AUTORITÉ DES MARCHÉS FINANCIERS

INCENTIVE MANAGEMENT GUIDELINE

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Introduction

The *Sound Commercial Practices Guideline* presents the outcomes expected of financial institutions in regard to their obligations to adhere to sound commercial practices and to treat clients fairly.[1] The expectations set out in that guideline[2] include the expectation that any real or potential conflicts of interest will be avoided or managed in a manner that ensures the fair treatment of clients (FTC).

Incentives offered to staff, intermediaries[3] or other persons acting on behalf of a financial institution or involved in offering its products and services are a potential source of conflicts of interest.

The *Incentive Management Guideline* complements the *Sound Commercial Practices Guideline*. Specifically, it sets out the AMF's expectations of the financial institution with respect to the management of incentive arrangements.

The financial institution is expected to design incentive arrangements that support FTC. It is also expected to implement risk management procedures and controls in order to fulfill its FTC obligation.

1 *Insurers Act*, CQLR, c. A-32.1, sections 50 and 51;
Act respecting financial services cooperatives, CQLR, c. C-67.3, sections 66.1 and 66.2;
Trust Companies and Savings Companies Act, CQLR, c. S-29-02, sections 34 and 35; and
Deposit Institutions and Deposit Protection Act, CQLR, c. I-13.2.2, sections 28.11 and 28.12.
The term "financial institution", when used in this guideline, refers to financial institutions that are subject to the legal obligation to adhere to sound commercial practices in accordance with the aforementioned enabling statutes. Consequently, the term does not include federations of mutual insurance associations.
Moreover, although these statutes refer specifically to "clientele", the terms "client" and "clients" are used in this guideline.

2 Specifically, see section 6.2 of the draft updated *Sound Commercial Practices Guideline*.

3 Intermediaries are persons authorized to offer financial products and services pursuant to the Act respecting the distribution of financial products and services, CQLR, c. D-9.2.

Definitions

Incentives

Incentives fall into two main categories:

- Monetary incentives, including:
  - commissions paid based on services expected and provided (e.g., initial sales, renewals, trailers)
  - Bonuses and salaries paid on achievement of performance targets and criteria (e.g., volume of sales, retention, growth, FTC)

- Non-monetary incentives, including:
  - rewards or privileges (e.g., travel, hospitality, goods, entertainment, gifts, titles, club or organization memberships, contest entry, client referrals, access to services, conferences, seminars, conventions or other events) provided on achievement of performance targets and criteria

Performance targets and criteria

Targets and criteria for assessing performance may be quantitative or qualitative:

- Quantitative performance targets and criteria reflect contribution to the financial institution's financial performance (e.g., sales volumes, profitability, productivity)
- Qualitative performance targets and criteria reflect FTC (e.g., results of controls, compliance with the financial institution's policies, disciplinary actions, complaints, client satisfaction)

Incentive arrangement

"Incentive arrangement" means the incentive itself, including the various features related to payment or recovery of the incentive, and the performance targets and criteria associated with the incentive.

1. Governance

> The AMF expects the financial institution's decision-making bodies to place FTC at the centre of decisions concerning the way incentive arrangements are managed.

Incentive arrangements reflect the values and objectives the financial institution wants to achieve and are key elements in establishing a business culture. Among other things, they demonstrate the importance that the financial institution places on FTC.

Policies, procedures and controls relating to incentive arrangements should therefore be monitored by the board of directors and senior management.

Among other things, the AMF expects the board of directors to:[4]

- Ensure that FTC is taken into consideration when implementing and assessing the effectiveness of policies, procedures and controls related to incentive arrangements
- Ensure that corrective adjustments are made to incentive arrangements when expected FTC outcomes cannot be achieved
- Ensure appropriate measures are taken with respect to the clients involved when a practice that could adversely affect FTC is identified

Among other things, the AMF expects senior management to:

- Develop and periodically review policies, procedures and controls related to incentive arrangements for continued effectiveness in managing risks of practices arising that could adversely affect FTC
- Review incentive arrangements periodically and at least once a year with input from the appropriate functions (e.g., risk management, compliance and human resources)
- Assess the impacts on the clients involved when a practice that adversely affects FTC is identified and take appropriate measures when required

[4] *Insurers Act, CQLR, c. A-32.1, section 94*
Act respecting financial services cooperatives, CQLR, c. C-67.3, sections 66.1 and 99
Deposit Institutions and Deposit Protection Act, CQLR, c. I-13.2.2, section 28.38
Trust Companies and Savings Companies Act, CQLR, c. S-29.02, section 75

2. Managing incentive arrangements

> The AMF expects established incentive arrangements to be managed in a manner that enables the financial institution to fulfill its FTC obligation.

Incentive arrangements arise primarily from the compensation and performance management programs the financial institution implements and the agreements it enters into with intermediaries and other persons acting on its behalf and involved in offering its products and services.

Incentive arrangements may vary depending on the nature of the financial institution's activities, the products or services offered, the distribution strategies used, and the roles and responsibilities of the persons involved in offering products and services.

The financial institution is expected to obtain reasonable assurance that the incentive arrangements put in place by intermediaries or other persons acting on its behalf and involved in offering its products and services are managed in a manner that enables it to fulfill its FTC obligation.

Expectations to achieve this outcome

- Establish a design and review process for incentive arrangement that includes the following:
  - Quantitative and qualitative performance targets and criteria are clearly defined, measurable and aligned to enable the financial institution to fulfill its FTC obligation
  - Any incentive offered is consistent with the level of service expected throughout the product's life cycle [5]
  - Incentive arrangements related to similar products[6] offered by the financial institution are comparable
  - If an incentive for the same product differs across distribution strategies and results in differences in the cost of the product for the client, this difference si commensurate with the level of service expected
  - Incentive arrangements consider the influence staff in certain positions may have (e.g., where there are reporting relationships) and potential pressures that may result from such influence in the offering of services and products
- Ensure that staff, intermediaries or other persons acting on behalf of the financial institution and involved in offering its products and services are informed in a timely manner of the incentive arrangements that apply to them

[5] "Life cycle of a product" means from product design to after-sale service.

[6] Products with features that can meet a client's needs and that involve the same level of service that is expected and provided. See example 2 in Appendix B.

- Collect and use information and key indicators[7] to be able to identify, in particular:
    - o Persons, lines of business and products most at risk of practices that could adversely affect FTC
    - o Trends, unusual sales spikes and practices that could adversely affect FTC
- Implement, periodically review and, when necessary, improve controls taking into account the identification and assessment of risks of practices that could adversely affect FTC and the assessment of results of controls
- Implement, with input from the human resources function when necessary, appropriate measures to correct practices that could adversely affect FTC, including:
    - o Taking appropriate steps or corrective actions when incentive arrangements result in inappropriate practices with clients, including through chargeback mechanisms for recovering an incentive once it has been paid
    - o Implementing appropriate measures, particularly at the human resources level, to demonstrate that practices that could adversely affect FTC are unacceptable
    - o Making the necessary corrections to incentive arrangements
    - o Establishing chargeback mechanisms so that incentives can be recovered if necessary once they have been paid

[7] Appendix A: Examples of information/key indicators

3. Identification and assessment of risks of practices that could adversely affect FTC

The AMF expects the financial institution to identify and regularly assess risks of practices that could adversely affect FTC that may arise from incentive arrangements.

Risks of practices that could adversely affect FTC may arise from, among other things, the design of incentive arrangements, the specific characteristics of the financial institution's business model[8] and the inefficiency of information systems and controls in place.

Appendix B provides a non-exhaustive list of examples of incentive arrangement features that may increase the risks of practices that could adversely affect FTC.

Expectations to achieve this outcome

- Review on a regular basis and as needed incentive arrangements with sufficient attention given to identify and assess features that may increase the risks of practices that could adversely affect FTC
- Give sufficient attention to incentive arrangements that are primarily based quantitative performance targets and criteria
- Elements to consider include:
    - The combining of various types of incentive arrangements for the same sale
    - Sales campaigns or other promotions
    - Risks arising from incentives offered to staff with the ability to influence others in the offering of products and services
    - Incentive arrangements implemented by intermediaries or other persons acting on the financial institution's behalf and involved in offering its products and services[9]
- Assess the likelihood of occurrence and potential impact on clients of practices that could adversely affect FTC, taking into consideration the controls put in place.

[8] For example, if the financial institution designs and sells its own products, if it controls the firm that distributes its products or its products are distributed by independent firms, if it outsources some of its activities to a service provider, etc.

[9] Sections 3 and 4 of the *Commercial Practices Guideline*.

4. Controls[10]

> The AMF expects the financial institution to establish controls to identify any inappropriate practices with clients resulting from incentive arrangements.

The financial institution is expected to perform controls to, in particular:

- Detect inappropriate practices with clients
- Determine residual risks of practices that could adversely affect FTC
- Ensure that the incentive arrangements as designed enable the achievement of the expected FTC outcomes

As the degree to which incentive arrangements present risks of practices that could adversely affect FTC increases, the need for the financial institution to ensure the effectiveness of its controls will also increase.

Expectations to achieve this outcome

- Ensure that staff applying the controls have the required competence and experience and are sufficiently independent to carry out their functions
- Ensure that controls take into account:
    - o The identification and assessment of risks of practices that could adversely affect FTC that may arise from incentive arrangements
    - o The analysis of information and key indicators collected
- Use various types of controls to assess staff interactions with clients [11]
- Regularly review the results of controls to ensure that
    - o Controls focus on risks of practices that could adversely affect FTC
    - o FTC outcomes are assessed
    - o Areas of concern or issues that must be addressed by the financial institution in order to fulfill its FTC obligation are identified

[10] With reference to sections 3 and 4 of the *Sound Commercial Practices Guideline*, where the financial institution's products and services are offered through intermediaries, the financial institution obtains reasonable assurance that the controls applied by the intermediaries allow it to fulfill its FTC obligation.

[11] For example, observing or listening to interactions with clients when products and services are being offered, mystery shopping, client surveys.

Appendix A

Examples of information/key indicators

This appendix provides a non-exhaustive list of examples of information and indicators that may be used by the financial institution to identify the individuals, lines of business and products that present the greatest risk of practices that could adversely affect FTC.

These examples do not necessarily apply to every type of product or service offered. They are drawn from various sources, including work carried out by the AMF in the context of its oversight and supervisory activities.

To determine which individuals are most at risk of practices that could adversely affect FTC, the financial institution may identify individuals:

1. For whom monetary incentives constitute a large percentage of total remuneration
2. For which products with higher commission rates represent a higher-than-normal percentage of sales
3. Who sell products to clients who do not fall within the defined target client groups for the products
4. With frequent chargebacks owing, for example, to products being cancelled shortly after they are sold
5. Who are the subject of repeated complaints from clients
6. With unusually high lapse rates on new business
7. With high penetration rates for cross-selling
8. With an unusually high number of product replacement transactions
9. Whose sales or practices are the subject of reports or measures by staff who apply controls

To determine which products are most at risk of practices that could adversely affect FTC, the financial institution may identify products:

10. With higher sales incentives
11. With sales incentives that are higher than for those offered by the same institution for similar products
12. That are the subject of sales campaigns or other promotions
13. For which there is an unusual increase in sales
14. With higher- than-normal lapse rates
15. With low renewal rates
16. With high claim denial rates
17. With sales that increase during specific periods, such as the bonus calculation period

Appendix B

Examples of incentive arrangement features

This appendix provides a non-exhaustive list of examples of incentive arrangement features that may increase the risks of practices that could adversely affect FTC.

These examples do not necessarily apply to every type of products or service. They are drawn from various sources, including work carried out by the AMF in the context of its oversight and supervisory activities.

Incentives

1. Higher bonus rates with higher sales volumes
2. Different incentives for similar products (risk of the more lucrative product being sold rather than the product that is best suited to the client's needs and situation)
3. Salaries increased or decreased, benefits provided or withdrawn or any penalty imposed (e.g., dismissal) depending on whether primarily quantitative performance targets and criteria are achieved or not
4. Bonus paid on each sale beyond a predetermined sales threshold. Individuals could attempt to complete as many sales as possible before the end of the bonus calculation period
5. Commission paid for ongoing services[12] that underestimate with the level of service expected
6. Significant discrepancies between commissions for the initial sale and ongoing services, which can cause individuals to propose a replacement transaction with no clear benefit for the client in order to receive greater compensation
7. Incentives offered for the same product that differs across distribution strategies (e.g., through a distributor or through a representative) and result in differences in the cost of the product for clients
8. Additional Incentives offered for sales of a specific product for a limited period

Performance targets and criteria

9. Quantitative performance targets and criteria that factor heavily in the payment of incentives
10. Performance targets or criteria that are ineffective in measuring or ensuring the achievement of the expected FTC outcomes
11. Use of targets and criteria to measure collective performance without sufficient weight being assigned to individual FTC performance
12. Incentive arrangements for managers that focus on quantitative performance targets and criteria

[12] E.g., renewal commissions, trailing commissions.

13. Incentive arrangements for debt collection staff that focus on the amount they collect (quantitative performance targets and criteria that increase the risk of staff engaging in inappropriate debt collection practices)
14. Performance measurement criteria that include cross-selling objectives

Other features

15. Renewal commissions are vested for life and paid to inactive, replaced or retired intermediaries (may result in clients being “orphaned” or a new intermediary attempting to sell another product to them in order to earn remuneration)
16. Agreements with intermediaries (e.g., distribution, financial assistance, access to IT platforms/software, call center) that allow the financial institution to influence the decisions, operations and practices of intermediaries or that restrict market access for intermediaries

    For example:

    - Imposition of a minimum volume or a deadline for attaining a minimum volume
    - Inclusion of a bonus or a share of the profits based on contract experience

    Such arrangements could have an effect on the advice provided by intermediaries or incentivize them to place a majority of new policies with a specific insurer.

    The making of certain agreements (e.g., distribution, financial support, other long-term benefits) may also be contingent on the making of other agreements.
17. Incentive arrangements that could entail penalties or fees for clients, such as withdrawal fees
18. Chargeback mechanism that may influence practices. A person may, for example, induce a client to keep an unsuitable product in order to avoid chargeback
19. Incentives offered on a discretionary basis
20. Incentive arrangements under which, for example, the sales commission may increase depending on the interest rate negotiated with the client, the amount invested or borrowed, or the amount of insurance coverage