

IIROC NOTICE

Rule Notice Guidance Note

Dealer Member Rules

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Principal Protected Notes Compliance Review: Findings, Requirements and Recommendations

During 2008, continued volatility and sharp declines in financial markets triggered a “protection event” (monetization) for a number of PPNs sold by IIROC Dealer Members.

IIROC undertook a compliance review of the sale and the subsequent monetization process by its Dealer Members. The review related solely to the activities of Dealer Members. A representative sample of Dealer Members were audited to determine whether:



- the selling firm’s knowledge of the product was adequate;
- the firm’s training for their sales personnel was adequate;
- the product was suitable for clients who purchased the PPNs;
- there was appropriate disclosure to investors at the point of sale, at the time of monetization of some of the PPNs, and on client statements, and
- the standards and controls around the sales of these products were generally adequate.

This review was conducted before the release of IIROC’s Product Due Diligence Guidance Note 09-0087 in early 2009. The results of this PPN review were considered and helped in the development of the Product Due Diligence review methodology.

Background

Key Features of Principal Protected Notes

A key feature of a principal protected note (PPN) is that an issuer, usually a bank, guarantees to return 100% of the invested capital as long as investors hold the notes until maturity. PPNs offer investors the opportunity to share in the increase in value of the underlying portfolio investments (a stock, an index, or a mix of equities, commodities or hedge funds) while paying for the protection of their initial investment either through fees and/or ceding a portion of the return.

PPNs are often sold as fixed income alternatives to low yielding investments such as guaranteed investment certificates. They are often marketed as a buy-and-hold investment strategy that allows investors to share in the upside potential of the investment without risk to their principal investment. Most often, the return is only achieved at maturity. However, some PPNs do provide a return of “cash flow” that is usually drawn from the equity.

PPNs are products that are distributed within the non-prospectus or exempt market by a wide variety of financial institutions (including but not limited to IIROC Member firms). An Information Statement must be provided to the client upon the initial purchase of a PPN. Most PPNs have a medium term to maturity, typically between 4 to 8 years. However, some of these notes have a maturity date of up to 15 years.

Pricing and Protection Event (Monetization) Triggers

The value of a PPN, although a debt instrument, is expressed in units represented by a net asset value or NAV. A typical debt instrument is normally expressed in terms of its face value with a coupon or interest rate. The term NAV is most commonly used in relation to mutual funds.



The NAV of the PPN can be affected significantly by volatility in the value of the investment portfolio assets. Safety strategies are built into the product structure of the notes to guard against this. If the NAV of the PPN hits a value trigger, often when the cost of protection is equal to the NAV of the PPN, a reallocation of the holdings occurs. When such a reallocation action occurs, known as a “knock-out scenario” or a “protection event”, then the PPN becomes “monetized”.

Monetized notes no longer carry any exposure to other underlying investments and will deliver minimal or no return on investment. Return of capital is still guaranteed, but only if the notes are held to maturity.

The Regulatory Review¹

IIROC conducted this regulatory review during 2009 at a representative sample of Dealer Members, to determine IIROC Dealer Members’ knowledge, training and controls around the sale of PPNs and to assess whether clients were sold suitable products and received the appropriate disclosures.

For this review IIROC gathered security record data concerning PPNs from Dealer Members as at December 31, 2008, disclosures relating to the monetization events, marketing material provided at the time of purchase, and client account data for PPN purchases. The compliance review of Dealer Members and their registered representatives entailed the following:

1. Identification of Dealer Members that were the major participants in the PPN market

The compliance review examined 15 IIROC Dealer Members. The data collected eventually allowed IIROC to survey approximately 41,000 client accounts. Of the approximately 41,000 client accounts, IIROC confirmed the prevalent view that retail clients were the main holders of PPNs:

¹ In July 2006, the Canadian Securities Administrators issued CSA Notice 46-303 – *Principal Protected Notes*, detailing the concerns of the CSA about the distribution and sale of PPNs. Specifically, the CSA flagged “inadequate” disclosure, concerns over suitability compliance and the use of PPNs as a vehicle to sell alternative products to retail investors. In July 2007, the CSA did a follow-up with its release of CSA Notice 46-304 and then issued a second update to it with CSA Notice 46-305.

In May 2007, the IDA issued Bulletin 3624 and released a document entitled *Due Diligence Guidelines on Principal-protected Notes*. The document was expressly designed to assist Dealer Members in meeting know-your-product requirements for PPNs and addressed know-your-client and suitability obligations of Dealer Members and their registered representatives (RR).

This document included a 118-item questionnaire to help Dealer Members and registered representatives assess various aspects of risk and structure to apply due diligence in determining suitability.

In July 2008, new federal regulations – Principal Protected Notes Regulations – for federally regulated financial institutions (FRFI) came into effect. These new federal regulations replaced the 2002 disclosure regulations entitled Index-linked Deposits Interest Disclosure Regulations.

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- Individuals accounted for 96% of the accounts;
- Corporations accounted for approximately 4% of the accounts.

Using the security record data received and using predetermined selection criteria, IIROC identified a sample size of 174 client accounts to review in detail for disclosure and suitability.

2. Determination of how prevalent the monetization events had been

IIROC identified a total of 169 known monetized PPNs as of December 2008. IIROC was able to determine that 12 institutions were involved in the issuance of the 169 PPNs that were known to have experienced monetization events as at the end of 2008. Of these 12 issuers of PPNs that had been monetized:

- 9 issuers are financial institutions of which 8 are Canadian banks and 1 is a subsidiary of a Caisse group.
- 1 issuer is a province of Canada.
- 2 issuers are investment companies, 1 is a public company and the other is a wholly owned subsidiary of a public company.

Based on the data from Dealer Members for the 169 known monetized PPNs, IIROC observed that in those situations where a parent firm issued PPNs that were subsequently monetized, the parent firm's Dealer Member subsidiary had the largest relative exposure measured by the number of clients.

3. Completion of a review to assess the disclosure made to clients at the time of sale and at the time of monetization, the extent of the product knowledge, training of the registered representatives at the time of sale and a review of the suitability of these investments for the clients to whom they were sold

The IIROC business conduct review included the sales and disclosure practices of the selected Dealer Members. The key considerations included the assessment of the suitability of the PPN investments for each of the relevant 128 client accounts (selected from the 174 samples), the disclosure made to clients, and the extent of the registered representatives' product knowledge and training. In addition, IIROC reviewed the accuracy of the valuations disclosed on the December 2008 month-end statements for the 174 client accounts.



Summary of Key Findings and Deficiencies for IIROC Dealer Members

For each of the 169 monetized PPNs, IIROC examined the marketing material at the time the notes were distributed and the notification documents at the time the notes were monetized. Throughout its review, IIROC assessed whether Dealer Members discharged their due diligence obligations, specifically in meeting their know-your-product and know-your-client obligations as they related to PPNs.

The findings listed below are limited to those that directly apply to Dealer Members and their obligations to their clients. Other findings or deficiencies that are directly attributable to the PPN issuer or to a third-party service provider have not been included in this summary.

A. Client receipt of the issuer disclosure documents

The review found that the dissemination of the required disclosure to clients was inconsistent amongst Dealer Members. Although Dealer Members indicated that they believed it was the issuer's responsibility to deliver the disclosure documents to clients, many Dealer Members had no clear due diligence process in place with the product issuers to ensure that the Information Statement was indeed distributed to clients. Most Dealer Members did not have a sufficient evidentiary record to establish that this information was delivered by the product issuers to their clients.

IIROC Requirement

IIROC Rules (38.1; 2500-2700;) and National Instrument 31-103(s.11.1) require an IIROC Dealer Member to have, maintain and apply written policies and procedures, acceptable to IIROC, that establish a system of internal controls and supervision in support of investment suitability advice and recommendations for both retail and institutional clients. Dealer Members are required to have a "new product due diligence" policy, and are required to implement procedures to ensure that any of their clients who purchase a PPN receive the required disclosure. In addition, all dealers who sell these products must maintain evidence of the dissemination of this material to their clients for IIROC examination.

B. Monetization notice

IIROC reviewed 33 dealer/issuer agreements to determine how monetization notices were distributed to clients. The majority of Dealer Members appeared to rely on product issuers to distribute the monetization notices (protection event notification) directly to unit holders of the security without benefit of a contractual agreement requiring the product issuers to distribute on their behalf. Further, the Dealer Members were unable to produce adequate evidence to assure IIROC that the firm's clients actually received the required monetization notices. IIROC was, therefore, not able to confirm that all clients received monetization notices.



IIROC Recommendation

All Dealer Members should review their contractual agreements with issuers to ensure they clearly delineate which party is responsible for the distribution of protection event notification. Further, as part of the due diligence procedure, where a Dealer Member relies solely on a third party for the distribution of the material to their clients, the Dealer Member should obtain and retain in its files confirmation that this protection event notification has been given.

C. Marketing material

Not all Dealer Members who were examined produced their own marketing material for distribution to potential investors. Where marketing material was produced, it made reference to the issuer-provided Information Statement as the source of additional and more detailed information. Most of the Dealer Member marketing material was not adequate on its own as some key information was absent, such as information about the possible protection events (monetization events). Much of the marketing material examined also did not contain adequate information regarding charges and fees.

IIROC Requirement

While product issuer disclosure in the form of the Information Statement is the main offering document for the principal protected notes, IIROC Rule 29.7 (1) requires Dealer Members to ensure any sales literature or other advertising and correspondence does not fail to fairly present the potential risks to the client or contain omissions of a material fact.

All Dealer Members who sell PPNs to their clients must ensure that any marketing material they produce is accurate and fairly presents the potential risks (which includes but is not limited to possible protection events and early trading fees) to the client.

D. Dealer Member sales of PPNs

This product offered clients protection of their principal investment while allowing them to share in the market upside potential. While this product offered limited downside capital risk, there was no indication that the risks associated with the possibility of monetization of PPNs or the substantial time horizon of these investments were highlighted to these clients by the Dealer Member.

The review found that some of the Registered Representatives (RRs) of Dealer Members sold the PPN products as simple and low risk products. Some believed that the financial stability of the issuer or guarantor of the instrument ensured that the product was low risk.

It was clear that some RRs did not understand all of the features of the PPN products that they were recommending to their clients. PPNs and other debt structured derivative products are complex or have unique features which may not be fully understood by the retail customers



to whom they are offered. It is the obligation of the firm to ensure that the products are properly understood by their RRs so they can assess the suitability of the product for their clients.

IIROC Requirement

As gatekeepers, Dealer Members must take a proactive approach to reviewing and monitoring products with unique and complex features before they are offered for sale to their clients. This should be accomplished through a written policy for new product due diligence and the adherence to the written procedures called for in the policy.

Dealer Members should not rely solely on the perceived low risk and financial stability of the manufacturer of the instrument to determine the product risk. A Dealer Member must make its own determination on products as described in the March 2009 Guidance Notice on Best Practices for Product Due Diligence. In addition, Dealer Members must ensure that their RRs understand the products that they are selling.

E. Suitability Obligation

IIROC determined that the PPN products were suitable for the 128 accounts tested.

IIROC Requirement

IIROC suitability rules require each Dealer Member to use *“due diligence to ensure that the acceptance of any order from a customer is suitable for such customer based on factors including the customer’s financial situation, investment knowledge, investment objectives and risk tolerance.”*

It is important that all Dealer Members take into consideration all factors which one might reasonably conclude will affect the assessment of suitability. This includes, and is not limited to, the financial situation, investment knowledge, investment objectives, risk tolerance, age, investment time horizon, and the goals of the client when the firm or the RR recommends an investment product. The Investment Dealers Association of Canada (IDA) report *“Analysis of Hedge Funds”* released in May 2005 states that *“the risk that investments locked in for as long as 10 years may earn zero is no small risk to a retail investor”*, in particular for investors that are elderly.

F. Education and training

This review found that there was no uniformity in the level of training offered to RRs on PPNs and indicated that the training and education programs on structured products at many Dealer Member firms could be improved. Some Dealer Members required their RRs to educate themselves and to seek out the product information independently without the firm’s assistance. Other Dealer Members developed and provided extensive education and training materials to their RRs prior to the sale of these products.



IIROC Requirement

The Canadian federal regulations on PPN products require that disclosure to investors is “*by means of a person who is knowledgeable about the terms and conditions of the note*”. In addition, IIROC rules relating to suitability and guidance relating to best practices for product due diligence clearly indicate that “*recommendations to clients require knowledge of the products sold to those clients. Even in the institutional setting, the Dealer Member must make a determination that the assessment of new and different products falls within the client’s expertise.*” It is clear that Dealer Members must ensure that their RRs and sales staff are educated on and understand all of the important features of any products the firm allows them to sell prior to marketing the product to their clients.

G. Security as disclosed in the client statement

Some clients may have had difficulty in monitoring their PPN investment due to a lack of clarity of information in monthly statements. Deficiencies were found in the identification of the product as a PPN, the identification of the issuer, the full name of the PPN investment and the maturity date of the PPN investment.

The review found that the information contained in the monthly client account statement generally was not adequate for the client to understand the full name of the security purchased. Specifically, the account statements did not clearly identify the security name of the PPN position since it was abbreviated or shortened often making it unintelligible to an ordinary reader. In addition, the maturity date of the PPN was not noted on the client account statement. These inadequate descriptions made it likely that most clients would not be able to readily understand what they held or know when to redeem the PPN investment.

A client must be able to understand their account statement and must be able to identify their security holdings. Abbreviations of the security name are common. However, they must be used with discretion and should not render the disclosure to be of limited or minimal informational value. Pertinent and necessary information, such as the PPN’s maturity date, must be included. The maturity date of the PPN is a critical piece of information that could affect a client’s decision to either hold or redeem a security.

IIROC also noted that a few Dealer Members incorrectly classified the PPNs they sold as “mutual funds” or as “alternative strategy funds” on the client statements. A mutual fund is in a different asset class and has different product attributes from that of a PPN, which is a structured debt instrument. “Alternate strategy fund” is not a defined term. Using this term together with a PPN can lead to confusion or add ambiguity for the client.



IIROC Requirement

Dealer Members must ensure that the disclosure or characterization of the security position on the account statement is accurate, clear and informative, specifically by providing the full security name, the maturity date and its asset class.

Next Steps

IIROC has followed up with all firms involved in this review, providing them with findings and any deficiencies which are specific to the firm. IIROC has ensured that any deficiencies have been addressed.

IIROC also undertook a broader Product Due Diligence compliance review to determine whether Dealer Members have properly and effectively incorporated IIROC Guidance on product due diligence that was released in March 2009. The results of the New Product Due Diligence compliance review are being released simultaneously.