

IIROC NOTICE

Rules Notice Guidance Note Dealer Member Rules

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Contact:

Richard J. Corner
Vice President, Member Regulation Policy
416 943 6908
rcorner@iiroc.ca

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Sale of principal protected notes by Approved Persons of IIROC Dealer Members

Background and purpose of this guidance

On August 30, 2012, the Canadian Securities Administrators, except the securities regulator in Quebec (“CSA”) issued CSA Multilateral Staff Notice 46-306, *Third Update on Principal Protected Notes* (“CSA Notice”). The CSA Notice confirms the view of the applicable CSA jurisdictions, namely that compliance with the “know your client” and suitability obligations (“Obligations”) is a critical aspect of investor protection and should apply to sales by registrants of principal protected notes¹ (“PPNs”).

The CSA Notice goes on to discuss their understanding that PPNs that are not Specified PPNs² are generally distributed through registered dealers, which would include IIROC Dealer Members. The CSA Notice also sets out their expectation that banks or other federal or provincial deposit-taking

¹ In CSA Multilateral Staff Notice 46-306 and for the purposes of this Guidance Note a principal protected note (“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. PPNs include, but are not limited to, instruments commonly described as market-linked or index-linked GICs and linked notes.

² In CSA Multilateral Staff Notice 46-306 and for the purposes of this Guidance Note a specified principal protected note (“Specified PPN”) is a PPN with the following features:

- (i) a term to maturity of five years or less; and
- (ii) eligibility for coverage by the Canada Deposit Insurance Corporation (or a provincial equivalent).



institutions that distribute PPNs that are not Specified PPNs will do so only through registered dealers in order to ensure the application of the usual know your client and suitability obligations.

The effect of the CSA Notice is to:

- continue to permit PPNs with a term of five years or less (Specified PPNs) to be sold by representatives of financial institutions, without the application of the SRO's know your client and suitability obligations; and
- to require that PPNs that are not Specified PPNs be sold only through registered dealers.

The recognizing regulators have asked the SROs to take appropriate actions to clarify the applicability of these know your client and suitability obligations to all dealings in PPNs by SRO-registered representatives. To this end, IROC is issuing this Guidance Note to set out our expectations relating to the distribution of PPNs by IROC registered individuals.

Relevant IROC Dealer Member Rules, PPN distribution practices and IROC expectations

IROC Dealer Member Rule 18.14 permits Registered Representatives and Investment Representatives to engage in another gainful occupation, provided certain conditions set out within the rule are met. The dual employment of Registered Representatives and Investment Representatives at investment dealers and affiliated financial institutions is permitted. In general, IROC and securities regulators in Canada have accepted this practice, provided that the dual employment arrangement:

- does not create confusion in the mind of the client as to whom the client is dealing with; and/or
- is not used as a means of denying clients the regulatory protections afforded to them under IROC rules.

Based on our discussions with IROC Dealer Members³ and other research, it is also our understanding that the majority of PPNs, other than Specified PPNs, are sold through investment dealers, while the majority of Specified PPNs are sold through financial institutions.

³ As part of the research performed in developing this guidance note, IROC staff met with senior compliance staff from a majority of the bank-owned investment dealers. The meeting discussions focused both on determining the extent of bank-dealer dual employment of individuals with client facing responsibilities and on gaining a better understanding of the PPN distribution practices within the banks and the dealers. Based on these discussions and other research, it is our understanding that the dual employment of client-facing registered individuals at deposit taking institutions and IROC Dealer Members is not common.



From an investor protection perspective, the product features and types of risks assumed associated with all categories of PPNs⁴ are essentially the same, regardless of the distribution channel.

Therefore, where a dually employed individual sells a PPN to a client, this activity:

- could create client confusion as to which entity the client is dealing with (i.e. the financial institution or the IIROC dealer); and
- would result in the application of the know your client and suitability protections that is entirely dependent on the distribution channel.

As such, and consistent with IIROC Dealer Member Rule 18.14 governing outside employment, it is IIROC's view that all sales of PPNs, including Specified PPNs, by an IIROC registered individual must be transacted solely in their capacity as an employee or agent of the Dealer Member.

IIROC expects all IIROC Dealer Members to have policies and procedures in place to give effect to the foregoing and for there to be adequate supervision and compliance oversight of this activity to ensure that the Dealer Member's know your client and suitability obligations to clients are complied with.

⁴ Categories of PPNs include principal protected notes and market linked and index linked guaranteed investment certificates.