



Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels

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MFDA Bulletin

Policy

For Distribution to Relevant Parties within your Firm

Summary of Comments – Principal Protected Notes (“PPNs”)

On January 23, 2009, MFDA staff issued [Bulletin #0354-P](#) *Principal Protected Notes* (“PPNs”). The Bulletin advised Members of the Canadian Securities Administrators’ (“CSA”) request that the MFDA take appropriate action to ensure that know-your-client (“KYC”) and suitability obligations apply to all dealings in PPNs by Approved Persons of its Members. The Bulletin also notified Members that MFDA staff, to comply with the CSA request, would consider appropriate Rule amendments to require the sale of all PPNs by Approved Persons, including dually-employed Approved Persons, to be conducted through the Member firm and hence subject to product due diligence, KYC and suitability obligations under MFDA Rules. The Bulletin sought specific input from the industry on the impact and implications of amendments being considered by the MFDA.

The deadline for comments was February 20, 2009. The MFDA received 16 submissions in response to its request for comments. Attached, as Schedule A to this bulletin, is a summary of key comments received. MFDA staff is currently developing a discussion paper for consideration by the MFDA Policy Advisory Committee and will be considering the comments received in developing a Rule proposal.

SCHEDULE A

MFDA Bulletin #0354-P *Principal Protected Notes* **Summary of Comments**

Support for Recognition of PPNs as “Securities”

One commenter indicated support for the proposed amendments and suggested that PPNs should be recognized as “securities”, indicating that these are complex and relatively expensive products.

PPNs Sold Through Member

Three commenters indicated that all PPNs sold by their Approved Persons must be sold through the Member. One of these commenters indicated that they have developed and implemented specific policies regarding risk disclosure to clients in respect of PPNs, in compliance with CSA Notice 46-305 *Second Update on Principal Protected Notes*.

Desirability of Clear Information for Investors and Consistent Regulation Across Product Lines

It was noted that, irrespective of whether PPNs are securities or deposit instruments, they form part of many investors’ investment portfolios and, as such, it is in the public interest for investors to receive clear and pertinent information about them.

In addition, it was noted that there is significant investor interest in achieving consistent due diligence, KYC and suitability obligations across product lines given that PPNs and market-linked Guaranteed Investment Certificates (“GICs”) are sold to the same end investors that purchase investment funds and that many firms distribute PPNs of third parties or affiliates in addition to investment fund products. One commenter noted that if mutual fund registrants are held to a different standard from non-registrants who sell such products, it will lead to confusion in the marketplace and among the investing public.

Federal Regulation Applicable to PPNs

Seven commenters noted that PPNs are deposit products that fall within federal jurisdiction and are appropriately and adequately regulated by the federal government. These commenters noted that the Department of Finance established principles-based disclosure standards for PPNs which came into effect on July 1, 2008 as regulations under the *Bank Act* (Canada) (the “Federal Regulations”). The Federal Regulations specify the content, manner and timing of disclosure that banks are required to provide for PPN sales through various sales channels and specifically require PPNs to be sold with both oral and written disclosures as well as by a “knowledgeable person” who is aware of the terms and conditions of the PPNs. It was suggested that the imposition of disclosure requirements on the sale of PPNs by the federal government was a recognition that the sale of these products falls within federal jurisdiction.

Three commenters also noted that the CSA was consulted by the Department of Finance in drafting the Federal Regulations. One commenter suggested that this consultation was done with the intention that the Federal Regulations would be treated as the complete regulatory regime with respect to PPNs.

One commenter noted that the disclosure requirements around PPNs are more stringent than those required for many other financial products sold in the exempt market. Another commenter stated that with the implementation of disclosure requirements under the Federal Regulations, PPNs issued by banks are adequately regulated at the federal level and that dealings in such products do not require additional regulation by securities regulators.

One bank-owned Member noted that it has established a policy where PPNs may only be sold through bank employees who are also MFDA Approved Persons, to specifically meet the “knowledgeable person” requirement. This commenter stated that implementation of the proposed amendments could result in some banks diverting their PPN sales through non-registered bank employees, as opposed to dually-employed MFDA licensed salespeople, resulting in sales conducted by less qualified representatives. Another bank-owned Member also noted that, as a matter of internal policy, it only allows the sale of PPNs by staff that is accredited and have the appropriate skills and knowledge. Another bank-owned Member noted that more than 99.5% of all of its bank-issued PPNs are sold by bank employees in compliance with the Federal Regulations.

CDIC Insurance Coverage

Four commenters noted that, in addition to robust regulation at the federal level, PPNs sold through bank branches are insured by the Canada Deposit Insurance Corporation (“CDIC”). As a result, investors receive full protection of the principal of their investment and are also protected up to the CDIC limit of \$100,000 in the event their financial institution becomes insolvent.

Principles-Based Approach Required

One commenter stated that the Federal Regulations adopted a principles-based approach and expressed concern that the MFDA’s proposed amendments would lead to more prescriptive requirements. Another commenter noted that any proposed amendments with respect to the regulation of PPNs should be principles-based, reflecting, as much as possible, differences in the way that business is conducted across firms. This commenter referenced recently-released guidance provided by the Investment Industry Regulatory Organization of Canada (“IIROC”) in respect of suitability and due diligence obligations for PPNs.

Jurisdiction Issues

Five commenters indicated that it is unclear whether the CSA or the MFDA has the authority to regulate the distribution and sale of PPNs. Four commenters expressed the view that neither the CSA nor MFDA have the authority to regulate the distribution and sale of PPNs.

One of these commenters noted that the CSA defines a PPN as “an investment product” rather than a “security” and suggested that this raises a question as to whether securities regulators have jurisdiction over the sale of such products. This commenter noted its understanding that PPNs are exempt from securities legislation in most provinces or considered to be exempt if issued by Schedule I or II banks. As a result, the commenter noted that it is incumbent on securities regulators to provide the premise from which they derive the authority to regulate these products. The commenter also stated that jurisdiction cannot be based on the investment component of PPNs, as other deposit instruments are also investments and do not fall under securities regulation nor do the activities of the Approved Persons who sell such products. This commenter noted that it has been the view of the MFDA that such products may be legitimately sold outside the dealer.

One commenter suggested that there are only two potential sources of authority to exercise jurisdiction and make the proposed amendments and that neither one is available to either the CSA or MFDA. This commenter first considered the potential assertion of jurisdiction on the basis that PPNs are securities. The commenter noted that, under the *Alberta Securities Act* and securities legislation of other major jurisdictions, PPNs, including market-linked GICs, are not securities and thus, neither the MFDA nor the CSA have authority to regulate their sale under securities law outside of jurisdictions where the legislature has defined securities to include these instruments. The commenter also noted the potential assertion of jurisdiction on the basis that persons performing the transactions are dually-employed Approved Persons. It was suggested that where a provincial securities commission accepts the registration of a dually-employed financial institution employee and the MFDA approves that person, the registration and approval are accepted on the clear understanding that the registrant will maintain two distinct roles with respect to their employment with the financial institution. Once registered, they have a role as an Approved Person who the MFDA maintains the authority to affect; and they have a role as a financial institution employee who neither the MFDA nor the CSA has the authority to affect. The commenter noted, as a result, when a dually-employed Approved Person is acting for their financial institution in a transaction regarding PPNs or market-linked GICs, neither the CSA nor the MFDA has the authority to control how or where that transaction is executed.

One commenter stated that the exceptions set out in Rule 1.1.1(a)(i) and (ii) for deposit instruments and Approved Persons dually-employed with a bank are an express recognition by the MFDA that it does not have the authority to regulate these activities. Several commenters noted that it is not appropriate for securities regulators to restrict dealings in federally regulated products where they are sold by dually-employed bank employees. It was suggested that the MFDA does not have the authority to regulate the way in which deposit instruments are sold within banks and any attempt to extend rule-making authority to the sale of any banking product raises serious jurisdictional issues.

One commenter noted that MFDA Rule 2.2.1 states that the Member and Approved Person must satisfy KYC requirements as they relate to “each client”. The commenter expressed the view that the concept of a client should be restricted to persons who already have dealings with the firm or are in the process of establishing dealings with the firm. In respect of dually-employed Approved Persons of bank-owned Members, the commenter expressed the view that a customer who has no dealings with the mutual fund dealer is not a client of the dealer. This commenter expressed the

opinion that the KYC rules made under the various securities statutes are similarly directed at clients and the same arguments apply.

Legal Opinion/Decision Regarding Jurisdiction Required

One commenter urged the MFDA to seek appropriate legal advice and circulate to the industry a formal legal opinion concerning whether the MFDA has a legal basis for claiming jurisdiction to make and enforce the Rules that the CSA has directed the MFDA to make and, in particular, as to whether the MFDA has the jurisdiction to regulate activities of Approved Persons that are outside their relationship with their MFDA dealer.

In the alternative, the commenter recommended that the CSA engage the federal government on an appropriate response if it believes that federal requirements for the regulation of PPNs do not accomplish the goal of providing adequate information to consumers to make appropriate investment decisions. The commenter also urged that the CSA, as part of such a process, clearly identify the risks and consumer protection gaps that would warrant greater regulation in this area.

Another commenter suggested that no amendments to MFDA Rules should be made until: (i) a Canadian court has established the CSA's jurisdiction over non-securities related activities; or (ii) PPNs are specifically designated as securities under law; and (iii) any directives that apply to PPNs apply to all avenues of distribution for this product.

Scope of PPN Activity Conducted Outside Members

One commenter, an industry organization, noted that GIC business, including market-linked GICs, is predominantly conducted outside the books and records of Members pursuant to MFDA Member Regulation Notice MR-0009 *Dual Occupations – Selling Deposit Instruments and Providing Non-Securities Related Financial Planning Services*.

This commenter estimated that a substantial portion (likely in excess of 50%) of the PPN market attributed to market-linked GICs, as per CSA Notice 46-304 (estimated by the CSA at \$17.1 billion), in conjunction with the portion of the PPN market attributed to MFDA Members, per CSA Notice 46-305 (10%), will be impacted by the proposed Rule amendments. The dollar value of market-linked GICs was estimated by the commenter to be between \$855 million and \$1.71 billion. With respect to conventional PPNs other than market-linked GICs, the commenter noted that while many Members already conduct this business through their books and records, some Members permit PPNs to be offered through dually-employed Approved Persons outside the Member, particularly through affiliated financial institutions. The commenter noted, however, that it did not have estimates for the scope of such activity.

Impact and Implications

Operational and Systems Issues

Six commenters stated that implementation of the proposed amendments would give rise to significant operational issues.

One commenter noted that the proposed amendments will require significant process changes, including tier one and two trade supervision system changes at MFDA Member firms, which will require considerable time as well as significant expense to implement.

One commenter noted that MFDA Members already face numerous challenges with PPN and GIC product suppliers in receiving accurate and timely data electronically in order to populate their back office systems and facilitate the business through their books and records. This commenter noted that manual operational processes must often be carried out by Members in order to facilitate data that is not provided by product suppliers electronically. In addition, the commenter stated that product suppliers who do provide data electronically often provide inaccurate data with respect to the identification of product type.

The commenter also expressed concern that accurate differentiation of product type between market-linked GICs (to be defined as PPNs) and regular GICs (to remain outside the definition of PPN) will present significant challenges for Members. The commenter expressed the view that GIC suppliers will not be able to facilitate the differentiation of their products as required. It was also noted that some Members who currently permit their Approved Persons to sell GICs and PPNs outside of the Member do not currently have systems that are capable of adequately recording and tracking market-linked GICs and PPNs. Interest rates and maturity dates were noted as examples of data that may require Members to enhance their systems.

Accounting, Tax and Capital Implications

Three commenters noted that if all sales of PPNs by Approved Persons are required to be conducted through the MFDA Member firm instead of the bank, such transactions will have to be recorded on the books of the Member firm rather than those of the bank. One of these commenters indicated that such a change would have significant implications from an accounting, tax and capital perspective. This commenter suggested that the MFDA consult with the Office of the Superintendent of Financial Institutions to ensure that the proposed amendments do not have any unintended consequences on banks from an accounting or capital perspective.

MFDA Member Fee Increases

Five commenters noted that the changes required by the proposed amendments will substantially increase the costs associated with PPN distribution for banks. Two commenters noted that the requirement for PPN sales to be made through the Member will lead to a substantial fee increase. In addition, two commenters noted that bank-owned MFDA Members will be required to pay higher premiums to the MFDA Investor Protection Corporation (“IPC”).

Two commenters expressed the view that the increased costs may have a detrimental effect on investors by increasing the costs associated with purchasing PPNs without a corresponding increase in the amount of information or protection provided.

Consumer Issues

Two bank-owned Members noted that customers are currently able to choose whether they will purchase PPNs at a bank or MFDA Member firm. These commenters expressed the view that the proposed amendments will likely result in customers being frustrated when they are required to use a new process to purchase a product that was previously sold by their bank, particularly if they have to open an account with an MFDA Member in order to carry out a transaction that they view as relatively simple. It was noted that some clients may decide to opt for products that do not require a change in procedure and additional paperwork. These commenters expressed the view that, in the current investment climate, it is important for banks to be able to offer customers a wide variety of investment options, especially products such as PPNs, where the protection of principal means there is an inherent limit to the financial risks associated with the product. Another commenter noted that in the current stock market slump, PPNs, including market-linked GICs, are currently proving their ability to protect investor capital, providing convincing evidence that the Canadian regulatory framework for PPNs meets the necessary requirements in its current form.

Transition/Impact on Previous Purchases

One commenter noted that implementation of the proposed amendments may pose operational challenges and create significant record-keeping obligations. This commenter emphasized that determining suitability for previously opened accounts will be complex and time-consuming and recommended that the MFDA consider a transition period for existing accounts. Another commenter also noted the need for an appropriate transition period, stating that many Members and the industry generally will require planning, time and expenditure to facilitate the implementation of all PPNs through Member books and records. Another commenter, referencing the same concerns, recommended that the proposed amendments have no impact on previous purchases.

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