

### 1.1.2 CSA Notice 46-303 - Principal Protected Notes

## CANADIAN SECURITIES ADMINISTRATORS' NOTICE 46-303 PRINCIPAL PROTECTED NOTES

### What is the purpose of this notice?

This notice details the concerns of the Canadian Securities Administrators (CSA) about the distribution and sale of Principal Protected Notes (PPNs) and the CSA's proposed course of action.

### 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 (Market-Linked GICs) and linked notes (Linked Notes). Market-Linked GICs are described as term deposits that guarantee principal through a CDIC-insured (or equivalent) deposit-taking institution or insurance company, with a return linked to a number of underlying investments, including stock market indices, mutual funds or hedge funds. Linked Notes are described as debt instruments that provide a principal guarantee through the credit-worthiness of the issuer, with returns linked to a variety of underlying investments, including stock market indices, mutual funds, and hedge funds.

### What concerns us about PPNs?

#### *Background*

The CSA is focussing on the structure and distribution of PPNs because of the recent significant growth in the sale of PPNs to retail investors and the development of increasingly complex structures that pose investment risks that investors may not be fully informed about.

According to the Spring 2005 Investor Economics Report on Market-Linked Instruments, as of December 2004, \$21 billion in assets was invested in these investment products, comprised of:

- \$15.7 billion in Market-Linked GICs; and
- \$5.3 billion in Linked Notes.

By way of comparison, in December 1999, only \$9.4 billion was invested in market-linked instruments. From December 1999 to December 2004, the number of market-linked instruments also increased from 67 to 282, and the number of product sponsors (the primary developer and marketer of the product) increased from 20 to 44.

Moreover, the market for PPNs linked to hedge funds has grown steadily from 1999 to 2005. In 1999, 7.5% of the PPN market was invested in hedge-fund linked products. By March, 2005, 24% of the market was invested in these products.<sup>1</sup>

In addition, recent types of PPN products are more complex and pose investment risks that investors may not be fully informed about. The component of each product not covered by the principal protection guarantee has a different degree of risk, which depends on the underlying investment linked to the notes. In some cases, the underlying investment is a hedge fund, fund of funds, or managed futures. Therefore, through the sale of PPNs, intermediaries are selling retail investors products with investment risks that are more like those risks associated with alternative asset classes otherwise not accessible to retail investors without a prospectus.

#### *Our Key Concerns*

We understand that many types of PPNs are sold without a prospectus under the prospectus exemption for guaranteed debt<sup>2</sup> or on the basis that they fall outside the scope of provincial securities legislation<sup>3</sup>. Many types of PPNs are more complex and pose more investment risks than the type of product that was contemplated when securities legislation was enacted excluding financial institution deposits from securities regulation and exempting guaranteed debt instruments. Our key concerns about PPN disclosure materials and how PPNs are being sold are:

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<sup>1</sup> Spring 2005 Investor Economics Report on Market-Linked Instruments, Volume 2, section 2, page 22.

<sup>2</sup> See section 2.34 of National Instrument 45-106 *Prospectus and Registration Exemptions*.

<sup>3</sup> Or, in Québec, also under an applicable exemption (see section 3(9) of the *Securities Act* (Québec)).

1. *Disclosure* – We are concerned that investors are not getting sufficient disclosure to allow them to make an informed investment decision. They are not getting sufficient disclosure about how PPNs are structured, how they work, and the fees and investment risks associated with them. Some of our more specific disclosure-related concerns are:

*Disclosure documents and marketing materials* - We are concerned that investors may not be getting sufficient disclosure about PPNs, whether in an information statement, offering memorandum, prospectus, or in sales and marketing materials. Some examples are:

- Sales and marketing materials contained poor or overly-promotional presentation of performance returns. For instance, they provided
  - disclosure about the potential upside return of the investment without providing sufficient information to allow an investor to understand how much the underlying investments would need to return, after fees, to deliver the upside that is being promoted,
  - “back-tested” performance returns to show what the performance would have been if the product had existed for a certain period of time without an explanation of why that particular period is being used and that the disclosure is essentially based on hypothetical performance, and
  - performance information presented in an unbalanced way.
- Disclosure in information statements provided for many PPNs was lengthy, complex and difficult to understand, particularly in the sections describing the methods used to deliver principal protection and the upside benefit of the return on the linked investment.
- Disclosure materials in some cases lacked a sufficiently understandable description of the structure (both for the guarantee and the underlying investment) and the various participants that stand behind the investment.

*Fees* - We are concerned that investors might not be aware of the full cost they are paying, or that there is a cost at all, for the guarantee provided with PPNs. In some cases, that cost is the additional fees to cover the insurance policy to back the guarantee. In other cases, there are multiple layers of fees including management fees, performance fees, up-front sales fees, and trailer fees. These fees can significantly reduce the returns that would otherwise be derived from the underlying investments.

*Lack of liquidity* - We are concerned investors might not be aware that the terms of the PPN frequently do not permit an investor to sell it before maturity, without significant penalty. It also means that investors who wish to sell a PPN before maturity might not receive 100% of the principal amount invested.

2. *Know your client and suitability obligations* - Any registrant that sells a security, including a PPN that is sold under a prospectus and registration exemption, must comply with the know your client (KYC) and suitability obligations. Additionally, the registrant must understand the PPN well enough to be able to assess its suitability for a client.<sup>4</sup> We are concerned that some sellers of PPNs are not meeting these requirements.

3. *Retailization of alternative investment products* - We are concerned that some PPNs are being used as vehicles for retail distribution of, or exposure to, complex alternative investment products like hedge funds, funds of funds, or managed futures, without the general protections Canadian securities laws provide or sufficient disclosure to permit an investor to make an informed investment decision.

4. *Referral Arrangements* - Securities laws in some jurisdictions and some self-regulatory organizations have specific requirements for how registrants handle referrals to and from registrants. Even where specific requirements do not exist, registrants are still bound by their general obligation to act in the best interests of their clients. We are concerned that some registrants may be making a referral to purchase a PPN without concluding that the referral is in the best interests of their clients.

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<sup>4</sup> The Mutual Fund Dealers Association Notice #MR 0048 *Know-Your-Product* describes the MFDA's views on this issue as it applies to mutual fund dealers.

### What is our proposed course of action?

We propose to consult with industry and other stakeholders about the structuring and marketing of PPNs. These consultations will include discussions about how issuers are using the existing prospectus and registration exemptions for PPNs, how they are interpreting the scope of these exemptions and the types of products they are selling under the existing exemptions.

Based on the results of our consultation process and our ongoing monitoring activities, we will determine the form and content of any new regulatory requirements or guidance needed to regulate the offering and sale of PPNs. We will provide notice of any further course of action we propose to take. CSA members may also take appropriate action at any time if they become aware of non-compliance with Canadian securities laws or activities that threaten investors or the integrity of the capital markets.

### What should issuers and dealers do now?

Any issuer that plans to offer a PPN should ensure that the accompanying disclosure documents and any sales and marketing materials are clear, comprehensive, balanced, and provide sufficient information for investors and their advisers to make informed investment decisions or recommendations.

Any person planning to sell PPNs should satisfy itself whether its representatives need to be registered and, if so, are properly registered to sell those products. Any registered dealer should also ensure that its representatives have the appropriate training and that they have a thorough enough understanding of the PPN to be able to assess its suitability for a particular client. Any registered dealer and its representatives should assess their policies for ensuring that any PPNs they recommend to clients are suitable.

### Questions

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

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