

IIROC NOTICE

Rules Notice Response to Comments

Dealer Member Rules

Please distribute internally to:

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Response to comments received on draft guidance notice: “Best practices for product due diligence”

On October 16, 2008, IIROC published for comment a draft guidance notice “Best Practices for product due diligence.” Comments were due by December 15, 2008. IIROC received a total of 6 comment letters. This notice summarizes and responds to the comments and includes the revised version of the notice showing all of the changes made¹. The final notice is being published simultaneously.

1. General Comments

This section summarizes the received comments, which have been divided into sections dealing with specific issues raised in the guidance notice.

¹ Individual comment letters are not being published because the request for comments did not give notice that they would be.



Rule or Guidance

Comments

Two comments supported the issuance of guidance rather than promulgation of new rules regarding product due diligence.

One letter stated that new rules are necessary because Rule 2600, titled “Internal Control Policy Statements”, does not contain a requirement for formal written policies and procedures regarding “new products.”

Response

Rule 29.27 (a)(i) requires written policies and procedures regarding the types of business in which a dealer member engages and the supervision of its registered representatives to ensure compliance with applicable regulations. The most important regulation to consider is the suitability requirement in Rule 1300, as acknowledged in the commenter's letter. The use of the term "internal control" is not simply restricted to the internal control guidelines outlined in Rule 2600. The requirement to “know the product” is inherent in existing rules and does not require the adoption of a new rule. In addition, as the “you’re your product” requirement flows from existing rules, there is no need for a specific rule outlining the need for policies and procedures related to this requirement.

Application of guidelines

Comments

Two comments urged IIROC to be flexible and reasonable in applying the guidelines, and to ensure the guidelines were not enforced as if they were rules.

Response

We agree. IIROC will endeavour to be both flexible and reasonable in the application of the guidelines. IIROC understands the need for flexibility in this area and believes we have demonstrated this in the decision to issue guidance, rather than passing prescriptive rules.

Adverse market effects

Comment

One comment noted that the guidelines might have the unintentional effect of discouraging dealer members from selling new products or of limiting their sales to those that have been manufactured by the dealer member or a close affiliate. The comment noted that the result



would be a lack of choice for investors, particularly those dealing with smaller, independent dealers that lack resources to conduct the necessary due diligence.

Response

IIROC is in favour of broad investor choice. We also believe that it is very important that customers receive informed advice from dealer members who understand the specifics of the products that they sell. If a dealer member is unable to devote resources to product due diligence and to fully understand the products that they advise on, the proper course of action for the dealer member is to restrict product offerings. Dealer members should not offer products to clients that the dealer member or representative does not fully understand. Investors need to be provided with information on the products that they are offered so they can make informed decisions.

Responsibility of the dealer member and the registered representative

Comment

One comment suggested that the role of the product review process should be to ensure that the level of disclosure and information availability meets the firm's standards and that it is then the responsibility of the registered representative to determine the suitability of products offered to particular clients.

Response

Rule 1300.1 regarding the suitability of products places the responsibility for ensuring that recommendations are suitable on the dealer member. While the actual recommendations may be made by individual registered representatives, it is the dealer member who has the responsibility for supervising these recommendations. Part of that supervision is ensuring that registered representatives understand the products they sell.

It is appropriate to expect that a dealer member has assessed the products its representatives sell and that they will provide guidance to its registered representatives on the types of clients for whom a product is appropriate. A dealer member's product due diligence involves ensuring proper disclosure of the products is available to their registered representatives and determining whether the products may be suitable for any clients of the firm. There may be products that are not suitable for any customer. And in these cases, a dealer member should refuse to recommend the product and should prohibit its representatives from recommending such products, regardless the level of disclosure provided to the client.



Comment

One comment suggested that the questions in the guidance notice take the dealer member assessment beyond what is necessary to conclude that a product has a place in the firm and into client level suitability.

Response

All of the questions posed in the guidance are about the product, not about the investor. The firm must know the answers to the questions listed that are relevant to a particular product before making it available. Making it available does not mean that the firm is suggesting that it is suitable for all investors. Answering the questions will help the dealer member to determine what registered representatives need to know about the product before recommending it to clients, and therefore to judge whether they may need additional information or training about the product. The registered representative that makes the decision to recommend a product to a specific client cannot do so, without knowing the answers about the product, nor can the firm supervise the registered representative's activities without knowing the answers to the same questions.

Relationship to other rules

Comment

One comment suggested that the guidance notice should remind dealer members of information barrier requirements and the implications of sharing material non-public information.

Response

We do not consider it necessary to remind dealer members of every rule that they may have to consider in relation to this particular process.

Comment

One comment suggested that advising dealer members that adherence to the guidelines may not constitute a “reasonable investigation” defence against liability for misrepresentation in a prospectus or a satisfactory defence in a civil action arising from distribution of a flawed investment product or misrepresentation in offering materials.

Response

The guidance does not purport to deal with the due diligence required for a prospectus. Further, IIROC guidance notices do not and should not purport to provide advice on civil liability issues, but only refer to IIROC rules and their interpretation by IIROC.



Product-specific guidance

Comment

Once comment suggested that IIROC provide product-specific guidance, similar to what it has done regarding principal-protected notes (PPN) and what the Financial Institutional Regulatory Authority (FINRA) has issued in the U.S.

Response

IIROC believes that it is a dealer member's responsibility to conduct due diligence on all products it sells. IIROC has issued advisory material in some cases, such as the guidance on PPNs. IIROC may provide information on other products. However, we believe that product due diligence is an obligation of dealer members; and the firms should be in the best position to understand the products that are under consideration for sale at their firms.

Application to institutional products

Comment

One comment proposed that the guidelines should not apply to products offered to institutional customers because they are accredited and are therefore more sophisticated in their product knowledge and understanding than retail clients.

Response

All institutional customers are not universally sophisticated. They can be knowledgeable about some products but not others. The tests for whether a client can be treated as an institutional client under IIROC Rule 2700 relate to assets under administration, not to knowledge or sophistication. Rule 2700 requires that dealer members make a determination whether a particular client is sufficiently knowledgeable to make an independent determination about the suitability of recommendations made by the dealer member. In order to make that base determination, the dealer member has to understand the particular product involved. Therefore, although the issues may be different or the degree of due diligence or products on which it should be exercised may vary as between institutional and retail-directed products, the requirement for appropriate product due diligence does not.

However, we agree that it would be helpful to add an explicit statement to the guidance notice that the due diligence requirement arises from a dealer member's regulatory obligations so that the extent of the obligation will vary depending on the type of client they are servicing.



Application to suitability-exempt discount brokers

Comments

One comment noted that the guidance notice was not explicit as to whether it applied to suitability-exempt discount brokers. Another suggested that suitability-exempt discount brokers should be exempt from the guidelines because the practices set out in the notice would create an undue burden when a dealer has no suitability obligation.

Response

While suitability-exempt discount brokers do not have to review products in relation to suitability, they might have to do so in relation to other gatekeeper obligations. Furthermore, suitability-exempt discount brokers often present information on products on web-sites to assist their clients. It is important that in doing so, they ensure that the information presented is not misleading through omission. In such instances, a discount broker may have to do sufficient due diligence to ensure that it is not assisting in misrepresenting a product to the public. It would, therefore, be inappropriate to specifically exempt any particular type of dealer member.

However, as noted above, we agree that it would be helpful to add an explicit statement to the guidance that the due diligence requirement relates directly to a dealer member's regulatory obligations, so that the extent of the obligation will vary with those obligations. We believe that such a statement will make it clear that a suitability-exempt discount broker does not need to conduct sufficient product due diligence to enable it to make suitability determinations.

2. Comments of specific provisions

Comment

One comment suggested greater flexibility and that firms should be expected to have written procedures only where they make sense and are appropriate for the size and scope of their business.

Response

We attempt to be as flexible as possible, but believe that all dealer members, whatever their size, should have written policies and procedures to deal with all regulatory requirements applicable to the business that they conduct.



New product definition

Comments

Four comments suggested that the definition of new product as presented in the guidance would include such things as prospectus issues and TSX listed common shares.

Response

The guidance is not directed at securities, such as listed common shares and fixed income products, where the suitability arises from the issuer's business and creditworthiness rather than from the specific characteristics of a particular product.

While we believe it is clearly stated in the "Background" section of the notice that this review deals with "alternatives to conventional equity and fixed-income investments," we have revised the wording in the guidance notice to be more specific in this area.

Comment

One comment suggested that the criteria in the guidance notice for identifying new retail products are equally applicable to institutional products.

Response

We agree that the conflicts of interest and material modifications criteria are equally applicable to institutional products, and we have made those changes in the final version of the notice. The differences in suitability obligations, client needs and sophistication between institutional and retail clients are significant. The other factors listed refer specifically to retail clients or dealer member activities that are more generally applicable to retail products and the greater need for advice for retail clients.

Comment

One comment asked what a "new type of retail investor" means in the criterion and how this would be identified in the new product review process? The draft guidance notice had stated that "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".

Response

A "New type" means a new category of retail investor that has not been sold this product in the past. There are no established categories of retail investors, but dealer members may categorize their retail clients for marketing and supervision purposes. An example would be



the sale of a product to all retail customers that had previously been sold only to high net worth clients or accredited investors.

Material modifications to existing products

Comment

One comment asserted that disclosure of material modifications is the responsibility of the issuer and assessing them is that of the registered representative.

Response

While we agree that the disclosure of modifications is more of an issuer responsibility, the guidance states that when such disclosure occurs, a dealer member should review its previous decisions in light of such change. It is a dealer member's responsibility for the same reasons as the initial product assessment is a dealer member responsibility. The dealer member must understand the product in order to supervise the activity of registered representatives who advise clients on the product.

Comments

Two comments suggested that the notice should be amended to clarify the meaning of "material modification." One suggested that it is unclear whether a change in risk characteristics as a result of market changes would constitute a material modification.

Response

We believe that the guidance note is clear in referring to a modification of the product. We do, however, agree that further guidance on materiality would be useful and have amended the guidance notice accordingly. For example, a product that could dramatically change in risk profile solely due to changes in external market conditions should be identified in the initial product assessment and should be reviewed as market conditions change. The guidance notice is clear on the types of effects that a modification would have to have in order for it to warrant a reassessment.

Questions about products

Comments

One comment questioned the inclusion of "Can less costly, complex, or risky products achieve the objectives? Does the yield justify the risks?" It suggested that if the level of disclosure is sufficient to determine these factors, it should be a client's decision whether to assume the risks.



Response

The comment suggests that the suitability obligation is on the client; however, this obligation rests with the registered representative and the firm recommending the product. All clients may not understand the broad range of available products. Structured products frequently reproduce the effects of bundles of products; however, these can come with significant fees and with risks. It is fair for a client to ask whether the investment returns are worth the fees, the associated risks and whether the same result could be obtained using a another product or strategy.

Comments

One comment questioned inclusion of: “Does the product present any novel legal, tax, market investment or credit risks? Will offering the product take advantage of a gray area of securities law or promote regulatory arbitrage?” It is suggested that securities regulators should mandate a level of disclosure that plainly states whether there are any novel or unique risks inherent in a product and ensure that legislation is crafted in a manner that would address the potential for regulatory arbitrage.

Response

Securities regulators do not review all available products or mandate disclosures about all products. For example, index-linked GICs are not securities and are not distributed under prospectus. Some products or strategies have been marketed as offering tax advantages; however in most cases, this is a matter requiring significant tax expertise.

Dealer members that offer investment products distributed under differing regulatory regimes need to fully understand the products before making recommendations about them to their clients.

Reliance on third party information

Comments

Two comments suggested that dealer members should be permitted to rely on information provided by the issuer in one comment and the manufacturer in the other.

Response

The guidance notice does not suggest that dealer members cannot rely on an issuer’s or manufacturer’s disclosure documents. In order to make the guidance notice clear, we have added a statement that in the absence of any apparently questionable data or claims, dealer members are entitled to rely on factual information provided by issuers or manufacturers of products under review.



There are, however, differences between disclosure documents, ranging from prospectuses that are reviewed by securities regulators to sales documentation. A dealer member must make a judgment about the extent to which it can rely on disclosure documentation, determine whether they have adequate answers to the relevant questions of their clients, and must decide whether the information provides sufficient disclosure or if it is overly promotional or not balanced in nature.

Preliminary Product Assessment

Comments

Two comments questioned the suggestion in the “Best Practice” section of the guidance notice, that the review of a proposed product or concept to determine, among other things, whether it is a new product or a material modification of an existing product, and whether there had been the appropriate level of internal review, should be done by compliance and/or legal personnel. Both comments suggested that such reviews need not be done by compliance or legal personnel and that this is too prescriptive. One suggested that such a function may actually be misaligned with the mandate of Compliance, that it is more appropriately undertaken by business units where the expertise lies.

Response

We agree that the statement is too prescriptive and have changed the guidance notice to state that a dealer member’s policies and procedures should assign this responsibility to conduct a preliminary assessment to the appropriate department within the firm.

3. Comments on implementation

Due diligence questionnaires

Comment

One comment noted that MFDA dealers have each created different due diligence questionnaires in response to MFDA Notice MR-0048, leading to lengthy delays in receiving responses from product manufacturers. It suggested that IIROC develop a due diligence questionnaire template.

Response

The variety of products being brought to the market will make it difficult to develop such a template. We also believe that such templates should be used with caution because they may limit the amount of novel analysis and review that may be necessary for complex or unique products.



To the extent that they may be useful, it is up to each dealer member, or dealer members acting collectively through associations such as the Investment Industry Association of Canada, to develop solutions such as templates that assist in fulfilling regulatory responsibilities.

Introducing/carrying broker arrangements

Comments

One comment noted that all of the introducing dealer members which have the same carrier share a common list of products, so that as soon as a new product is set up by one introducer it is available to the others. It notes that this creates an added burden for introducing dealer members because they cannot block access to new products that they have not reviewed.

Response

We agree that this issue may result in introducing dealer members having access to products they have not reviewed. We do, however, believe that introducing dealer members will develop compensating procedures and controls and that they may be able to enlist the assistance of their carrying broker in controlling access.

Following highlights the changes in the final guidance notice:

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 ~~educate registered representatives and supervisors~~ 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](#)
- ~~Offering the product raises conflicts of interest that have not previously been identified and addressed;~~
- ~~There has been a material modification to an existing product that is expected to present increased reputational, legal, market, investment or other risks; 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 [gray](#)[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 **compliance and/or legal** ~~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.