CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Staff Notice 44-305
2015 Update – Structured Notes Distributed Under the Shelf Prospectus System

January 22, 2015

Purpose

This notice sets out the views of CSA staff (we) regarding issues in connection with offerings of structured notes under the shelf prospectus system. This notice supplements and should be read together with CSA Staff Notice 44-304 – *Linked Notes Distributed Under Shelf Prospectus System* (SN 44-304). We have used the term "structured notes" instead of "linked notes" in this notice as that seems to be the term most used by the industry.

A structured note, or linked note, is a specified derivative, as defined in *Regulation 44-102 respecting Shelf Distributions* (Regulation 44-102), for which the amount payable is determined by reference to the price, value or level of an underlying interest that is unrelated to the operations or securities of the structured note issuer. Structured notes issued under the shelf prospectus system are generally non-principal protected securities issued by a bank or another financial institution. The underlying interests frequently include one or more stock indices, exchange-traded funds (ETFs), equities or notional reference portfolios.

Background

We discussed structured notes previously in SN 44-304. Since that time, the industry has continued to grow and the shelf prospectus system has evolved as an alternative distribution channel for retail investment products. Also, the Task Force on Unregulated Financial Markets and Products (TFUMP), a multilateral group of staff experts from various members of the International Organization of Securities Commissions (IOSCO), released its final report in December 2013. The TFUMP analyzed trends and developments in the retail structured product market and related regulatory issues encountered by IOSCO members.

We regulate structured notes primarily through our reviews of prospectus supplements filed for pre-clearance pursuant to undertakings that issuers provide under Part 4 of Regulation 44-102. As the industry continues to evolve, so does our regulatory approach. One of the challenges is to ensure consistency, where appropriate, in how we regulate structured notes and other types of products sold to retail investors, such as investment funds. CSA staff look to investment fund regulatory requirements and developments, where practicable, as a guide in conducting our reviews. Our regulatory approach also considers the guidance provided in the TFUMP report.

This notice updates and supplements SN 44-304 regarding:

- disclosure issuers should consider when preparing prospectus supplements for their structured notes;
- disclosure issuers should consider providing regarding their structured notes on an on-going basis; and

- the filing process to pre-clear novel supplements and for subsequent offerings of pre-cleared products.

1. Disclosure – Prospectus Supplements

The substantive details of structured note offerings are not generally contained in the base shelf prospectus, but rather in the prospectus supplement filed subsequently. Under the securities legislation of each jurisdiction, an issuer's prospectus must provide full, true and plain disclosure of all material facts relating to the securities offered by the prospectus.

1.1 Fees, expenses, product pricing and estimates of fair value

SN 44-304 discusses CSA staff's view that the full, true and plain disclosure requirement requires a clear and full explanation of fees that an investor will be paying. With respect to investment funds, the CSA has focused on initiatives aimed at improving the transparency of mutual fund fees and embedded commissions as a way to enable retail investors to better understand the costs of investing and to make more informed investment decisions.

Structured note issuers should similarly ensure that their disclosure provides sufficient transparency regarding fees including any financial benefits the issuer may embed into the structuring and pricing of the notes. The disclosure should enable an investor to readily assess the costs of investing in the note and the potential financial benefit the issuer and dealer will receive from the sale of the note. The disclosure required will vary depending upon the fee structure and whether the issuer has embedded a profit component into the offering price of the note.

Some structured note issuers charge fees on a basis similar to investment fund managers. These fees may include on-going management or administrative fees, sales commissions and on-going service fees or embedded trailing commissions paid to advisors. For structured notes that charge fees on a similar basis as investment funds, we would expect that the prospectus supplement include a table similar to those typically provided in investment fund prospectuses that clearly summarize all relevant fees in one easy to read section.[1] Issuers should also consider disclosing the dollar value of fees per note an investor can expect to pay on an annual basis and the total dollar value of fees if they hold the note to maturity.

In addition to the above-noted fees, the offering price of a structured note often embeds an estimated profit for the issuer as the offering price will be greater than the issuer's estimated costs to structure, distribute and hedge the note. This applies, in particular, in connection with structured notes that make use of embedded derivatives to provide different returns. It is our understanding that the issuer's estimate of the note's fair value and its potential profit is based on its valuation of the economic components embedded in the note at the time of issuance. Unlike other jurisdictions, such as the U.S. for instance, we have not consistently requested that issuers disclose their estimate of the note's fair value and potential profit.

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[1] See, for instance, Item 3.6 of Form 41-101F2 *Information Required in an Investment Funds Prospectus* and Item 8 Part A of Form 81-101F1 *Contents of Simplified Prospectus*.

In our view, this disclosure would provide improved transparency regarding the pricing and structuring of notes that make use of embedded derivatives and help ensure that investors better understand that the offering price of the note embeds an estimated profit margin. Consequently, CSA staff will, going forward, generally ask issuers to include the following in their structured note supplements:

- cover page disclosure of the issuer's estimate of the note's fair value based on its valuation of the economic components that could be combined to provide the same exposure as the structured note;
- a brief explanation that the fair value of the note is based on the issuer's estimate of the value of the note's economic components and a brief description of what those components are;
- explanation regarding why the issuer's estimate of the note's fair value may be different from the offering price including whether the offering price includes an estimated profit for the issuer and what fees, costs or other amounts that the issuer adds to its estimate of the note's fair value; and
- explanation that the issuer's estimate of the note's fair value may differ from the price at which an investor can sell the note in the secondary market and why.

We suggest that, other than the cover page disclosure, the foregoing disclosure regarding the issuer's estimate of the note's fair value appear under its own separate heading and, as appropriate, be included in the risk factor disclosure.

Further, CSA staff will generally ask issuers to include a statement in their base shelf prospectus or in structured note supplements that they have adopted written policies and procedures for determining the fair value of the note which include: (i) the methodologies used for valuing each type of component embedded in the note, (ii) the methods by which the issuer will review and test valuations to assess the quality of the prices obtained as well as the general functioning of the valuation process, and (iii) conflicts of interest. CSA staff may also request, on a confidential basis as part of a pre-clearance review, that issuers provide a description of the valuation models and assumptions used to estimate the fair value of a particular note.

1.2 What type of investor is the note designed for

In SN 44-304, we asked issuers to provide a brief description of the suitability of a structured note, including the characteristics of investors for whom the note may or may not be a suitable investment. This disclosure should provide investors with a quick overview of the note's key features, economic exposure, return profile, risks and what the issuer views to be the unique value-add of the product.

More recently, we have also been requesting that, in certain instances, issuers disclose relevant factors against which an investor can compare an investment in the note versus holding its underlying interest(s) directly, particularly when the underlying interest(s) is already easily available. Examples of factors that issuers should consider discussing include differences in the return profiles between the note and holding the underlying interest(s), terms to maturity, tax implications, any incremental costs associated with different fee structures between the note and the underlying interest(s), the primary means through which liquidity is provided including any

differences in the investor's ability to re-sell the product over a secondary market or investor redemption rights and the relative treatment of any distributions paid out.

1.3 Underlying Interests – Transparency, Quantitative Models, Investment Funds and Fixed Income Securities

Transparency

A structured note's underlying interest or reference asset must be sufficiently publicly transparent to enable the issuer to satisfy the full, true and plain disclosure requirement. Prospectus supplements must provide sufficient information regarding a note's underlying interest or reference asset in order to allow investors to make an informed decision. This is relatively straightforward when the underlying interest or reference asset is a public entity that is subject to some form of continuous disclosure regime.

Underlying interests for which providing full, true and plain disclosure may be particularly difficult include:

- some proprietary indices established by the issuer or an affiliate of the issuer;
- hedge funds and hedge fund replication strategies; and
- reference assets or interests for which there is no information in the public domain such as, for instance, a private discretionary managed account or portfolio of investments.

We will generally not recommend that an acceptance letter be provided in connection with prospectus supplements for notes linked to the foregoing underlying interests.

Quantitative Models

We have pre-cleared notes linked to the performance of quantitative models where the composition of the portfolio is dictated exclusively by the non-discretionary financial criteria of the model, but for the very limited discretion to substitute components of the underlying portfolio in exceptional circumstances. In such instances, we have asked issuers to provide disclosure regarding:

- the quantitative model including its methodology and financial criteria;
- the initial portfolio holdings under the model and the initial portfolio value;
- how transactions in the portfolio will be valued even when the portfolio only exists on a notional basis; and
- how investors may access on-going information regarding the portfolio free of charge.

Investment Funds

Notes linked to publicly offered investment funds that are actively managed and are not index participation units, as defined under *Regulation 81-102 respecting Mutual Funds*, generally raise significant policy concerns. CSA staff generally consider all such notes to be novel for the purposes of the undertakings provided under Regulation 44-102. Consequently, an issuer should file all such notes for pre-clearance. Issuers should also be aware that the review period may be longer than normal given the policy issues such notes raise.

Our concerns include:

- whether the note is converging into an investment fund;
- whether the note constitutes an indirect offering of the underlying investment fund;
- the relative benefits of the note, particularly since the underlying investment fund is generally already available to retail investors; and
- potential investor confusion regarding the two different products and in making a decision to invest in the structured note or the investment fund directly.

We suggest that the disclosure provided in prospectus supplements for notes linked to actively managed investment funds that are not index participation units include:

- clear bolded textbox disclosure on the cover page indicating that investors are buying notes, not the underlying investment funds, which carry different risks, have a different fee structure, and are subject to a different regulatory regime than the underlying investment funds. Investors will not receive any ongoing disclosure regarding the underlying investment funds that would be received by investors of the underlying investment funds; and

- a clear explanation of the differences between an investment in the note and a direct investment in the underlying fund. See section 1.2 above for examples of the factors that should be explained to investors.

CSA staff continue to consider whether to recommend that an acceptance letter be provided in these instances. Accordingly, issuers should file for pre-clearance every prospectus supplement for notes linked to investment funds that are not index participation units. We will continue to actively monitor these types of notes.

Fixed income securities

We have pre-cleared notes linked to the performance of fixed income securities, such as government bonds and investment grade corporate bonds, where there is sufficient market interest and publicly available information about the underlying issuer. In these instances, CSA staff will usually request that issuers ensure that adequate information about the underlying security is available to investors throughout the term of the notes including providing investors with access to the market value of the underlying bonds on a daily basis free of charge[2]. One way to accomplish this objective is for the issuer to post daily the bid and offering price for each underlying bond on its website.

If the composition of the portfolio of underlying bonds may change during the term of the note, we also request that issuers ensure that prices used for the purpose of notional sales and purchases are obtained through a process involving independent third parties. One way to accomplish this objective is by requiring the issuer's calculation agent to obtain different

[2] If the market prices for the underlying bonds are available only on paying platforms (e.g. Bloomberg), that information is not considered as available to investors free of charge.

quotations from at least three reputable investment dealers independent from the issuer and use, for notional sales, the highest bid price available and, for notional purchases, the lowest ask price available.

In the case of notes linked to investment grade corporate bonds, CSA staff will also consider the liquidity of the market for the underlying bonds. We expect the market for underlying corporate bonds to have a highly liquid secondary market. Underlying bonds that are not used as a component of any benchmark index that provides a broad measure of the bond market will generally not meet staff expectations.

1.4 Subscriptions In-kind or Exchange Offers

In some instances, we have observed issuers providing investors with the option of paying their subscription price for a note in-kind by exchanging any existing holdings they may have in the note's underlying interest. For example, an investor could pay the subscription price for a note linked to an ETF by tendering any units it already holds in the ETF. In such instances, the disclosure described in section 1.2 should explain the factors an investor should consider in making a decision to continue to hold the underlying interest directly or to invest in the note. In the context of equity linked notes, such exchanges may also raise the financing benefit concerns discussed in section 1.10 below.

1.5 Hypothetical or back-tested performance data

We have reviewed some prospectus supplements, for quantitative models in particular, that sought to include hypothetical or back-tested performance data regarding how the model or strategy would have performed had it been in existence over a specified historical performance period. We are concerned that the disclosure of such information in the prospectus supplement has the potential to be overly promotional and misleading. Consequently, we have requested its removal in our pre-clearance reviews.

We continue to review this issue and monitor regulatory developments in other IOSCO jurisdictions. We may also, in some instances, request that issuers provide, for our information only, hypothetical or back-tested performance data along with the mathematical formulas used.

1.6 Index linked notes - pricing versus total return index

In order to satisfy the full, true and plain disclosure requirement, CSA staff generally expect that issuers of notes linked to underlying indices will clearly disclose in the prospectus supplement whether the note is linked to the pricing index or total return index. We ask that this information be prominently disclosed on the cover page of the supplement in bold print. Further, the supplement should explain the expected difference in performance between the price index and the total return index so that an investor will have a better understanding regarding the potential distributions they will be foregoing.

1.7 Disclaimers of liability for third party information

CSA staff have seen disclaimers in prospectus supplements that relate to the accuracy of third party information disclosed in the prospectus that is publicly available. The disclaimers indicate that the issuer is not responsible for, or that the investors have no recourse against the issuer in connection with, information provided by third parties, including information relating to the

underlying interests and the underlying interests' issuer. The disclaimers are also sometimes accompanied by cautionary language that investors should not place undue reliance on such information.

We believe that such disclaimers and cautionary language do not reflect the liability for prospectus misrepresentations under securities law. Securities legislation makes an issuer liable for any misrepresentation in a prospectus, even if the misrepresentation in the prospectus is based upon information included from a reliable third party source. The only defence to a misrepresentation claim available to an issuer is that the investor making the claim was aware of the misrepresentation at the time of purchase. As issuers are unable to completely disclaim liability for third party information in a prospectus supplement, we will generally request that such disclaimers and cautionary language regarding undue reliance be removed.

Issuers, however, may include disclosure in prospectus supplements with respect to third party information that clearly identifies the information as third party information and states that the issuer has not verified and makes no representation regarding the accuracy or completeness of such information.

1.8 Clarity that structured notes are not fixed income securities

In order to help ensure that investors understand that structured notes are not fixed income securities, CSA staff ask issuers to include textbox disclosure on the cover page of their prospectus supplements which highlights, as appropriate, that:

- structured notes are not fixed income securities and are not designed to be alternatives to fixed income or money market instruments; and
- the notes are structured products that possess downside risk.

We also may request further disclosure, particularly in connection with notes that offer the potential for fixed return payments contingent on the performance of the note's underlying interest, such as auto-callables and reverse convertibles.

1.9 Use of hypothetical calculation examples

Issuers often provide hypothetical return calculation examples in prospectus supplements to illustrate how payouts for a structured note are calculated under various scenarios. As discussed in SN 44-304, calculation examples should use reasonable and balanced assumptions. We will generally request that issuers provide examples assuming at least three scenarios (negative, neutral and positive) and that issuers disclose the most negative scenario first.

1.10 Disclosure specific to equity linked notes – direct or indirect financing benefit

SN 44-304 discusses our views regarding direct or indirect financing benefits in connection with equity linked notes. Equity linked notes provide a return based on the performance of an underlying security of a single underlying issuer or a static basket of underlying securities of one or more underlying issuer(s).

SN 44-304 provides that to meet the full, true and plain disclosure requirement, the prospectus should disclose whether each underlying issuer will receive a direct or indirect financing benefit from the distribution of the equity linked notes. Whether an underlying issuer receives a direct or

indirect financing benefit will depend on the facts and circumstances of a particular distribution. We may consider that an issuer receives a financing benefit if, in addition to any limited purchases made pursuant to its hedging activities in connection with the note, the issuer of the equity linked note has purchased securities of the same type as the underlying security directly from the underlying issuer within a proximate period of time to the distribution of the equity linked notes.

We understand that employees responsible for the issuance of equity linked notes may not be privy to any information regarding the primary market purchases of a security of an underlying issuer made by other employees of the notes issuer. We understand that as a result of "ethical walls" between different groups of employees within the organizational structure of the notes issuer, consideration of whether the notes issuer has purchased securities of the underlying issuer within a proximate period of time to the distribution of the equity linked notes may be impractical. Our concerns regarding a direct or indirect financing benefit to the underlying issuer may be addressed through disclosure if the notes issuer relies on the existence of "ethical walls" within their organizational structure.

2. On-going Disclosure

The continuous disclosure requirements under securities legislation that apply to structured note issuers do not contemplate the distribution of retail investment products by those issuers. Consequently, potential gaps exist between the information structured note issuers are required to file and the additional information that may be relevant on an on-going basis to structured note investors.

Structured note issuers are subject to the on-going reporting requirements designed for operating businesses under *Regulation 51-102 respecting Continuous Disclosure Obligations.* These requirements focus on disclosure regarding the overall financial condition and operating results of the issuer. This can provide useful information regarding the issuer's overall credit quality and its ability to meet its obligations under the note, but somewhat limited information regarding the note itself.

Investment funds are subject to *Regulation 81-106 respecting Investment Fund Continuous Disclosure* which requires them to file on-going disclosure tailored specifically to the investment products being sold. Amongst other requirements, investment funds must publish daily net asset values and quarterly portfolio holdings, as well as file regular financial statements and management reports of fund performance for the funds.

SN 44-304 suggests that issuers inform investors how they can obtain additional on-going information regarding structured notes. More recently, issuers have been disclosing in their prospectus supplements a website on which they will publish additional on-going information about the note being offered. The information that is relevant to investors and the frequency with which it should be provided will vary depending on the type of note being offered.
Information that CSA staff expect issuers to consider disclosing on their websites going forward for each structured note during the term of the note and for a reasonable period afterwards, as appropriate, includes:

- composition of the underlying portfolio to which the note is linked;
- initial price or level of the underlying interest;
- the current and historical daily bid prices for the note where the issuer or a related entity of the issuer intends to maintain a secondary market;
- the daily indicative value of the note applying the payment formula under the note to the current value of the underlying interest;
- the daily current value of the underlying interest, obtained from a reliable and independent source;
- the amount of any early trading charge;
- any relevant trigger, barrier level or cap which can impact the return on the note;
- details about any call feature including call price and observation date;
- quarterly portfolio holdings;
- changes to the underlying portfolio or exposure and the prices/levels at which the changes or notional trades were made;
- distributions/coupons/return of capital payments including how they have been calculated;
- product fees that have accrued or been paid, broken down by each component;
- annual compounded rates of return for notes that have reached maturity;
- the existence of any special circumstances, market disruption or extraordinary events;
- where an investor can find more information regarding the underlying interest; and
- links to all of the disclosure documents related to the structured note offering.

The foregoing list is not exhaustive. CSA staff may request that issuers provide additional or different information as part of the pre-clearance process or on-going review of prospectus supplements.

3. Process

3.1 Pre-clearance – filing supplement templates on SEDAR

SN 44-304 describes the pre-clearance process for novel structured notes. Under this process, issuers file pricing supplement templates for review under the same SEDAR project number as the base shelf prospectus. Given the high volume of filings this can create under a single project number, we encourage issuers to notify staff in the principal regulator's jurisdiction via email to alert them that a supplement has been filed for pre-clearance. CSA staff will use its best efforts to review the materials filed for pre-clearance and provide a first comment letter within 10 business days.

In order to facilitate our tracking of multiple pre-clearance requests, we request that issuers not bundle multiple supplements together into the same submission. In instances where an issuer wishes to pre-clear multiple supplements at the same time, please file each supplement as a separate pre-clearance request and submission under the relevant SEDAR project number.

3.2 Pre-clearance – cover letters

In addition to the guidance provided in SN 44-304, CSA staff also request that issuers provide the following information in the cover letter requesting pre-clearance:

- a brief description of what the issuer considers to be novel about the product for the purposes of the undertakings provided under Regulation 44-102;
- a brief description of the process followed by the issuer to design the product, including the assessment performed to identify investors' needs; and
- additional measures, if any, beyond the issuer's normal policies and procedures that will be taken to ensure that the product is promoted appropriately, including how the dealer's sales representatives will be educated regarding the novel features of this product.

3.3 Subsequent offerings of pre-cleared products

In order to better facilitate the administration and tracking of prospectus supplements filed in connection with subsequent offerings that are based on a pre-cleared prospectus supplement or template of a prospectus supplement, we request that the issuer:

- include a cover letter that refers to the acceptance letter the issuer is relying upon including the SEDAR project number and submission number and that explains why, in its view, pre-clearance of the current prospectus supplement is not required;

- file a copy of the acceptance letter the issuer is relying upon;

- file a black-lined document showing a comparison of the current prospectus supplement against the pre-cleared prospectus supplement or template; and

- please not bundle multiple offerings together into the same submission on SEDAR, but rather file each supplement as a separate submission under the relevant SEDAR project number.

We also remind issuers to pay the requisite filing fees in connection with each subsequent offering[3].

3.4 Undertaking for notes linked to equity securities that are not listed on a Canadian stock exchange

CSA staff have been requesting that issuers file an undertaking (the Unlisted Issuer Undertaking) in connection with notes qualified under a base prospectus that may be linked to equity securities and that are not listed on a Canadian stock exchange. This undertaking is requested in addition to the undertaking required to be filed under Part 4 of Regulation 44-102 in connection with distributions of novel specified derivatives. Pursuant to the Unlisted Issuer Undertaking, issuers commit to not proceed with a distribution of notes linked to equity securities that are not listed on a Canadian stock exchange without first filing a draft prospectus supplement for pre-clearance. The undertakings generally contain carve-outs, subject to certain conditions, for SEC well-known seasoned issuers, other U.S. issuers listed on a national securities exchange registered with the SEC and U.S. 40 Act Companies that issue index participation units.

[3] In Ontario, each supplement must be accompanied by a $500 activity fee under OSC Rule 13-502 – *Fees*.

Next Steps

CSA staff will continue to review structured notes filed for pre-clearance and monitor the development of the structured note industry generally. We will continue to consider what gaps may exist under our regulatory approach to structured notes and whether more formal regulatory requirements may become necessary to ensure we are regulating like products in a consistent way to achieve investor protection and fair and efficient capital markets. In the interim, we will continue to provide updates regarding our views, concerns or initiatives in connection with structured notes as necessary.

Questions

Please refer your questions to any of the following people:

Quebec
Marc-Olivier St-Jacques
Securities Analyst, Corporate Finance
514 395-0337, ext : 4424
marco.st-jacques@lautorite.qc.ca

Sophie Fournier, CFA
Analyst, Investment Funds
514 395-0337, ext : 4426
sophie.fournier@lautorite.qc.ca

Ontario
Darren McKall – Manager
Investment Funds and Structured Products
Ontario Securities Commission
416 593-8118
dmckall@osc.gov.on.ca

Doug Welsh – Senior Legal Counsel
Investment Funds and Structured Products
Ontario Securities Commission
416 593-8068
dwelsh@osc.gov.on.ca