

1.1.3 CSA Notice 46-304 Update on Principal Protected Notes

CANADIAN SECURITIES ADMINISTRATORS' NOTICE 46-304

UPDATE ON PRINCIPAL PROTECTED NOTES

What is the purpose of this notice?

This notice provides an update on the Canadian Securities Administrators' (CSA) consideration of Principal Protected Notes (PPNs).

What is a PPN?

A PPN is an investment product that offers an investor potential returns based on the performance of an underlying investment and a guarantee that the investor will receive, on maturity of the PPN, not less than the principal amount invested. For the purpose of this notice, PPNs include the instruments commonly described as market-linked GICs and market-linked notes.

Background

On July 7, 2006, the CSA published CSA Notice 46-303 – *Principal Protected Notes* (CSA Notice 46-303) and an Investor Watch which identified a number of the CSA's concerns about PPNs. The key concerns related to four main areas:

1. Inadequate, overly complex and inappropriate disclosure in PPN information statements and marketing materials.
2. Compliance with know your client (KYC) and suitability obligations by registrants in connection with sales of PPNs.
3. Use of PPNs as a vehicle for selling alternative investment products to retail investors.
4. Registrant referrals to purchase PPNs without a determination by a registrant that the referral is in the best interests of the client.

CSA Consultations and Market Analysis

Since the publication of CSA Notice 46-303, the CSA has engaged in extensive consultations with industry stakeholders about the distribution and regulation of PPNs.

The CSA's consultations included meetings with representatives of:

- PPN issuers
- PPN manufacturers and distributors
- the Investment Dealers Association of Canada (IDA)
- the Mutual Fund Dealers Association of Canada (MFDA)
- the *Chambre de la sécurité financière* (CSF)

- law firms
- the federal Department of Finance

PPN Market

According to the October 2006 Investor Economics Report on Market-Linked Instruments, as of June 30, 2006, the total PPN market in Canada represented approximately \$30.9 billion in assets, comprised of \$13.8 billion of linked notes and \$17.1 billion of linked GICs. Based on information contained in the report, as of June 30, 2006:

- Approximately 88% of all issued and outstanding linked notes had been issued by banks listed in Schedule I or Schedule II to the *Bank Act* (Canada);
- Approximately 42% of linked GICs had been issued by banks and trust companies and another 53.5% had been issued by caisses populaires/credit unions.

Based on our consultations and the figures cited in the report, we understand that a majority of PPNs are issued by federally regulated financial institutions, primarily Schedule I and Schedule II banks. We also understand that caisses populaires based in Québec issue the vast majority of the linked GICs that are issued by caisses populaires/credit unions.

Through our consultations, we also understand that approximately 70-80% of linked notes are sold by IDA registrants and another 10% of linked notes are sold by MFDA members and their representatives.

Proposed Federal PPN Regulations

On March 19, 2007, the federal government released its *Budget Plan 2007*. In a companion document to the *Budget Plan 2007* entitled *Creating a Canadian Advantage in Global Capital Markets*, the federal government announced that it will "soon release for comment principles-based regulations for banks that issue [PPNs]..."¹ The Budget companion document includes the following statements about the proposed federal PPN regulations:

- The regulations will ensure that consumers are informed of the fees, returns, risks, and cancellation and redemption rights associated with PPNs;
- The regulations will require information to be clearly disclosed by qualified individuals in order to ensure that investors have the information they need to make more informed investment decisions;
- The regulations will require disclosure after purchase to aid investors in monitoring and tracking their investments.

¹ See page 39.

The CSA is consulting with the federal Department of Finance about the proposed federal PPN regulations and has provided comments on drafts of those regulations. We understand that the proposed regulations will apply to all PPNs (whether linked notes or linked GICs) issued by federally regulated financial institutions, including banks and authorized foreign banks under the *Bank Act* (Canada), retail associations under the *Cooperative Credit Associations Act* (Canada) and companies under the *Trust and Loan Companies Act* (Canada). We further understand that the Financial Consumer Agency of Canada (FCAC) will be responsible for compliance and enforcement of the proposed federal PPN regulations.

CSA's Proposed Course of Action

Full Review of Pending Proposed Federal PPN Regulations

Based on the statements made in the Budget companion document and our discussions with federal Department of Finance staff, we expect that the proposed federal PPN regulations will address our key disclosure concerns about PPNs identified in CSA Notice 46-303. Based on the market data that shows federal financial institutions issue a majority of PPNs, the proposed regulations will provide protection for a large proportion of PPN investors. The CSA will fully review the final form of the proposed regulations when the regulations are adopted. The CSA understands that the proposed regulations will be published for comment in the Fall of this year.

A significant portion of PPNs are issued by Québec-based caisses populaires that would not be subject to the proposed federal PPN regulations. Pending publication of those regulations, the *Autorité des marchés financiers* (AMF) will consider the appropriateness of regulating PPNs issued by these entities.

KYC and Suitability Obligations

As discussed above, registrants currently sell a substantial portion of linked notes. We think that compliance with KYC and suitability obligations are a critical aspect of investor protection and should apply to sales of all PPNs by registrants (except where a specific exemption exists). The IDA has confirmed that its regulations and by-laws that concern KYC and suitability obligations apply in respect of all dealings by its members, without limitation as to the type of investment product being sold. The CSA has initiated discussions with the MFDA regarding changes to MFDA rules that would confirm the application of KYC and suitability obligations to dealings in PPNs by MFDA members and their representatives. In Québec, mutual funds dealers are members of the CSF and are subject to the *Regulation respecting the rules and ethics in the securities sector* which provides that KYC and suitability obligations apply without limitation as to the type of investment being sold.

Conclusion

The CSA will continue to monitor the issue and sale of PPNs, but we believe that the regulatory initiatives described above will substantially address the key concerns identified in CSA Notice 46-303. In particular:

- the proposed federal PPN regulations contemplate disclosure enhancements for PPNs issued by federal financial institutions, which comprise a majority of the PPN market;
- the proposal for changes to be made to the MFDA rules (as discussed above), along with existing IDA and CSF standards, to ensure that KYC and suitability requirements apply when MFDA, IDA and CSF member registrants (or their representatives) sell PPNs;
- the concerns associated with the sale of PPNs as a vehicle for selling alternative investment products to retail investors will be substantially addressed by the improved disclosure and sales practices that should result from the changes contemplated above;
- finally, proposed National Instrument 31-103 – *Registration Requirements* (NI 31-103) includes provisions dealing with referral arrangements and practices by registrants relating to investment products, which would include PPNs.²

Questions

If you have any questions, please refer them to any of the following:

Erez Blumberger
Manager, Corporate Finance
Ontario Securities Commission
Tel: (416) 593-3662
E-mail: eblumberger@osc.gov.on.ca

Jason Koskela
Legal Counsel, Corporate Finance
Ontario Securities Commission
Tel: (416) 595-8922
E-mail: jkoskela@osc.gov.on.ca

Leslie Byberg
Manager, Investment Funds
Ontario Securities Commission
Tel: (416) 593-2356
E-mail: lbyberg@osc.gov.on.ca

Robert F. Kohl
Senior Legal Counsel, Registrant Regulation
Ontario Securities Commission
Tel: (416) 593-8233
E-mail: rkohl@osc.gov.on.ca

² The CSA published NI 31-103 for comment on February 20, 2007. See Part 6 of NI 31-103.

Marriane Bridge
Manager, Compliance
Ontario Securities Commission
Tel: (416) 595-8907
E-mail: mbridge@osc.gov.on.ca

Gordon Smith
Senior Legal Counsel
Legal Services, Corporate Finance
British Columbia Securities Commission
Tel: (604) 899-6656
E-mail: gsmith@bcsc.bc.ca

Cynthia Martens
Legal Counsel
Alberta Securities Commission
Tel: (403) 297-4417
E-mail: cynthia.martens@seccom.ab.ca

Barbara Shourounis
Director
Saskatchewan Financial Services Commission
Tel: (306) 787-5842
E-mail: bshourounis@sfsc.gov.sk.ca

Lucie J. Roy
Conseillère en réglementation
Service de la réglementation
Autorité des marchés financiers
Tel: (514) 395-0337, ext. 4364
E-mail: lucie.roy@lautorite.qc.ca

Neil Sandler
Legal Counsel
New Brunswick Securities Commission
Tel: (506) 643-7857
E-mail: neil.sandler@nbsc-cvmnb.ca

July 27, 2007