

CANADIAN SECURITIES ADMINISTRATORS' NOTICE 46-305 SECOND UPDATE ON PRINCIPAL PROTECTED NOTES

This notice provides an update on the Canadian Securities Administrators' (CSA) review of Principal Protected Notes (PPNs) and the recent coming into force of federal regulations applicable to PPNs (the Federal PPN Regulations).

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

Identification of Concerns with PPNs

On July 7, 2006, the CSA published CSA Notice 46-303 – *Principal Protected Notes* (the 2006 Notice) 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

Following publication of the 2006 Notice, the CSA's review of PPNs included:

- extensive consultations with industry stakeholders about the distribution and regulation of PPNs;
- an analysis of the issuer and distribution channels for the PPN market; and
- discussions with the federal Department of Finance about the proposed Federal PPN Regulations.

As a result of its consultations and market analysis, the CSA determined that the majority of PPNs (comprised of linked notes and linked GICs) are issued by federally-regulated financial institutions, primarily Schedule I and Schedule II banks. The CSA also notes that 70-80% of linked note PPNs are sold by members of the Investment Industry Regulatory Organization of Canada (IIROC) (formerly the Investment Dealers Association of Canada (IDA)) and another

10% of linked note PPNs are sold by members of the Mutual Fund Dealers Association of Canada (MFDA). The majority of linked GICs are issued by *caisses populaires* based in the province of Québec.

Previous Update on CSA's Review of PPNs and Proposed Course of Action

On July 28, 2007, the CSA provided an update on its review of PPNs in CSA Notice 46-304 *Update on Principal Protected Notes* (the 2007 Notice). In the 2007 Notice, we reviewed the data on issuer and distribution channels for the PPN market and noted that we were consulting with the federal Department of Finance regarding proposed Federal PPN Regulations. We also described our intention to review the final form of the proposed Federal PPN Regulations to determine whether they addressed our key disclosure concerns for PPNs issued by federally-regulated financial institutions. The 2007 Notice further noted that the CSA had 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.

Federal PPN Regulations

On July 1, 2008, the Federal PPN Regulations came into force. The regulations 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) (Federal Financial Institutions). The Federal PPN Regulations specify requirements for the content, manner and timing of disclosure for PPNs issued by Federal Financial Institutions. The Financial Consumer Agency of Canada (FCAC) will be responsible for compliance and enforcement of the Federal PPN Regulations.

A copy of the Federal PPN Regulations can be found at:

- <http://laws.justice.gc.ca/en/showtdm/cr/SOR-2008-180>

Prior to their publication in final form, the CSA consulted with the federal Department of Finance about the Federal PPN Regulations. We have reviewed the Federal PPN Regulations and think that they impose significant disclosure obligations for PPNs issued by Federal Financial Institutions. Further, in light of the market data that shows Federal Financial Institutions issue a majority of PPNs, the disclosure required by the Federal PPN Regulations could assist a large proportion of PPN investors.

KYC and Suitability Obligations

Compliance with KYC and suitability obligations is a critical aspect of investor protection and should apply to sales of all PPNs by registrants (except where a specific exemption exists).

As explained in the 2007 Notice, the IDA (now IIROC) has confirmed that its regulations and by-laws that impose KYC and suitability obligations apply to all its members' dealings without limitation as to the type of investment product being sold. The MFDA has recently issued suitability guidelines confirming that its members are responsible for assessing the suitability of recommendations made with respect to all business of the member, including investment advice

or recommendations relating to PPNs.¹ The CSA continues to support the further objective of ensuring that KYC and suitability obligations also apply to all dealings in PPNs by representatives of IIROC and MFDA members. The CSA is discussing this objective with IIROC and the MFDA.

In Québec, representatives of mutual funds dealers are members of the *Chambre de la sécurité financière* and are subject to the *Regulation respecting the rules of 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 Federal PPN Regulations, together with our regulatory initiatives, substantially address our key concerns with PPNs identified in the 2006 Notice. In particular:

- the Federal PPN Regulations prescribe disclosure enhancements for PPNs issued by Federal Financial Institutions, which comprise a majority of the PPN market;
- we continue to discuss with IIROC and the MFDA how best to ensure that KYC and suitability obligations apply to all dealings in PPNs by representatives of IIROC and MFDA members;
- the improved disclosure and sales practices that should result from the changes contemplated above substantially address the concerns associated with the sale of PPNs as a vehicle for selling alternative investment products to retail investors;
- proposed National Instrument 31-103 – *Registration Requirements* (NI 31-103) has specific requirements relating to registrant referral arrangements.²

In addition, the Autorité des marchés financiers intends to establish guidelines relating to disclosure, sales and sound business practices for PPNs sold by financial institutions authorized to carry on business in Québec. The majority of linked GICs are issued by *caisses populaires* based in the province of Québec.

The CSA will continue to monitor the issue and sale of PPNs.

Questions

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¹ Member Regulation Notice MR-0069 – *Suitability Guidelines* published by the MFDA on April 14, 2008.

² The CSA published NI 31-103 for comment on February 29, 2008. See Part 6 of NI 31-103.

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