1.1.2 CSA Staff Notice 44-304 - Linked Notes Distributed under Shelf Prospectus System

CSA STAFF NOTICE 44-304

LINKED NOTES DISTRIBUTED
UNDER SHELF PROSPECTUS SYSTEM

Introduction

CSA staff (we) have noticed an increase in the use of the shelf prospectus system for the distribution of linked notes. For purposes of this notice, a linked note is a specified derivative (as defined in National Instrument 44-102 *Shelf Distributions* (NI 44-102)) for which the amount payable is determined by reference to the price, value or level of an underlying interest that is unrelated to the operations or securities of the linked note issuer.

These linked notes are generally securities issued as part of a medium term note program established by a bank or another financial institution. The underlying interest is frequently one or more stock indices, equities, commodities, investment funds or notional reference portfolios. Linked notes are frequently targeted at the retail market.

This Notice provides guidance to issuers that intend to qualify linked notes for distribution by way of a shelf prospectus. It includes:

- a description of the concerns we have identified in prospectus disclosure for linked notes offered under the shelf prospectus system;
- a description of some things we think an issuer of linked notes should consider in deciding how to comply with the requirement for a prospectus to provide full, true and plain disclosure of all material facts relating to the securities being offered (the full, true and plain disclosure requirement);
- notice to issuers of linked notes that, before exercising our discretion to receipt a base shelf prospectus that qualifies linked notes, we will ask the issuer to file an undertaking to pre-clear prospectus supplements or templates of prospectus supplements pertaining to linked notes that the issuer has not previously distributed in a jurisdiction in Canada; and
- a description of the pre-clearance process we will follow.

Disclosure concerns

The substantive details of linked note offerings are not typically contained in the base shelf prospectus - a document that is subject to regulatory review in advance of distribution. Often those details are set out in a lengthy prospectus supplement. Unless the issuer considers the prospectus supplement to be for a “novel” derivative that is subject to regulatory pre-clearance under NI 44-102, it is generally filed with the regulators after the distribution has already taken place. As a result, any review of the prospectus supplement is on a post-distribution basis.

Since summer 2006, we have asked issuers filing base shelf prospectuses to file interim undertakings to pre-clear certain prospectus supplements pertaining to linked notes before exercising our discretion to receipt the base shelf prospectus. As a result, we have reviewed and pre-cleared most of the prospectus supplements qualifying linked note distributions since that time. In many of these cases, our review resulted in the inclusion of additional disclosure that we think was necessary for the shelf prospectus, the prospectus supplement and documents incorporated by reference to comply with the full, true and plain disclosure requirement. The general disclosure matters discussed below highlight the focus of our pre-clearance reviews.

Disclosure in prospectus supplements about linked notes

Under the securities legislation of each jurisdiction, an issuer’s prospectus must provide full, true and plain disclosure of all material facts relating to the securities offered by the prospectus. When an issuer is using the shelf prospectus system under NI 44-102, the full, true and plain disclosure requirement can be met by the combination of disclosure in the base shelf prospectus, the prospectus supplement and other documents the instrument permits the issuer to incorporate by reference.

This Notice describes some areas we think an issuer should consider in meeting the full, true and plain disclosure requirement for linked note offerings. CSA staff are currently applying the disclosure standards discussed below in reviewing prospectus supplements that are submitted for pre-clearance.

General disclosure matters

(a) Clear description of linked note

When the prospectus supplement or the base prospectus is offering linked notes, issuers should consider what information investors and their advisers would need to assess the nature of that security. Issuers may find that describing the linked notes in plain language, without being overly technical or relying on the use of complex jargon, will help a person trying to understand the nature of the security.

(b) Cover page disclosure

Given the unique characteristics of linked notes, issuers should consider whether investors and advisers would benefit from additional disclosure about the linked notes on the cover page of the prospectus supplement. Some examples of disclosure an issuer could consider are:

- explaining the linked note is a derivative product;
- informing readers that the linked note does not represent a direct investment in the underlying interest;
- describing whether an investor has any direct rights with respect to the underlying interest; and
- a summary of the key features of the investment including the underlying interest, the payout formula and the extent to which the investor's principal investment is at risk.

(c) Limits on investment returns

If a feature of a particular linked note is a limit on the return the issuer will pay to investors, we will generally conclude that the prospectus does not meet the full, true and plain disclosure requirement unless the shelf prospectus or prospectus supplement clearly explains that investors' returns will be capped at a certain amount and that they will not be able to participate in any returns on the underlying interest that exceed that maximum.

(d) Principal protection

In most linked note offerings some or all of the principal amount invested is at risk. In those cases where the issuer or another entity guarantees that an investor will receive some or all of the principal amount invested, we will generally conclude that the shelf prospectus and the prospectus supplement does not meet the full, true and plain disclosure requirement unless the issuer discloses that the principal protection depends on the creditworthiness of the issuer or guarantor. If principal protection only applies where the linked notes are held to maturity, this fact should also be disclosed in the prospectus supplement. The issuer should also disclose whether or not the linked notes qualify as a product covered by the Canada Deposit Insurance Corporation or any other similar product insurer.

(e) Past performance

Where the prospectus supplement contains past performance information for the underlying interest, the prospectus supplement should clearly state that past performance is not an indicator of future performance. Information provided should not include only the best periods for past performance while ignoring negative periods. This disclosure would be necessary to meet the full, true and plain disclosure requirement.

Issuers can refer to Item 4 of Part B of Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance* for further guidance on presentation of past performance information.

(f) Use of hypothetical calculation examples

Where an issuer uses hypothetical examples to illustrate how payouts for a linked note are calculated, the issuer should use reasonable and balanced assumptions and should disclose those assumptions. In particular, it may be misleading to emphasize potential gains while minimizing the risk of loss. It should also be clear that the hypothetical examples are not indicators of future results. This disclosure would generally be necessary to meet the full, true and plain disclosure requirement.

(g) Use of total return figures

If total return figures are used in the presentation of past performance data or assumptions for hypothetical calculation examples, the issuer should also refer to the equivalent compound annual returns in an equally prominent way in the prospectus supplement to meet the full, true and plain disclosure requirement.

(h) Benefit to issuer or affiliates of the issuer

For the purposes of the full, true and plain disclosure requirement, the issuer should clearly identify any benefits that will accrue to it or to any other parties that are involved in structuring or administering the linked note offering.

(i) Full explanation and transparency of fees and expenses

The full, true and plain disclosure requirement requires a clear and full explanation of fees that an investor will be paying. An issuer should clearly disclose any direct or indirect fees, expenses, costs or other charges that may be imposed on investors in linked notes. This would include any charges embedded in the formula used to determine payment at maturity, or in the offering price of the linked notes. For example, disclosure should be made of any fees or costs associated with enhanced participation rates, principal protection and any hedging activities undertaken by the issuer or any other party involved in product structuring on behalf of the issuer.

Issuers should consider what format the disclosure could take that would make the information easy to understand. For example, including all applicable fees, charges and expenses an investor would pay in a single table might be a useful format for this disclosure. This would allow investors to more easily determine the total cost of investing in a linked note without having to refer to various sections of the prospectus supplement.

(j) Conflicts of interest

We think that it is important for investors to understand where issuer and investor interests in a linked note might conflict. To meet the full, true and plain disclosure requirement, the prospectus supplement should disclose any actual or potential conflicts of interest that might arise from the different roles an issuer and its affiliates could have in connection with a linked note offering. Risk factor disclosure should also address these conflicts. Without this disclosure, investors may find it difficult to make an informed investment decision.

Investors may also find it helpful to understand how issuers will address situations where the issuer finds that its interests conflict with those of an investor. One way an issuer could do this is to disclose any policies or processes it has in place to deal with conflicts of interest or perceived conflicts identified by the issuer.

Some examples of conflicts we have seen, and how some issuers have resolved them, are:

1. Where an issuer or an affiliate of the issuer is also the calculation agent for the linked notes, the issuer provided disclosure to enable an investor to understand any risk that the calculation agent might not make decisions in the investor's favour.

2. A calculation, valuation or determination that the calculation agent must make for a linked note may require the calculation agent to apply material discretion or may not be based on information or calculation methodologies utilized by or derived from independent third party sources. In these situations, we have seen prospectus disclosure indicating that the calculation agent/issuer has a policy that would appoint an independent calculation expert to confirm its calculation, valuation or determination.

3. A conflict or perceived conflict may arise because an investor cannot easily verify payouts for certain linked notes. This might arise where the calculation formula the agent uses to determine payout amounts is complex, such as where the calculation depends not only on the final value of the underlying interest but also on the performance pattern of the underlying interest during the term of the note. Such complexities are compounded when the issuer or agent of the issuer has discretion to change the composition of the underlying interest. In situations like these, we have seen some issuers develop and disclose that they have an independent and objective review of the calculation process to deal with the potential conflict.

4. Some linked notes are linked to a portfolio or basket of underlying interests that may change from time to time in the discretion of the issuer or an investment manager retained by the issuer. This structure may generate additional conflicts. For these products, some issuers have appointed an independent committee made up of three independent members to oversee how the issuer handles the conflicts of interest. The issuers' prospectus disclosure has addressed how this type of body could assist the issuer to revolve the conflicts of interest it identified.

(k) Continuous disclosure

Because linked notes often constitute unsecured debt obligations of the issuer, an investor purchasing these notes would usually want to understand the credit quality of the issuer. As part of their investment decision, investors would also want to understand how they will be able to monitor changes in the underlying interest from which the linked note derives its value.

When considering the full, true and plain disclosure requirement, issuers should think about informing investors on how they can obtain on-going information about the issuer, the underlying interest and the performance of the linked notes.

(l) Risk disclosure

An issuer will generally find it difficult to meet the full, true and plain disclosure requirement without adequately disclosing the risks relating to the issuer and the particular linked note it is offering. The issuer should highlight any features of linked notes that differ from conventional debt securities, as well as the additional risks that may result from those differences. Risks for the investor will also usually be different than if the investor held the underlying interest directly. As a result, where an investor in a linked note does not have the same rights as it would if it held the underlying interest directly, we will generally consider that disclosing this information is necessary to meet the full, true and plain disclosure requirement.

(m) Suitability statement

Given the complexity of linked notes, it is important that issuers consider including a brief description of the suitability of a linked note for particular investors. This description may include the characteristics of investors for whom the linked note may or may not be a suitable investment.

(n) Secondary market and early redemption

If the linked note is redeemable, the full, true and plain disclosure requirement requires a description of how the redemption price is determined. In addition, where the issuer or a related entity intends to maintain a secondary market for its linked notes, the full, true and plain disclosure requirement would be satisfied by describing how bid-ask pricing is determined, as well as the limitations or conditions affecting the issuer's commitment to maintain a secondary market. Where principal protection is a feature of the linked note, it should be made clear, if it is the case, that investors will not benefit from this feature if they liquidate their investment prior to maturity.

(o) Underlying interest

In order to satisfy the full, true and plain disclosure requirement issuers must provide sufficient information regarding the underlying interest in order to allow investors to make an informed investment decision. As a result, issuers should consider whether the disclosure in the base prospectus or prospectus supplement would provide investors with sufficient information about the underlying interest so that an investor can fully understand the nature of its exposure under the linked note.

We have seen many linked note offerings use a market index or a basket of market indices as the underlying interest. Where this is the case, issuers may want to consider whether the indices on which they are basing the offering are "publicly available". We would generally consider a market index to be publicly available if there is market transparency of the index methodology, the constituents that make up the index, and the calculation of the index through information that is published and circulated to the public on a regular basis.

In some cases we believe that it would be difficult for an investor to readily access information about an underlying interest. In order to meet the full, true and plain disclosure requirement, issuers of linked notes tied to these underlying interests should pay special attention to whether adequate information about the underlying interest will be made available to investors. Areas where we think this could be particularly difficult are:

- proprietary indices established by the issuer or an affiliate of the issuer;
- hedge funds and hedge fund replication strategies; and
- any reference asset or interest for which there is no information in the public domain.

Specific disclosure for equity linked notes

Some linked notes (often called equity linked notes) provide a return based on the performance of an underlying security of a single underlying issuer or a static basket of underlying securities of one or more underlying issuer(s), where the issuer of the note and the underlying issuers (i.e. the issuers the note is linked to) are not the same. For the purposes of this Notice, equity linked notes do not include notes where the underlying issuer is an investment fund or the basket of underlying securities is a managed portfolio.

Investors in equity linked notes generally need specific information about the underlying issuer(s) to make informed investment decisions. This part of the Notice provides an issuer of equity linked notes with guidance on the disclosure it should consider including in its prospectus supplement to satisfy the full, true and plain disclosure requirement.

(a) Underlying issuer

An issuer of equity linked notes can meet the full, true and plain disclosure requirement in a number of different ways:

1. The issuer could include, or incorporate by reference, prospectus-level disclosure about an underlying issuer directly in its prospectus supplement.

2. The issuer could include "abbreviated disclosure" about an underlying issuer in its prospectus supplement if there is sufficient market interest and publicly available information about the underlying issuer. An issuer that chooses to include only abbreviated disclosure should consider whether that abbreviated disclosure satisfies the full, true and plain disclosure requirement. We will generally consider that the full, true and plain disclosure requirement is not met unless the disclosure includes, at a minimum:

    - a brief description of the name and business of each underlying issuer;
    - disclosure about the availability of information about each underlying issuer (on, for example, SEDAR); and
    - information concerning the market price of each underlying security (as, for example, quoted on the exchange on which the underlying security is listed).

    We will generally consider that there is sufficient market interest and publicly available information about an underlying issuer if the underlying issuer:

    - is a reporting issuer in at least one jurisdiction of Canada and has been a reporting issuer in a jurisdiction of Canada for at least 12 months;
    - is not on a list that identifies those reporting issuers that have been noted in default in a relevant jurisdiction in Canada, as described in CSA Notice 51-322 *Reporting Issuer Defaults*;
    - has filed a current AIF in at least one jurisdiction in which it is a reporting issuer;
    - has listed the underlying security on a short form eligible exchange (as defined in National Instrument 44-101 *Short Form Prospectus Distributions*);
    - is not an issuer whose operations have ceased or whose principal asset is cash, cash equivalents or its exchange listing;
    - is an electronic filer under National Instrument 13-101 *System for Electronic Document Analysis and Retrieval (SEDAR)*; and
    - has a market capitalization of at least Cdn$75 million.

3. The issuer could include other alternative disclosure provided the full, true and plain disclosure requirement is met.

(b) Direct or indirect financing benefit

To meet the full, true and plain disclosure requirement, the prospectus supplement should disclose whether each underlying issuer will receive a direct or indirect financing benefit from the distribution of the equity linked notes.

Whether an underlying issuer receives a direct or indirect financing benefit will depend on the facts and circumstances of a particular distribution. We may consider that an underlying issuer receives a financing benefit if the issuer of the equity linked notes has purchased securities of the same type as the underlying security directly from the underlying issuer within a proximate period of time to the distribution of the equity linked notes.

If an underlying issuer will receive a direct or indirect financing benefit, both the issuer of the equity linked note and the underlying issuer should refer to National Policy 41-201 *Income Trusts and Other Indirect Offerings* for further guidance.

(c) Physical delivery of underlying security

Certain equity linked notes may provide for the physical delivery of underlying securities at maturity. In this case, the prospectus supplement should disclose whether the underlying securities to be delivered will be subject to any resale restrictions under National Instrument 45-102 *Resale of Securities*. We understand that in most circumstances the underlying securities to be delivered will be freely tradeable.

Undertaking to pre-clear prospectus supplements

Due to our public interest concerns, before the securities regulators issue a final receipt for a base shelf prospectus that qualifies linked notes, issuers will be asked to file an undertaking to pre-clear prospectus supplements or templates for prospectus supplements pertaining to linked notes that the issuer has not previously distributed in a jurisdiction in Canada. These undertakings are in addition to the undertakings that are required under Part 4 of NI 44-102 for novel specified derivatives and asset backed securities.

The undertaking is not intended to capture "plain vanilla" debt securities where payment of the principal is guaranteed and the return is not linked to a derivative instrument. It is also not intended to capture derivatives of an issuer that are linked to the issuer's own securities, such as "plain vanilla" options and warrants.

A proposal to amend NI 44-102, which mirrors the broadened pre-clearance approach set out in this Notice, was published for comment on December 21, 2006. The comment period closed on March 31, 2007.

Issuer speed to market concerns

We recognize that issuers are concerned that the pre-clearance process could potentially affect their ability to take immediate advantage of perceived market opportunities. We have attempted to address this concern in the following three ways:

(a) Pre-clearance of templates of prospectus supplements

An issuer may submit for review a template of a prospectus supplement that it will use for future linked note offerings. To assist CSA staff in a review, the template should usually include most of the disclosure that the issuer would include in the prospectus supplement; however, the issuer may omit certain disclosure relating to information that the issuer would only know when the particular linked note distribution is identified. CSA staff would treat a pre-cleared template as supporting all subsequent offerings of linked notes by the issuer that are identical or substantially similar to the linked note described in the template.

(b) No pre-clearance of new tranches or series of previously issued linked notes

We will generally not ask an issuer to pre-clear a prospectus supplement that pertains to a new tranche or series of previously issued linked notes for which the issuer pre-cleared a prospectus supplement.

We will also generally not ask an issuer to pre-clear a prospectus supplement that pertains to a linked note that is not materially different from a previously issued linked note for which the issuer pre-cleared a prospectus supplement. We would not usually consider a change in the underlying interest to be a material difference unless it was a different type of underlying interest. For example, if the underlying interest is a publicly available market index, we do not think it is a material difference to use a different publicly available market index. Changing the underlying interest to a mutual fund or a notional reference portfolio, however, would likely result in the need for pre-clearance. We would also not consider a change to features such as the term to maturity or the level of principal protection to be material. We would usually consider introducing a new fee or a change to the payout mechanism to be a material difference.

(c) Shortened review time

The time period to provide initial comments on a prospectus supplement or a template of a prospectus supplement submitted for pre-clearance will be shortened from the 21 days set out in Part 4 of NI 44-102 to 10 working days. This shorter timeframe is consistent with the review period outlined in subsection 5.3(2) of National Policy 43-201 *Mutual Reliance Review System for Prospectuses* for complex offerings distributed under a short-form prospectus.

Pre-clearance process

The following is a summary of the process CSA staff will follow to pre-clear a prospectus supplement or template of a prospectus supplement:

- an issuer will file the prospectus supplement or template of a prospectus supplement and any other relevant material through SEDAR;

- the filing should be under the same SEDAR project number as the final base shelf prospectus;
- the filing subtype should be “prospectus supplement” and the document type should be “draft shelf prospectus supplement”;
- the filing should remain private;
- the filing should include a cover letter requesting pre-clearance of the prospectus supplement or template of a prospectus supplement;
- an issuer should identify, where possible, in the cover letter any previously issued linked notes of the issuer or other issuers that are similar to the linked notes being pre-cleared;
- the principal regulator will coordinate the receipt of comments from all jurisdictions where pre-clearance is sought;
- an initial comment letter will be issued through SEDAR within 10 working days of receiving the request for pre-clearance;
- the issuer should file its response to the initial comment letter through SEDAR;
- once all comments have been resolved, a letter confirming acceptance of the prospectus supplement will be issued through SEDAR; and
- a copy of the final version of the prospectus supplement or template of a prospectus supplement, which incorporates all changes required to address comments raised during the review, will be attached to the acceptance letter.

Once the issuer gets the acceptance letter, it may offer identical or substantially similar products based on that prospectus supplement or template of a prospectus supplement without the need for further pre-clearance. When filing the prospectus supplement for subsequent offerings based on the pre-cleared prospectus supplement or template of a prospectus supplement the issuer should:

- include a cover letter referring to the acceptance letter for the pre-cleared prospectus supplement or template of a prospectus supplement and setting out the basis for determining that pre-clearance of the current prospectus supplement is not required; and
- file a blacklined document showing a comparison of the current prospectus supplement against the pre-cleared prospectus supplement or template of a prospectus supplement.

Where an issuer is uncertain whether a prospectus supplement for a new offering would need to be pre-cleared, we would encourage the issuer to either treat the product as novel or to seek input from CSA staff prior to proceeding with the offering.

Future action

We will continue to monitor linked note offerings as both the nature of linked notes and the regulatory landscape evolve. We may provide additional guidance by updating this Notice or propose additional amendments to NI 44-102 or other instruments.

Questions and comments

Questions and comments may be referred to:

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