

# IIROC NOTICE

## **Rules Notice Guidance Note**

Dealer Member Rules

*Please distribute internally to:*

Corporate Finance

Credit

Institutional

Legal and Compliance

Research

Senior Management

*Contact:*

Louis Piergeti

Vice-President, Financial & Operations Compliance

416.865.3026

[lpiergeti@iiroc.ca](mailto:lpiergeti@iiroc.ca)

Judy Long

Director, Business Conduct Compliance

416-943-5844

[jlong@iiroc.ca](mailto:jlong@iiroc.ca)

**09-0087**

**March 23, 2009**

## **Revised on March 25, 2009:**

### **Best practices for product due diligence**

This guidance notice provides guidance on the introduction and supervision of new products.

The dealer member's suitability obligation in recommendations to clients requires knowledge of the products sold to those clients. Even in the institutional setting, the dealer member must make a determination that the assessment of new and different products falls within the client's expertise.

This guidance is based on a similar notice issued by the Financial Industry Regulatory Authority ("FINRA") in April 2005 and findings from a recent IIROC Compliance Sweep of all dealer members that acted in the manufacture or distribution of third-party asset-backed commercial paper.



## **Background**

Investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of greater safety or higher returns. Products such as principal protected notes, asset-backed securities and other debt structured derivative products are complex or have unique features that may not be fully understood by the retail customers to whom they are offered, or even by the registered representatives who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest.

As gatekeepers to the securities industry, dealer members must take a proactive approach to reviewing and improving their procedures for introducing new products and monitoring those that are not new but that have unique and complex features that may require monitoring. While suitability requirements and other sales practice obligations attach to the recommendation and sale of a product, adequate procedures for reviewing products before they are offered to the public can greatly enhance a firm's ability to detect and avoid conflicts, unsuitable recommendations, and other problems before violations occur.

The requirement for product due diligence arises from a dealer member's regulatory obligations. Those obligations may differ between different types of dealers or customers; for example, different suitability standards apply to dealings with institutional and retail customers, and suitability-exempt discount brokers have no suitability obligations. The extent of product due diligence required will vary with the regulatory obligations of the dealer to its clients, but no dealer member that trades with or for clients is automatically exempt from needing to conduct product due diligence.

Dealer members are responsible for meeting their regulatory obligations. They cannot simply rely on the work of others. If assessment of new products that will be sold through a dealer member is done by a parent company or affiliate, the dealer member should be represented in the process and must ensure that it has sufficient documentation of the process and decision. It must also make its own determination on related matters such as suitability to its clients, marketing material and training of supervisors and registered representatives.

## **Written procedures for vetting new products**

As part of the obligation to have effective internal controls, all dealer members that sell new products must have formal written policies and procedures appropriate to their business to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from a regulatory, risk management and business perspective. At a minimum, those procedures must identify what constitutes a new product, and ensure that the right questions are asked and answered before one is offered for sale.



## **New Product Identification**

It is critical for a dealer member to be able to determine what will go through the product due diligence process.

A dealer member needs to ensure that it can identify products requiring review through its supervisory processes and systems. For example, one control method is to review all products added to systems used to record client transactions to identify any types of products that should go through the due diligence process; another is to decide on the criteria for determining that a product has to be considered for review.

These guidelines are not directed at listed equities and fixed income products, but to more complex and non-transparent products having features such as embedded derivatives, variable maturities, complex fee structures or opaque assets.

The following are sample criteria for identifying products or transactions for institutional and retail clients that may require due diligence review:

### Products to be offered to institutional clients

- The product is new to the Canadian marketplace or to the dealer member;
- The product design raises legal, funding, accounting, taxation, regulatory, compliance or appropriateness issues for the dealer member or its institutional clients not previously considered;
- The product design and/or the product disclosures make product pricing difficult due to unique or unverifiable valuation issues;
- The combined risk profile of the product is unique such that a new model is required to value the product and/or measure product risk, or revisions need to be made to an existing model;
- The product exposes the dealer member to market, liquidity or counterparty risk that is new or different in magnitude from that previously incurred;
- Offering the product raises conflicts of interest that have not previously been identified and addressed;
- The product raises potential franchise and/or reputational risks;
- The product requires new trade processing capability, including settlement, delivery or custody, or exposes the dealer member to new settlement risks;
- There has been a material modification to an existing product that is expected to present increased reputational, legal, market, investment or other risks.



## Products to be offered to retail clients

The same considerations as detailed above for an institutional client plus the following:

- The product has never previously been sold to the dealer member's retail clients;
- The product will be offered by registered representatives who have not previously sold it, to a new type of retail investor, or within a new geographic region;
- Offering the product involves new or significantly changed sales practices, marketing strategies, fees or costs; or
- Changes to an existing product that materially change the time horizon, potential for loss, expected return or mark-to-market volatility of the product.

This list is not necessarily exhaustive of all factors that determine whether a product requires due diligence review. Dealer members should not simply assume that if something is similar to a product already in the marketplace, whether offered by the firm or by competitors, that little or no review is necessary.

Any material modification to a product marketed by a dealer member should be subject to the same level of review as a new product. A material modification is a change to the characteristics or terms of a product that may change the conclusions of the product assessment or the suitability of the product for certain types of clients. While a change in the market or economic conditions may affect a firm's or representative's recommendation about a particular product, it generally does not constitute a modification of the product itself.

It is also important that the standards for determining what level of review is appropriate for any given product or modification of a product are clearly communicated and applied throughout the firm in a consistent manner.

IIROC believes that when dealer members are unsure as to whether a product warrants review, the best practice is to err on the side of caution.

### **Ask the right questions**

The fundamental goal of every due diligence process should be to ensure that the right questions are asked and satisfactorily answered. Asking the right questions is critical not only to determine whether the product should be offered at all, but also to identify important features that should be highlighted for marketing and training.

While the right questions will depend in part on the nature of the product, at a minimum every dealer member should ask and answer the following questions before a new product is offered for sale:



- For whom is the product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled? Conversely, to whom should the product not be offered?
- What investment need does the product fulfill? How does the product add to or improve the firm's current offerings? Can less costly, complex, or risky products achieve the objectives?
- What performance assumptions underlie the product, and how sound are they? What market or other factors influence the investor's return?
- How liquid is the product? Is there a secondary market for the product? What risks must be disclosed, and how will that disclosure be made?
- What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks?
- What costs and fees for the investor are associated with this product? Are they appropriate and transparent? How do they compare with comparable products offered by the firm or by competitors?
- How will the dealer member and its registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
- Does the product present any novel legal, tax, market investment, or credit risks?
- Will offering the product take advantage of a grey area of securities law or promote regulatory arbitrage?
- What is the complexity of the product in structure, function, and description? Does such complexity impair understanding and transparency of the product? Does such complexity impact suitability considerations and/or the training requirements associated with the product?
- How will the product be marketed? What promotional and sales materials will be used? What risks must be disclosed, and how will that disclosure be made? Will sales and marketing materials be considered by those responsible for the review?
- What are the qualifications of the people making determinations about a new product's assumptions, performance, and risk, and do such qualifications provide the expertise necessary to reach sound conclusions?
- Will the product necessitate the development or refinement of in-firm training programs for registered representatives and their supervisors? If so, how and when will the training be provided?
- Do the dealer member's current systems support the product, or will new systems be



required?

Dealer members are entitled to rely on factual information and disclosure documents provided by issuers or manufacturers of products under review, unless there are obvious reasons to question their validity. However, in doing so the dealer member will have to judge whether the disclosure document answers all the relevant questions and whether it provides sufficient, balanced disclosure or is overly promotional in nature.

## **Best Practices**

To help dealer members determine whether their current procedures for product due diligence are sound, IIROC considered new product practices reviewed during its compliance sweep of dealer members involved in the manufacture or distribution of third-party ABCP.

These recommended practices facilitate compliance with suitability obligations, mitigation of conflicts of interest, and planning for appropriate training and supervision. This guidance notice is not a comprehensive roadmap for compliance and supervision, but rather highlights measures that some dealer members are using to ensure better compliance.

Dealer members should consider the information in this section in assessing their own procedures and in implementing improvements that are tailored to and work best for their firm. While a particular sound practice may work well for a large firm, the same approach may not be effective or economically feasible for a smaller firm. While dealer members must adopt procedures and controls that are effective given their size, structure, and operations, a firm may not fail to have relevant policies and procedures because of limitations related to its size, structure, or operations.

Dealer members should consider the following components of an effective product due diligence program:

- A standardized process that requires a written “new product” proposal;
- A preliminary assessment of a proposed product or concept by personnel or a department designated in the firm’s policies and procedures to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;
- For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales, and operations;
- A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm’s senior management;
- An assessment of the extent of training in product features and risks necessary to



ensure that registered representatives and supervisors can judge the suitability of recommendations and sales to clients and the development and implementation of the necessary training;

- If the product is approved, a determination of the appropriate level of and process for post-approval follow-up, including consideration of:
  - o Monitoring of customer complaints and grievances related to the product;
  - o Reassessment of training needs on a continuing basis;
  - o Monitoring of compliance with restrictions placed on the sale of the product;
  - o Periodic reassessment of the suitability of the product.

### **Next Steps**

To ensure that dealer members develop and implement procedures for product due diligence and undertake adequate supervision of the due diligence process, IIROC will undertake a “Product due diligence “sweep later in the year. This sweep will test selected dealer member’s product due diligence processes and will also test whether new products have been subject to a review prior to offering such products to their clients.