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Canadian maple bonds: A legal overview

By Sherry Roth and D'Arcy Nordick, Stikeman Elliott LLP

The maple bond market in Canada evolved as a result of changes announced in the February 2005 Canadian Federal Budget removing the "foreign property limit" that restricted Canadian institutional and individual investors in tax deferred investments (including pension and retirement funds) to holding no more than 30% of total assets in foreign securities. Since then, the maple bond market has been accessed by numerous foreign debt issuers, and some domestic Canadian issuers, using existing debt issuance programmes.

MAPLE BONDS

While there is some discussion in the market, it is generally agreed that a maple bond is an issue of Canadian dollar denominated medium term notes which are placed primarily in the Canadian domestic market and settle and/or clear in the Canadian clearing system operated by CDS Clearing and Depository Services Inc. (CDS).

A defining feature of the maple bond market is the relative ease and speed with which issuers can access this market as the documentation and legal considerations, coupled with market practice, have evolved to provide issuers with timely access to this market in an extremely efficient and cost-effective manner. Issuers can use existing debt issuance programmes to access the maple bond market provided such programmes allow for, or can be amended to accommodate, the requirements discussed below. For purposes of this article, we will discuss the requirements relevant to an issuer that is not a "reporting issuer" in Canada.

INITIAL CONSIDERATIONS

A review of the issuer's programme documentation and disclosure record is generally undertaken to confirm there are no legal or market impediments to issuing maple bonds in Canada under the issuer's programme.

Clearing systems for settlement. Canadian investors in maple bonds prefer to have the notes settle and/or clear in CDS. Most programmes provide for the use of the Depository Trust Company (DTC) or Euroclear Bank S.A./N.V. (Euroclear) and Clearstream Banking, société anonyme (Clearstream, Luxembourg) for settlement

and the programme needs to provide flexibility for settlement in alternate clearing systems.

CDS and DTC operate a bridge that permits notes deposited with and settling in DTC to clear through CDS. There is no bridge allowing notes settling through Euroclear and Clearstream, Luxembourg to also clear through CDS. However, Clearstream, Luxembourg and Euroclear can hold interests in maple bonds on behalf of their participants through accounts in their respective names with CDS participants.

Form of global note. Certain clearing systems, such as Austraclear and Euroclear France, allow for uncertificated or "dematerialised" global notes. CDS requires, and the debt programme must allow, issuance of certificated global notes as a physical, originally signed global note must be deposited with CDS for settlement. CDS will accept bearer global notes, but for the sake of US TEFRA compliance, it is preferable that a registered global note is issued as discussed below.

Withholding tax. Advice will be required from local counsel that no withholding tax will be applicable to principal and interest payments made to Canadian investors. Investors are advised to seek their own advice, but from a due diligence perspective, all parties need to be comfortable that no withholding tax issues will arise.

GENERAL CANADIAN SECURITIES LAW REQUIREMENTS

To sell securities to Canadian investors, an issuer must either qualify a prospectus in Canada or have an exemption from this requirement available and dealers/managers must be registered in the relevant Canadian jurisdictions or there must be an exemption from this registration requirement available. The exemptions that are typically relied upon are the "accredited investor" exemption and the "exempt securities" exemption.

Accredited investors can purchase securities without a prospectus being qualified in Canada and no dealer/manager registration is required except in Ontario, Yukon Territory and Newfoundland and Labrador. Accredited investors include Canadian financial institutions; governments, municipalities, crown corporations and their agents; pension funds; high net worth

individuals; trust companies and investment funds – with some limitations.

“Exempt securities” are exempt from the prospectus requirements and there are no dealer/manager registration requirements except in Ontario, Yukon Territory and Newfoundland and Labrador. Exempt securities include debt securities of or guaranteed by (i) foreign governments if the debt security has an approved credit rating from an approved credit rating agency; (ii) certain Canadian financial institutions, other than subordinated debt; and (iii) certain enumerated Supranational Agencies, being Inter-American Development Bank, Asian Development Bank, International Bank for Reconstruction and Development and International Finance Corporation, if such debt securities are payable in Canadian or US dollars and subject, in certain circumstances, to filing requirements. The European Bank for Reconstruction and Development, African Development Bank and Caribbean Development Bank have applied for and received orders from various (but not all) regulators in Canada exempting their debt securities from the

prospectus and dealer/manager registration requirements in those jurisdictions.

RESALES

Maple bonds purchased by Canadian investors under the “accredited investor” exemption can only be sold to other Canadian investors pursuant to a prospectus qualified in Canada or pursuant to an exemption from the prospectus requirement and the dealer registration requirement, which exemptions would include sales to other accredited investors. Notes which are “exempt securities” may be sold to “retail” investors and, as the securities are themselves exempt from the prospectus and dealer registration requirements, another exemption is not necessary for resales.

PRINCIPAL DOCUMENTS

The transaction documents for a maple bond will be based on the underlying programme documents. The principal issue documents are essentially the same as are used for a regular issue under the debt programme, i.e. the form of global note (with the required CDS legend), the offering document containing the terms and conditions

of the notes as supplemented/amended by a pricing supplement or final terms, a subscription agreement incorporating the terms of the programme or dealer agreement and the usual condition precedent documents such as closing opinions and certificates.

Subscription agreement and final terms. Some additional provisions are needed in the subscription agreement and pricing supplement/final terms to cater to the Canadian market.

The subscription agreement may provide for sales to be made on a “best efforts” agency basis (rather than as an underwriting). However, sales by foreign financial institutions must be made on a fully underwritten basis to avoid regulatory issues in Canada. The subscription agreement will include Canadian selling restrictions to ensure sales are made in compliance with Canadian securities laws and are exempt from prospectus requirements and in compliance with or exempt from dealer registration requirements. A description of CDS and of the clearing and settlement procedures with other clearing systems is also generally appended to the pricing supplement/final terms.

Global note. While CDS will accept global bearer notes, it does not have mechanisms in place to certify non-US ownership as required under the TEFRA D rules. Because of this, most maple bonds are structured using a registered global note, registered in the name of the nominee of CDS.

Where the relevant programme only provides for the issue of bearer securities, issuers may:

- amend the programme, if possible, to allow for the issue of registered notes, which can be costly and time consuming;
- use another programme (such as a US MTN or global programme) if available; or
- issue bearer notes under the TEFRA C rules (which do not require certification of non-US ownership), represented on issue by a permanent global note; however this carries additional risks for an issuer as there is no safe harbour under the TEFRA C rules.

Additional documents. The only additional documents required are the Canadian wrap, CDS letter of representations and, in some cases, a Canadian agency agreement.

Canadian wrap. There is no legal requirement to provide Canadian investors with any offering document where sales are being made under the “accredited investor” or “exempt securities” exemptions referred to above. However, where any offering memorandum is provided to prospective Canadian investors, additional disclosure must be given under relevant Canadian securities laws. The Canadian

“wrap” sets out this additional information for Canadian investors.

As Canadian securities law is administered by Canada’s provinces and territories, each Canadian province and territory into which maple bonds are offered requires specific disclosure and selling restrictions which are included in the wrap. The wrap is used to physically wrap the hard copy prospectus or information memorandum for the debt programme. The Canadian wrap is typically merged with the programme offering document and the pricing supplement/final terms to create a single electronic pdf document that is sent to investors. The wrap and the programme offering document are together referred to as the Canadian offering memorandum.

Disclosure in the Canadian offering memorandum must not include a “misrepresentation” under Canadian securities laws, being an untrue statement of a material fact or an omission to state a material fact that is required to be stated to make any statement not misleading in light of the circumstances in which it was made.

It is common practice to market maple bonds on a roadshow using a preliminary Canadian offering memorandum, including a preliminary term sheet which is subsequently finalised together with the pricing supplement/final terms and delivered after pricing, either prior to or on closing.

CDS letter of representations. CDS requires all issuers to sign a non-negotiable letter of representations before it will make the maple bonds eligible in the CDS book entry system. Under this document, an issuer makes representations to CDS about itself and the maple bonds and provides an indemnity to CDS. CDS issues the ISIN and CUSIP for the maple bonds.

Canadian agency agreement. Unless the agents appointed for the programme have a presence in Canada and will undertake duties necessary to facilitate an issuance of maple bonds, additional agents may be needed to provide paying agency and authentication agency services. These additional agents will often be appointed under a new agency agreement or under a letter agreement supplemental final terms to the programme agency agreement.

Most programmes contemplate the involvement of additional agents. If a programme does not contemplate additional agents, amendments will be needed in the pricing supplement to allow for their appointment.

Because CDS requires originally signed global notes to be deposited on settlement, where bearer notes are being issued there is almost always an agent appointed in Canada to authenticate the global note and deposit it with CDS on the issue date to avoid security and

insurance issues with transporting a “live” bearer note, particularly where the issuer and its programme agents are located overseas. Many issuers prefer this process for registered notes also.

Paying agents must be able to make payments of principal and interest on the maple bonds in Canadian dollars to the account of CDS. If an issuer wishes to continue using its programme agents or does not want to, or cannot, appoint additional paying agents, then the programme agent can appoint a sub-paying agent in Canada and payments in respect of a maple bond could be paid to the programme agent who would pass those funds to a sub-agent in Canada.

US issuers may require a paying agent in Canada to be qualified with the US Internal Revenue Service as a withholding qualified intermediary that will file necessary US tax reports or, in the alternative, will withhold and remit any US withholding tax arising on payments made to note holders.

OTHER CONSIDERATIONS

Governing law. Canadian investors do not require an issue of maple bonds to be governed by Canadian law but generally accept the governing law of the programme.

Listing. There are no requirements for maple bonds to be listed. If maple bonds are to be listed, applications need to be made by Canadian counsel to regulators in certain provinces for permission to refer to the listing in the Canadian offering memorandum distributed in those provinces.

Conditions precedent. If the deal is syndicated among a group of dealers and if the size and tenor of the notes warrant, the dealers may require closing certificates from the issuer and legal opinions and

auditors’ comfort letters in the form generally provided under the programme.

Settlement. On closing, payment is made directly to the issuer (or swap counterparty) by the lead dealer/manager outside CDS and on confirmation of receipt of this payment the issuer delivers the global certificate to or to the order of the lead dealer/manager for deposit by the lead dealer/manager with CDS.

Due diligence. There will often be an oral due diligence call prior to settlement to confirm the disclosure in the Canadian offering memorandum, but the practice varies.

Filings. Post-trade reports setting out prescribed information will have to be filed on behalf of the issuer with the applicable regulators and applicable fees will also have to be paid within 10 days of the trade where the “accredited investor” exemption is relied upon. In some provinces the fees are a percentage of the amount of the securities sold in the jurisdiction and the fees can be substantial. The Canadian offering memorandum will also have to be delivered the applicable regulators for their files (it is not reviewed). No filings are required and no fees are payable where “exempt securities” exemption is relied upon.

**This article was written by Sherry Roth, Principal, Dauntsey House, 4B Frederick’s Place, London EC2R 8AB, UK; D’Arcy Nordick, Partner, Stikeman Elliott LLP, Barristers & Solicitors 5300 Commerce Court West, 199 Bay Street, Toronto, ON, Canada M5L 1B9.
Tel: +44 20 7367 0188, +1 416 869 5500
Fax: +44 20 7367 0160, +1 416 947 0866
Email: sroth@stikeman.com, dnordick@stikeman.com
Web: www.stikeman.com**