

## CSA Multilateral Staff Notice 46-306

### *Third Update on Principal Protected Notes*

**August 30, 2012**

This CSA Multilateral Staff Notice is being published by staff of all members of the Canadian Securities Administrators, except the securities regulator in Québec (the **CSA** or **we**).

#### **Substance and Purpose**

This notice provides an update on the CSA's consideration of Principal Protected Notes (**PPNs**), and serves as a supplement to the following previous CSA Notices:

- CSA Notice 46-303 *Principal Protected Notes* dated July 7, 2006 (**Notice 46-303**)
- CSA Notice 46-304 *Update on Principal Protected Notes* dated July 27, 2007 (**Notice 46-304**)
- CSA Notice 46-305 *Second Update on Principal Protected Notes* dated August 29, 2008 (**Notice 46-305**).

In Notice 46-305, the CSA communicated that the one remaining initiative to address our concerns about PPNs was to work with the Investment Industry Regulatory Organization of Canada and the Mutual Fund Dealers Association of Canada (the **SROs**) to ensure that know-your-client (**KYC**) and suitability obligations apply to all dealings in PPNs by individual registered representatives of their member firms (**SRO representatives**). This notice reports on the course being taken by the SROs to pursue that objective.

This Notice also sets out our expectation that banks and other federal and provincial deposit-taking institutions will use registered dealers (and registered individuals acting on behalf of those dealers) to distribute PPNs that do not fall within a limited class.

#### **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 purposes of this notice, PPNs include, but are not limited to, instruments commonly described as market-linked or index-linked GICs and linked notes.

## **KYC and Suitability Obligations for SRO Members**

In Notice 46-304, we stated that 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 from these obligations exist). The SROs have confirmed that their KYC and suitability rules apply to all dealings in PPNs by SRO representatives that are transacted through their member firms.

However, if SRO representatives deal in PPNs outside of their member firms (and not in their capacity as an employee or agent of the member firm), the SRO's rules may not apply.

### **Application of KYC and Suitability Obligations to all Dealings in PPNs by SRO Representatives**

The CSA want to ensure that SRO representatives who sell PPNs only do so in their capacity as an employee or agent of their member firm, so that the usual KYC and suitability obligations in the SRO rules apply to these sales.<sup>1</sup>

To achieve this objective, the recognizing regulators asked the SROs to take appropriate actions to clarify the applicability of these obligations to all dealings in PPNs by SRO representatives. To this end, each of the SROs will soon be issuing a notice to their members setting out their expectation that all dealings in PPNs by SRO representatives must be transacted by these individuals in their capacity as an employee or agent of their member firm.

## **PPN Distribution Channels and CSA Expectations**

### ***CSA Consultations and Market Analysis***

Following publication of Notice 46-303, the CSA undertook extensive consultations with industry stakeholders about the distribution and regulation of PPNs, and analyzed the issuers and distribution channels for the PPN market. As a result of our consultations and market analysis, we determined that the majority of PPNs are issued by federally-regulated financial institutions, primarily Schedule I and Schedule II banks.

We understand that

- Schedule I and Schedule II banks are still the major issuers of PPNs
- a substantial portion of the PPNs issued by provincially-regulated financial institutions are issued by financial services cooperatives based in the province of Québec.

We also understand that while some PPNs are distributed directly by banks or other federal or provincial deposit-taking institutions, those PPNs that are not distributed through registered dealers are generally limited to circumstances where the PPN (a **Specified PPN**) has the following features:

- a term to maturity of five years or less, and

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<sup>1</sup> Except where the PPN is itself a contract of insurance that is required by applicable insurance legislation to be distributed through a licensed insurance agent.

- eligibility for coverage by the Canada Deposit Insurance Corporation (or a provincial equivalent).

### **CSA Expectations for Distribution of PPNs by Banks and other Federal and Provincial Deposit-Taking Institutions**

The CSA expect that these institutions will distribute PPNs that are not Specified PPNs only through registered dealers in order to ensure the application of the usual KYC and suitability obligations.

#### ***Compliance with CSA Expectations***

We will continue to monitor the distribution of PPNs. If we become aware that the sales practices of any deposit-taking institution do not accord with our above-noted expectation, we will take appropriate action.

### **Questions**

If you have questions regarding this Notice, please direct them to any of the following:

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

Anne Hamilton  
Senior Legal Counsel, Capital Markets Regulation  
British Columbia Securities Commission  
Tel: (604) 899-6716  
E-mail: [ahamilton@bcsc.bc.ca](mailto:ahamilton@bcsc.bc.ca)

Navdeep Gill  
Manager, Registration  
Alberta Securities Commission  
Tel: (403) 355-9043  
E-mail: [navdeep.gill@asc.ca](mailto:navdeep.gill@asc.ca)

Douglas Brown  
Director of Legal and Enforcement  
Manitoba Securities Commission  
Tel: (204) 945-0605  
E-mail: [Doug.Brown@gov.mb.ca](mailto:Doug.Brown@gov.mb.ca)

Dean Murrison  
Director, Securities Division  
Saskatchewan Financial Services Commission  
Tel: (306) 787-5842  
E-mail: [dean.murrison@gov.sk.ca](mailto:dean.murrison@gov.sk.ca)

Susan Powell  
Senior Legal Counsel, Regulatory Affairs  
New Brunswick Securities Commission  
Tel: (506) 643-7697  
E-mail: [susan.powell@nbsc-cvmnb.ca](mailto:susan.powell@nbsc-cvmnb.ca)

Bill Slattery  
Executive Director of Securities  
Nova Scotia Securities Commission  
Tel: (902) 424-7355  
E-mail: [slattejw@gov.ns.ca](mailto:slattejw@gov.ns.ca)