund and the information folder of a segregated fund. However, unlike the existing documents, it would not contain educational material on investing or material on the track record of the fund. Instead, the educational material would be included in a consumers’ guide and the track record of the fund in the continuous disclosure record.

The *continuous disclosure record* would consist of the periodic financial statements of the fund together with management reports of fund performance.

Both the foundation document and the continuous disclosure record would be available on the fund manager’s website and in paper form. The Joint Forum proposed an “access equals delivery” approach for these documents.

Finally, there would be a *consumers' guide*. This would be a joint regulatory-industry document and would contain educational material on segregated funds and mutual funds. The Joint Forum proposed that market participants would offer the guide to those investors whom they believed would benefit from reading it.

We fully support the layered approach to disclosure. We recognise that implementation of this approach is not easy. In particular, the form and content of the fund summary document must be carefully thought out. The fund summary document must also pass the test of cost-benefit analysis. The experience of the FSA in this respect may be instructive.

The UK Experience

In the United Kingdom, investors are required to be provided with a Key Features Document (“KFD”) at the point of sale. The KFD serves a similar purpose to the proposed fund summary document. The FSA is aware that many investors do not read the KFD. Reasons for this may include:

- Failure of the document to stand out and identify itself as being important;
- A perception that it appears boring and impenetrable;
- Uncertainty about the exact role of the documentation; and
- Reliance by many investors on the advice delivered orally by their adviser.

In July 2005, the FSA issued a consultation paper on a Quick Guide, which would replace the KFD.³⁹ The Quick Guide was intended to be a stand-alone document to be placed at the top of the marketing pack. It would follow a tabular format containing ten set numbered questions and bulleted answers and be no longer than two sides of printed paper. Specimens were provided in the consultation paper.

In March 2006, the FSA announced that it would delay the implementation of these proposals.⁴⁰ Cost-benefit analysis had shown that there would be significant costs to implementing the proposals. Furthermore, consumer testing had indicated that the benefits of change would be limited.

³⁹ Financial Services Authority, Consultation Paper 05/12 -- Investment Product Disclosure: Proposals for a Quick Guide at the Point of Sale, July 200

f) Investment Rules

The investment rules governing mutual funds are set out in National Instrument 81-102 *Mutual Funds*. Those governing segregated funds are set out in Part X of the CLHIA Guidelines (Part IX of the revised Guidelines, which will become effective on June 30, 2006).

The investment rules governing segregated funds are less restrictive than those applicable to mutual funds. As a result, segregated funds are able to offer a wider choice of investment strategies. Unlike mutual funds, segregated funds may invest in real estate. Segregated funds also have greater latitude to invest in mortgages.

More importantly, segregated funds may use derivatives for the purpose of leverage and short selling. Mutual funds may only use derivatives for hedging purposes and may not use leverage or short selling.⁴¹ Leverage and short selling are essential techniques in the implementation of hedge fund investment strategies. These strategies may be offered by segregated funds but not by mutual funds.

The Joint Forum has a project to “work with stakeholders to identify the problems resulting from differences in investment rules for pension funds, mutual funds, segregated funds, and other pooled investment funds; develop recommendations for possible solutions; and coordinate the implementation of adopted solutions”.⁴²

We support this project. We believe that the exercise should be taken as an opportunity to broaden the investment powers of mutual funds rather than to restrict those of segregated funds. The ability to use leverage and short selling allows the implementation of absolute return investment strategies that enhance the efficiency of investors’ portfolios.

Recommendation #6: The proposed harmonization of investment rules applicable to mutual funds and segregated funds should be taken as an opportunity to broaden the investment powers of mutual funds rather than to restrict those of segregated funds.

⁴⁰ Financial Services Authority, Press Release -- FSA Update on Investment Product Disclosure, March 24, 2006.

⁴¹ Some mutual funds have received exemptive relief to short sell, subject to a limit of 10 per cent of their net assets.

⁴² Joint Forum of Financial Market Regulators, Strategic Plan 2005 -- 2008, May 200

g) Distribution

The sales practices relating to mutual funds are governed by National Instrument 81-105 *Mutual Fund Sales Practices* (“NI 81-105”). NI 81-105 has been very successful in its objective of ensuring that mutual funds are sold on the basis of what is suitable for, and in the best interests of, investors rather than on the basis of incentives received by dealers and their sales representatives.

NI 81-105 begins by prohibiting the payment of any monetary or non-monetary compensation by a fund manager to dealers in connection with the distribution of the units or shares of a mutual fund, except for those forms of payment which are specifically allowed. The latter include sales commissions (subject to numerous conditions) and trailer fees, provided the latter are based on assets under administration.

NI 81-105 defines the types of cost that may be paid by a fund manager in connection with marketing and educational events and the conditions that must be met. For instance, a mutual fund manager may allow a dealer representative to attend an educational seminar organized by the manager only if the seminar is held in Canada or the continental United States, and not in some exotic location.⁴³

Also, NI 81-105 prohibits a fund manager from directing transactions to the trading desk of a dealer as an inducement to the dealer to sell its mutual funds. It regulates other sales practices such as the rebating of commissions by dealers to their clients, the provision of financial assistance by managers to dealers, the making of a charitable donation by a manager where the tax benefit accrues to a dealer, and tied selling. It requires disclosure of all compensation payable to dealers and of all equity interests between a manager and a dealer.

When selling segregated funds, life insurance agents must comply with the requirements of the relevant provincial or territorial insurance act, regulations thereunder and industry codes of conduct. These requirements are not as detailed as those of NI 81-10

⁴³ A conference or seminar may also be held, under certain conditions, at a location where a portfolio adviser of the mutual fund carries on business.

Because segregated funds are considered to be a life insurance product for regulatory purposes, a life insurance agent is not required to possess a mutual fund licence when selling a segregated fund. This is the case even when the asset underlying the segregated fund is a mutual fund. This approach places form ahead of substance and appears anomalous to us.

Mutual fund managers have long recognized that mutual funds and segregated funds compete with one another. In their view, the playing field is not level because life insurers can offer to intermediaries various inducements to sell their products, which mutual fund managers are not allowed to offer. There is some justification in this view. The sales practices applicable to segregated funds and to mutual funds should be harmonized. We note that a similar recommendation was made by the Joint Forum:

“Some conflicts cannot be policed by disclosure or competitive market forces and should simply be prohibited, such as non-educational trips, incentives contingent on meeting specified assets and sales thresholds, excessive promotional events and items, excessive payment of marketing expenses and reciprocal commissions.”⁴⁴

The Joint Forum has a project to “examine the regulation of intermediaries and recommend ways to minimize possible conflicts or undue burden and promote equivalent consumer protection, focusing initially on intermediaries who sell mutual funds and IVICs (i.e., segregated funds).”⁴⁵ We recommend that this project be assigned high priority.

Recommendation #7: The project to examine the regulation of intermediaries should be assigned high priority.

iii. Universal Life Insurance

Despite their status as a life insurance product, segregated funds are essentially an investment product. On the other hand, universal life insurance combines permanent insurance protection with an investment vehicle.

⁴⁴ Joint Forum of Financial Market Regulators, Recommendations for Changes in the Regulation of Mutual Funds and Individual Variable Insurance Contracts, December 15, 1999.

Although universal life insurance has been around in Canada for some 20 years, the product only took off during the stock market boom of the latter half of the 1990s. The product lost in popularity during the bear market of 2000 to 2002 but it has since made a come back.

Because universal life insurance is a life insurance product, a life insurance agent is not required to possess a mutual fund licence when selling a universal life insurance policy. This is the case even when the underlying investment is a mutual fund. Again, this situation appears anomalous to us.

Recommendation #8: The project to examine the regulation of intermediaries should address the anomaly whereby life insurance agents may sell segregated funds and universal life insurance policies without a mutual fund licence even when the underlying asset is a mutual fund.

A major benefit of universal life insurance is that any income or gain on the investment component is tax-exempt. The maximum amount that may be invested in the tax-exempt investment component depends upon the amount of life insurance coverage.

Another advantage of universal life insurance is its flexibility. For instance, the amount and timing of deposits are flexible within certain limits. The minimum deposit is an amount just sufficient to pay for the life insurance coverage. The maximum deposit is prescribed by tax regulations and, as explained above, depends on the amount of life insurance coverage. In a year when the policyholder's income is high, he may make a larger deposit, thereby building up the investment component more quickly. In a year when his income is low, he may make a smaller deposit or even pay just the minimum amount.

Implications of the Insolvency of a Life Insurer

Universal life insurance policies form part of the insurer's general fund. In this, they differ from segregated funds which, as their name implies, are segregated from the insurer's general fund.

The distinction matters in the event of the insolvency of the insurer. Holders of universal life insurance policies would have a claim on the assets of the general fund together with the insurer's

⁴⁵ Joint Forum of Financial Market Regulators, Strategic Plan 2005 -- 2008, May 2005

other creditors. On the other hand, the assets of segregated funds and their value to investors would not be impacted by the insolvency of the insurer, although the guarantees might be impaired by the insolvency.

Purchasers of life insurance products enjoy a degree of protection in the event of the insolvency of the life insurer. All life insurers are required to be a member and contribute to the funding of Assuris (formerly CompCorp), which administers the industry's consumer protection fund. In the event of insolvency of a member, Assuris guarantees that policyholders will recover at least 85 per cent of their promised benefits under a variety of products. Benefits under certain ceilings are 100 per cent protected. In the case of death benefits, the ceiling is \$200,000 and in the case of cash values (i.e., investments), \$60,000. Holders of segregated funds with guarantees are eligible for cash value coverage whereas holders of universal life insurance policies are eligible for both death benefit and cash value coverage.

Recent insolvencies of life insurers include those of Les Coopérants (1992), Sovereign Life (1992) and Confederation Life (1994).⁴⁶

a) An Illustration of Universal Life Insurance

In practice, universal life insurance policies exhibit a wide variety of features. Indeed, the choice of options can be rather bewildering. Examples of options are:

- The type of coverage (e.g., single life, joint life, or multiple life);
- The death benefits (e.g., level face amount or face amount plus fund; the face amount may or may not be indexed to inflation);
- The investment options (see section 6(c)(ii) below);
- The type of premium (e.g., level or yearly renewable term); and
- Optional benefits (e.g., renewable term benefits, accidental death benefit, total disability benefit, etc.).

⁴⁶ Source: Assuris.

A straightforward example will be used to illustrate how the product works. Suppose that a client purchases life insurance coverage of \$500,000 and invests certain amounts over time in the investment component.

The investment component will grow tax-free over the life of the client. Suppose that, at the time of the client's death, the investment has grown to \$500,000. A total amount of \$1 million, consisting of the death benefit of \$500,000 together with the value of the investment component, will be paid tax-free to the beneficiary.

As shown by this example, a universal life insurance policy is a tax-efficient way to transmit wealth to one's beneficiaries. Another use of the product is to supplement the holder's income during retirement. At the age of, say, 65 years, the holder may borrow a loan, using the policy as collateral, and use the proceeds to supplement his income from other sources. The loan, together with interest, will be repaid at the death of the holder out of the tax-free proceeds of the policy.

The product also has applications in business contexts. When a partner dies, the proceeds of a universal life insurance policy may provide the funds for the surviving partners to buy out the deceased partner's share.

b) The Investment Component

The investment component may be invested, at the holder's choice, in a range of investments. These may include daily interest accounts, term deposits, mutual funds (including third-party funds), and even hedge funds. The mutual funds may include index funds as well as actively managed funds. The holder may change the investment mix as he wishes.

The Investor Does Not Own the Investments

The investor does not own the investments. Instead, the investor owns an insurance contract whose value is linked to that of the investments. This is similar to a structured note, where the investor does not own the underlying investment. Instead, the investor owns a note whose value is linked to that of the underlying investment.

The life insurer does not usually bear any investment risk. It hedges the risk by investing the deposits in the investments selected by the investor.

No Guarantee

The investment component is not principal-protected unless it is invested in products, such as term deposits, which themselves enjoy principal protection.

Protection from Creditors

Life insurance policies cannot be seized by the holder's creditors if the named beneficiary is a spouse, child, grandchild, or parent of the insured person (there are variations among the provinces) or if the beneficiary is designated irrevocably.

iv. Similarity of Segregated Funds and Universal Life Insurance

As investment wrappers, segregated funds and universal life insurance policies work in much the same way. The major difference is that the life insurance component is relatively small in a segregated fund whereas it plays an important role in a universal life insurance policy.

If one accepts that the regulation of segregated funds and mutual funds should be harmonized, then it requires but one small step to suggest that the harmonization efforts should extend to the investment component of universal life insurance policies.

Recommendation #9: Consideration should be given to extending to universal life insurance policies the current initiatives to harmonize the regulation of segregated funds and mutual funds.

Abbreviations

CAPSA	Canadian Association of Pension Supervisory Authorities
CCIR	Canadian Council of Insurance Regulators
CISRO	Canadian Insurance Services Regulatory Organizations
CLHIA	Canadian Life and Health Insurance Association
CLHIA Guidelines	CLHIA Guidelines on Individual Variable Insurance Contracts Relating to Segregated Funds
CPPI	Constant Proportion Portfolio Insurance
CSA	Canadian Securities Administrators
FSA	Financial Services Authority (UK)
FSCO	Financial Services Commission of Ontario
GIC	Guaranteed Investment Certificate
IDA	Investment Dealers Association of Canada
IVIC	Individual Variable Insurance Contract
Joint Forum	Joint Forum of Financial Market Regulators
KFD	Key Features Document (UK)
MCCSR Guideline	Minimum Continuing Capital and Surplus Requirements Guideline
MGA	Managing General Agent
MLPI	Multilevel Portfolio Insurance
NAIC	National Association of Insurance Commissioners (US)
NI 81-105	National Instrument 81-105 <i>Mutual Fund Sales Practices</i>
OSC	Ontario Securities Commission
OSFI	Office of the Superintendent of Financial Institutions
RRSP	Registered Retirement Savings Plan
SEC	Securities and Exchange Commission (US)
UCITS	Undertakings for Collective Investment in Transferable Securities
VPPI	Variable Proportion Portfolio Insurance

Appendix 1

1. Structured Note Fundamentals

The building blocks of a structured note are:

- A zero-coupon bond; and
- A derivative in the form of a call option.

i. Zero-Coupon Bonds

A zero-coupon bond is a debt instrument that does not pay periodic interest and is redeemed for its face value at maturity. Prior to maturity, it trades at a discount to its face value.

The advantage of a zero-coupon bond is that it enables the purchaser to avoid reinvestment risk, which is the risk that cash flows received prior to maturity and may need to be reinvested at a lower interest rate than the current rate. There is no reinvestment risk because, by definition, a zero-coupon bond pays no coupon. Reinvestment risk is particularly relevant when interest rates are trending downwards.

The price of a zero-coupon bond depends on the time remaining till maturity and on the interest rate required by investors. The latter will itself depend on a number of factors, including the rating of the issuer's debt.

Table 1 illustrates the relationship between the price of a zero-coupon bond, the time to maturity, and the interest rate. Assume that there are seven years till maturity and that the annual rate of interest is 6 per cent. Table 1 shows that the price of a bond with a face value of \$1,000 is \$665. This is the amount that, when invested at a compound annual interest rate of 6 per cent, gives \$1,000 in seven years' time.

The longer the time to maturity, the lower the price of the bond will be. This can be seen by looking across the "6 per cent" row of Table 1. If the time to maturity is lengthened to eight years and the annual rate of interest is maintained at 6 per cent, the price of the bond will decline to \$627, compared with \$665 in the original case.

The higher the rate of interest, the lower the price of the bond will be. This can be seen by reading down the “7 years” column. If the annual rate of interest is increased to 7 per cent and the time to maturity is maintained at seven years, the price of the bond will decline to \$622, compared with \$665 in the original case.

Table 1
Relationship Between the Price of a Zero-Coupon Bond,
the Time to Maturity, and the Interest Rate
(Assuming a face value of \$1,000)

	Time to Maturity	
	<u>7 years</u>	<u>8 years</u>
6 per cent	\$665	\$627
7 per cent	\$622	\$582

ii. Options⁴⁷

An option may be a *call* option or a *put* option.

Call Options

A *call* option gives the holder the right, but not the obligation, to buy an asset (known as the *underlying asset*) at a specified or determinable price (known as the *exercise price* or *strike price*) at the end of or during a period of time (known as the *term* of the option). An option which may be exercised only at the end of the term is known as a *European* option whereas an option which may be exercised at any time during the term is known as an *American* option. The price for which an option may be bought or sold is known as the *premium*.

When the price of the underlying asset is equal to the exercise price, a call option is said to be *at-the-money*. In this situation, it makes no difference to the holder whether the option is exercised or not.

⁴⁷ For a useful introduction to options in a Canadian context, see Montréal Exchange, Equity Options Reference Manual, March 2004.

When the price of the underlying asset is higher than the exercise price, a call option is said to be *in-the-money*. In this situation, it is worth exercising the option. Assume the underlying asset is a stock whose price is \$50. Assume also that the exercise price is \$40. On exercising the option, the holder will pay the exercise price of \$40 to acquire the stock which he can then immediately sell on the market for \$50, thereby making a \$10 profit before taking the cost of the premium into account.

When the price of the underlying asset is lower than the exercise price, a call option is said to be *out-of-the-money*. It will not be worth exercising the option. Suppose the price of the underlying stock is \$30. There would be no point in paying the exercise price of \$40. If the investor wants the stock, he can buy the stock on the market at the cheaper price of \$30.

Put Options

A *put* option gives the holder the right, but not the obligation, to sell the underlying asset at the exercise price at the end of the term (in the case of European options) or during the term (in the case of American options).

When the price of the underlying asset is equal to the exercise price, a put option is said to be at-the-money. There is no profit or loss to be made from exercising the option.

A put option is in-the-money when the price of the underlying asset is lower than the exercise price. The holder will then make a profit from exercising the option. Assume the price of the underlying stock is \$30 and the exercise price is \$40. On exercising the option, the holder will sell the stock for the exercise price of \$40. At the same time, he can purchase the stock on the market for \$30, thereby making a \$10 profit before taking the cost of the premium into account.

A put option is out-of-the-money when the price of the underlying asset is higher than the exercise price. In that situation, it will not be worth exercising the option. Assume the price of the underlying stock is \$50. There would be no point in exercising the option and receiving the exercise price of \$40 when the holder can sell the stock on the market for \$50.

Risks to the Holder of an Option

The buyer (also known as the *holder*) of an option knows in advance the maximum amount of the potential loss. The loss cannot be greater than the premium paid.

Consider a call option. If the price of the underlying asset remains below the exercise price throughout the term, the holder will simply let the option expire unexercised. The holder's loss will consist in the premium paid to acquire the option.

Now, assume the price of the underlying asset rises above the exercise price. In this case, the holder can realize a profit by exercising the option. Since there is no limit to how high the price of an asset can rise, the potential profit to the option holder is unlimited.

In the case of a put option, if the price of the underlying asset remains above the exercise price throughout the term, the holder will simply let the option expire unexercised and the loss will consist in the premium paid to acquire the option.

Now, assume the price of the underlying asset drops below the exercise price. In this case, the holder can realize a profit by exercising the option. Since the price of an asset usually does not drop below zero, the potential profit to the option holder is limited to the exercise price less the cost of the premium.

Exchange-Traded Options versus Over-the-Counter Options

Options may be purchased on an exchange. Such options are standardised as to contract size, maturity date, exercise price, etc. Exchange-traded options are issued and their settlement guaranteed by a clearinghouse. This effectively eliminates *counterparty risk*, which is the risk that the counterparty does not perform its obligations. In Canada, settlement is guaranteed by the Canadian Derivatives Clearing Corporation, which is owned by Bourse de Montréal Inc. In the U.S., settlement is guaranteed by the Options Clearing Corporation, a clearing house owned by a group of broker-dealers and other financial institutions.

When a party has specific requirements that cannot be met by exchange-traded options, it may purchase an option *over-the-counter*. In this case, the terms of the option are tailored to meet the exact requirements of the parties involved. In over-the-counter transactions, there is no

clearinghouse to guarantee settlement. Hence, the creditworthiness of the counterparty is very important.

In the case of structured notes, the options are usually purchased over-the-counter.

Pricing of Options

The price of an option depends on the following variables:

- The exercise price;
- The price of the underlying asset;
- The time remaining until the expiration of the option;
- The dividend yield on the underlying asset;
- The interest rate;
- The volatility in the price of the underlying asset.

The price of a call option varies *directly* with all the variables above except the exercise price and the dividend yield. For instance, the longer the time to expiration, the higher the price of the call option will be. This is because the longer the time to expiration, the more likely it is that the current price will rise above the exercise price.

On the other hand, the price of a call option varies *inversely* with the exercise price and the dividend yield. Thus, the higher the exercise price, the lower the price of the call option will be. This is because the higher the exercise price, the less likely it is that the price of the underlying asset will rise above the exercise price.

American options are more flexible than European options because they can be exercised at any time during the term of the option whereas European options can only be exercised on the last day of the term. For this reason, American options are more expensive than European options.

At the end of the term, the price of an option is determined solely by the exercise price and the price of the underlying asset. For instance, the price of a call option will be equal to the positive difference, if any, between the price of the underlying asset and the exercise price. This difference

is sometimes referred to as the *intrinsic value* of the option. Of course, if the difference is negative, the option will have no value.

The actual option pricing formula is complex. There is an urban legend that, when Fischer Black and Myron Scholes devised the original option pricing model at the University of Chicago in 1973, they had to enlist the assistance of the Mathematics Department to solve the problem. Today, option prices are found by using computer models that are descendants of the Black-Scholes model.

iii. How to Construct a Structured Note

A number of steps are involved in assembling the building blocks into a structured note.

The Wrapper

First, it is necessary to identify the investment vehicle through which the structured product will be offered to investors. This investment vehicle will be used to wrap or package the building blocks.

In the case of a principal-protected product, the most natural wrapper would be a note or other debt instrument. This is because the holder of a note normally has a right to be paid the face value at maturity.

It is also necessary to identify the entity that will issue the note (“the issuer”). The identity of the issuer will often influence the characteristics of the note.

Assume that the return on the note is linked to that of a single stock, ABC Limited (“ABC”), so that at maturity the investor will receive a return equal to the percentage increase in the stock price of ABC between the issue and maturity dates, net of fees and expenses. The stock of ABC thus constitutes the underlying asset.

The other characteristics of the note are:

- It is issued in denominations of \$1,000;
- It does not pay any coupon;

- It has a seven year term;
- The principal is protected at maturity; and
- The participation rate is 100 per cent .

The participation rate is a fixed percentage of the growth of the underlying asset. Since the participation rate in this case is 100 per cent , the note holder will receive at maturity a return equal to 100 per cent of the increase in the stock price of ABC, net of fees and expenses. Assume that ABC currently trades at \$50 per share. If the price per ABC share at maturity is \$75, then the stock price will have increased by 50 per cent . In addition to the principal, the note holder will receive a return of 50 per cent , less fees and expenses. If the price per ABC share at maturity is less than \$50, the note holder will receive only the principal but no return.

Protecting the Principal

It is necessary to ensure that the issuer is able to repay the note's principal at maturity. This is done by purchasing a zero-coupon bond. The annual rate of interest on a zero-coupon bond issued by a creditworthy issuer and with seven years till maturity is, say, 6 per cent . In section above, it was explained that, for every \$1,000 of face value, such a bond can be purchased for \$66. When the bond matures in seven years' time, it will be redeemed for its face value of \$1,000 and the proceeds used to repay the note's principal.

Hedging the Equity Risk

It is also necessary to protect the issuer from any exposure to the equity risk involved in the note, as represented by the obligation to pay at maturity a return equal to the percentage increase in the price of the underlying asset. This is done by purchasing a call option on the underlying asset.

After investing \$665 in the zero-coupon bond, there remains \$33. This amount is used to buy an at-the-money European call option on ABC with a seven-year term and an exercise price of \$50. Since \$1,000 will currently buy 20 shares of ABC at the price of \$50 per share, it is necessary to buy an option on 20 ABC shares. The option price is always a fraction of the underlying share price. For now, assume that, by coincidence, the option price is such that the available sum of \$335 suffices to buy an option on exactly 20 shares.

Fast-forward in time. Assume that in seven years' time, the stock price of ABC has dropped to \$4. Since the call option is out-of-the-money, it will simply expire unexercised. The note holder will earn no return.

Now assume that in seven years' time, the stock price of ABC has increased by 50 per cent to \$7. The price of a call option on one share will be equal to its intrinsic value of \$25 (i.e., the stock price of \$75 less the exercise price of \$50). On being exercised, the option on 20 shares will generate total proceeds of \$500 (i.e., 20 options times \$25 option price). This is equal to the return that needs to be paid to the note holder (\$1,000 investment times 50 per cent return), before fees and expenses.

iv. Structural Variations on the Note

In the example above, it was assumed that, by coincidence, the option price is such that the available amount of \$335 suffices to buy exactly the required number of 20 shares. The real world is rarely quite so accommodating. Assume the option price is such that the available amount of \$335 is sufficient to buy an option on only 16 shares, which is 80 per cent of the required number.

This means that the product is not internally coherent. Before it is ready to be brought to market, it is necessary to revisit one or more of its characteristics.

One possibility would be to reduce the participation rate from 100 per cent to 80 per cent. Take the example where the stock price of ABC in seven years has gone up by 50 per cent to \$7. With an 80 per cent participation rate, the return to the noteholder would be \$400 (i.e., \$1,000 investment times 50 per cent return times 80 per cent participation rate). This is identical with the proceeds from exercising the option on 16 shares (i.e., 16 options times \$25 option price).

Another possibility would be to lengthen the term of the note. It was noted earlier that, the longer the time to maturity, the lower the current price of a zero-coupon bond. This will leave more money to be invested in the call option, making it possible to buy an option on more shares.

Yet another possibility would be to place a cap on the return of the note. For instance, investors may be allowed 100 per cent participation in the increase in the ABC stock price but only up to a price of, say, \$80. This would be implemented by means of a second option. This time, we would

sell a European call option on ABC with a seven-year term and an exercise price of \$80. If the stock price rises above \$80, whoever bought the option will exercise it. This means that the note holders will not benefit from increases in the stock price above \$80. However, the proceeds of sale of the second option will make more funds available to purchase the first option, such that it is possible to buy an option on 20 shares.

Three possibilities have now been identified for the product:

1. An 80 per cent participation rate, a seven year term, and no cap on the return;
2. A 100 per cent participation rate, a term longer than seven years, and no cap on the return; and
3. A 100 per cent participation rate, a seven-year term, and a cap on the return when the ABC stock price reaches \$80.

Obviously, all kinds of other combinations are possible. For instance, it would be possible to introduce a minimum guaranteed return in the form of a coupon. This will obviously come at the cost of something else, for instance a lower participation rate. It will be up to the product structurer to ascertain which combination of features is most valued by investors.

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