

## IIROC Issues Final Guidance on Underwriting Due Diligence

In December 2014, the Investment Industry Regulatory Organization of Canada ("IIROC") issued its final guidance (the "Guidance") regarding due diligence conducted by underwriters on public offerings of securities in Canada. The proposed guidance, originally published by IIROC in March 2014 (the "Proposed Guidance"), was amended to address a number of comments received from industry participants.

The Guidance is meant to foster consistency and enhanced standards amongst IIROC Dealer Members, not necessarily to create new legal obligations or change existing ones. The Guidance describes common practices which may not be relevant in all cases. Underwriters are expected not to put "form over substance" and to exercise their professional judgment in determining the appropriate level of due diligence to conduct on an issuer.

The Guidance contains nine principles. The significant changes IIROC made to the Proposed Guidance are as follows:

1. **Due Diligence Plans:** In the comments received by IIROC, concern was expressed that the Proposed Guidance would require an underwriter to prepare a written due diligence plan for every offering. To address this concern, IIROC amended this item to state that the decision to prepare a written due diligence plan is a contextual determination and if the underwriter has written policies and procedures in place which adequately set out the matters to be considered, a separate written due diligence plan may not be necessary.

2. **Involvement of Syndicate Members:** Commenters noted that certain expectations with regard to the role of syndicate members (eg. being provided copies of all due diligence materials) were not practical with respect to how syndicates are formed and operated. IIROC amended the Proposed Guidance so that due diligence materials are only provided to syndicate members upon request and it is not necessary for syndicate members to prepare their own due diligence plans where the lead underwriter has done so.
3. **Due Diligence Sessions:** Based on the comments received, IIROC revised the Proposed Guidance so that Q&A sessions could be attended by "investment banking professionals with an appropriate level of seniority" rather than requiring the participation of "senior investment banking professionals".
4. **Materiality Thresholds:** Commenters suggested that materiality thresholds should be added to the Guidance. IIROC agreed and accordingly, the Guidance provides that underwriters may choose to establish a materiality threshold in the due diligence plan and this may extend to the use of sampling in situations where it is impractical to review all existing documentation.
5. **Reliance on Third Party Experts:** Often an underwriter is faced with conducting due diligence on issuers in industries requiring specialized technical knowledge. While an underwriter may seek its own experts, it may be more economical or reasonable to rely on the issuer's third party experts. IIROC added this point to the Guidance.

Below is a summary of the Guidance:

### Policies and Procedures

**Principle:** 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 underwriters to determine the scope and objectives of the due diligence investigation and have an understanding of the 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. A written due diligence plan may not be necessary if the underwriter's written policies and procedures adequately set out the matters to be considered.

### 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; reviewing business plans, budgets and projections; in-depth discussions with the issuer's management, personnel, independent auditors and external legal counsel; reviewing disclosure documents; reviewing operational data, material contracts and correspondence; reviewing customer lists and discussions with suppliers; and reviewing external information relating to the business of the issuer. Research analysts and industry experts may be consulted. Underwriters should ensure that 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 securities laws. Underwriters should ensure they understand the political and cultural environment in which foreign issuers do business. Procedures should be established to handle "red flags" that may arise, including follow up with the issuer or adding risk factors to the prospectus.

## 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, underwriters' 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, including any difficulties encountered in obtaining requested information.

### 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 still need to consider the qualifications and reputation of the experts giving the opinion. Underwriters should ensure they review the financial information of an issuer, particularly for initial public offerings and offerings of infrequently traded issuers. Underwriters may obtain their own experts or may rely on the issuer's third party experts, if appropriate.

### 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. Upon request, 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 underwriters, each underwriter 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.

With the Guidance now in effect, we suggest that underwriters review their current due diligence policies and practices to identify deficiencies and augment them, where necessary.

by Barbara Collins

For more information please contact:

Vancouver

Barbara Collins

604.691.7490

[barbara.collins@mcmillan.ca](mailto:barbara.collins@mcmillan.ca)

[a cautionary note](#)

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