

IIROC Issues Proposed Guidance on Underwriting Due Diligence

On March 6, 2014, the Investment Industry Regulatory Organization of Canada ("IIROC") issued a request for comment on proposed guidance (the "Proposed Guidance") regarding due diligence conducted by underwriters on public offerings of securities in Canada. The Proposed Guidance is meant to foster consistency and enhanced standards amongst IIROC Dealer Members. The Proposed Guidance was developed to address variations and inconsistencies in due diligence and record keeping practices of Dealer Members. IIROC distilled practices and guidelines prepared by a committee of senior industry representatives, the due diligence guidelines prepared by the Investment Industry Association in 2006, and input from various other industry groups and prepared the Proposed Guidance to reflect the views of IIROC staff on due diligence matters. IIROC intends that the Proposed Guidance be simply a guide to common practices and not create a new standard of due diligence.

By conducting due diligence on public offerings, underwriters act as one of the gate keepers to capital markets, ensuring fair and efficient markets and enhancing investor confidence.

While due diligence is a fluid process, and underwriters are expected to tailor the due diligence they conduct to the particular issuer and industry, there are key principals that IIROC expects underwriters to follow and which the Proposed Guidance builds on. Overall, underwriters are expected to not put "form over substance" and are expected to exercise their professional judgment in respect of the due diligence they conduct on an issuer.

Below is a summary of the Proposed Guidance:

Policies and Procedures

Principal: Each Dealer Member is expected to have written policies and procedures in place relating to all aspects of the underwriting process and to have effective oversight of these activities. These policies and procedures should reflect that what constitutes reasonable due diligence involves, for each underwriting, a contextual determination.

- Underwriters must make such investigations to verify facts and ensure that a prospectus contains full, true and plain disclosure of material facts. "Reasonable due diligence" is a matter of the professional judgment of investment banking professionals formed in the context of the circumstances of the offering and goes beyond simply ticking boxes on checklists.

Due Diligence Plan

Principle: The Dealer Member should have a due diligence plan that reflects the context of the offering and the level of due diligence that will be reasonable in the circumstances.

- It is important for Dealer Members to determine the scope and objectives of the due diligence investigation and have an understanding of business of the issuer. Due diligence plans are typically coordinated with the underwriter's legal counsel. Expectations of the due diligence process should be reflected in the plan and be communicated with management of the issuer.

Due Diligence Q&A Sessions

Principle: Due diligence "Q&A" sessions should be held at appropriate points during the offering process and are an opportunity for all syndicate members to ask detailed questions of the issuer's management, auditors and counsel.

- Due diligence questions should be prepared in advance to allow issuers, auditors and counsel to prepare thoughtful responses. These sessions also allow the parties to address any red flags that arose during the due diligence process. Incomplete or evasive answers should trigger follow up questions and further review.

Business Due Diligence

Principle: The Dealer Member should perform business due diligence sufficient to ensure that the Dealer Member understands the business of the issuer and the key internal and external factors affecting the issuer's business. A Dealer Member should use its professional judgment when determining which material facts will be verified independently depending on the circumstances of the transaction.

- Underwriters should touch on principal elements of business due diligence, which include: visiting the issuer's offices and sites; a review of management and personnel; review of disclosure documents; review of operational data, material contracts and correspondence; reviews of customer lists and discussions with suppliers; and review of external information relating to the business of the issuer. Research analysts and industry experts may be consulted. Underwriters should ensure that the documents and files reviewed are not chosen solely by the issuer. Enquiries by underwriters with third parties should be done in a manner to avoid violating "tipping" rules under securities laws. Underwriters should ensure they understand the political and cultural environment in which foreign issuers do business.

Legal Due Diligence

Principle: Dealer Members should clearly understand the boundary between business due diligence and legal due diligence, to ensure that matters that should be reviewed by the underwriters are not delegated to underwriters' counsel. Dealer Members should provide adequate supervision of the legal due diligence performed by underwriters' counsel.

- The scope of legal and business due diligence should be carefully delineated. Subject to any limitations on counsel's retainer, underwriter's counsel has a professional obligation to all the underwriters, not just the lead underwriter. Counsel should clearly communicate the results of their due diligence to all members of the syndicate.

Reliance on Experts and Other Third Parties

Principle: The extent to which a Dealer Member should rely on an expert opinion is a contextual determination, having regard to the qualifications, expertise, experience, independence and reputation of the expert.

- While underwriters are not liable for misrepresentations for expertised parts of a prospectus, underwriters need to still consider the qualifications and reputation of the experts giving the opinion. Underwriters should still ensure they review the financial information of an issuer, particularly for initial public offerings and offerings of infrequently traded issuers.

Reliance on Lead Underwriter

Principle: Each syndicate member is subject to the same liability for misrepresentation under securities legislation. A syndicate member should satisfy itself that the lead underwriter performed the kind of due diligence investigation that the syndicate member would have performed on its own behalf as lead underwriter.

- While the lead underwriter takes primary responsibility for due diligence, each syndicate member must satisfy itself that the lead underwriter performed the type and scope of due diligence the syndicate member would have undertaken. Each syndicate member should receive copies of all reports and correspondence dealing with due diligence.

Due Diligence Record-Keeping

Principle: A Dealer Member should document the due diligence process to demonstrate compliance with its policies and procedures, IIROC requirements and applicable securities laws.

- While there is no universal file retention policy amongst Dealer Members, each Dealer Member should retain due diligence records to demonstrate it conducted reasonable due diligence and that its policies and procedures were properly followed.

The Role of Supervision and Compliance

Principle: IIROC Dealer Member Rule 38 requires each Dealer Member to have a comprehensive and effective supervisory and compliance framework in place to ensure compliance with policies and procedures, IIROC requirements and applicable securities laws. A Dealer Member's execution of the prospectus certificate should signify that the Dealer Member has participated in the due diligence process through appropriate personnel and internal processes.

- A senior investment banking professional should be involved throughout the due diligence process to ensure proper supervision and compliance with all aspects of the underwriter's due diligence policies.

IIROC requests comments from industry professionals by June 4, 2014. After considering the comments it receives, IIROC may make revisions to the Proposed Guidance before issuing the final Guidance notice.

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[a cautionary note](#)

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