



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

Ian C.W. Russell FCSI
President & Chief Executive Officer

December 16, 2008

Mr. Larry Boyce
Vice President, Business Conduct Compliance
Investment Industry Regulatory Organization of Canada
121 King Street West
Suite 1600
Toronto, Ontario
M5H 3T9

DELIVERED VIA EMAIL

Dear Mr. Boyce:

RE: Request for comments on draft guidance note: “Best practices for product due diligence” (the “Guidance Note”)

The Investment Industry Association of Canada (IIAC) appreciates the opportunity to comment on the Guidance Note, and commends the Investment Industry Regulatory Organization of Canada (IIROC) for undertaking the important task of completing its recent Compliance Sweep and making the results available in a timely fashion.¹ We appreciate that IIROC has presented these best practices in the form of a notice rather than as a new rule, which will allow the members to determine how to best and most appropriately adapt the practices into the business models of their respective firms.

Dealer members take very seriously their obligations when assessing and introducing new products to their clients, and recognize IIROC’s expectations under the Guidance Note, and in light of the findings of the Compliance Sweep, that members continue to monitor and improve their practices in this area.

IIAC members generally endorse the concepts and best practices put forward in the Guidance Note as a common sense approach to dealing with new products; however, there are a few areas that require more clarification and guidance, as outlined below. In

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¹ “Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial Paper in Canada”, October 2008.

addition, the IIAC urges IIROC to take a reasonable approach in interpreting and applying the finalized Guidance Note, and to recognize that not all members can be expected to follow every best practice to the letter where it is not appropriate for the business of the firm, or where it is not applicable to the product in question. It would be unfair to strictly enforce the suggested practices of the Guidance Note and penalize members where they have taken reasonable steps to implement the applicable portions of the best practices into their businesses where it is appropriate, practical and feasible to do so.

Reliance Upon Parent Companies and/or Affiliates

The IIAC agrees that it is the responsibility of the member firms selling the products to determine suitability for their own clients, to create marketing material and to train supervisors and registered representatives. It is not sufficient for a distributing member firm to accept a third-party or manufacturer's due diligence assessment without asking the appropriate questions, even where that entity is a parent company or affiliate. In many instances where the third-party is a parent company or close affiliate, the new product review process has already been structured to include representatives from all entities, and to document this process in writing. However, IIROC should be aware that this may have the unintentional effect of limiting the sale of products to those which have been manufactured by the selling company or a close, well-known parent or affiliate.

Members may be reluctant to sell new products manufactured by other members because they cannot take on the additional costs of conducting due diligence, when they may previously have relied upon the due diligence of the manufacturing firm. Ultimately, the result may be a lack of choice in the marketplace for investors, especially for those who deal with smaller, independent members that can no longer sell a wide variety of products because of a lack of resources.

Written Procedures for Vetting New Products

We agree that it is important and necessary for member firms to have formal written policies and procedures as part of their new product approval processes, but urge IIROC during its compliance reviews to be flexible in its approach with smaller firms who have access to fewer resources. Member firms should be expected to have written procedures only where they make sense and are appropriate for the size and scope of their businesses.

New Product Identification

The IIAC agrees that the effectiveness of the Guidance Note in improving due diligence and new product review processes across the investment industry depends primarily on ensuring that the right products are identified and reviewed. To this end, members would appreciate receiving more guidance as to which products are required to be reviewed.

In particular, the Guidance Note states that one of the criteria for determining if a product is "new" is whether "*there has been a **material modification** to an existing product that is expected to present increased reputational, legal, market, investment or other risks.*" It

would be greatly appreciated if the final Guidance Note could include more guidance on what constitutes a “material modification” to a product. For example, if external market circumstances change, increasing the risk associated with a product, it is unclear whether or not this would be considered a “material modification” to a product. Additional guidance would provide members with more certainty as to what products should be reviewed.

We also request that when drafting the final Guidance Note, that IIROC be mindful of the concern that an overly broad definition of “new product” or “material modification” could effectively create an unreasonably burdensome and impractical situation for members where due diligence is required on an almost continuous basis, and may not achieve the desired outcome of targeting products for review that are truly new and unique or which pose novel risks to consumers. Conversely, a definition that is drawn too narrowly may result in a situation where best practices will have to be developed on a granular level, requiring a level of detailed customization that is impractical for many members. A fine balance is required between providing members with a clearer definition of what constitutes a “new product” while maintaining the flexibility to allow members to implement these requirements in a way that makes sense for their business models and products.

Exemption for Order-Execution Only Services

We believe that IIROC should consider including in the final draft of the Notice an exemption from product due diligence requirements for order-execution only (i.e. “discount” or “self-managed”) brokerages operating under the suitability exemption provisions currently set out in IIROC Rule 3200. This is an example of a particular business model where the best practices set out in the Notice may cause an undue burden. The order-execution only service and business model provides clients with a low-cost way to transact in a broad range of investment products and the firm is precluded by regulation from making product recommendations to clients.

Clients taking advantage of this service generally prefer to engage in their own due diligence with respect to particular securities, to be in control of their own decisions, and recognize that they are responsible for their own investment choices on a “*caveat emptor*” basis. Mere provision of a facility to transact by a firm should not automatically trigger a product due diligence responsibility, the costs of which would be passed along to the client.

We recognize that the exemption should not necessarily be available to an order-execution only brokerage which is also involved in manufacturing products; however, in such instances the product due diligence requirements would arise from the firm’s role as a manufacturing member, rather than from its role as an order-execution only intermediary.

Asking the Right Questions

Again, we urge IIROC to be flexible with member firms in assessing whether or not the “right questions” have been asked during the due diligence process for new products. A

member should not be penalized for omitting to ask a particular question, especially where it has otherwise conducted its due diligence in good faith and in a manner appropriate for its size and business model.

IIROC should recognize that where a selling member has asked for due diligence information from a manufacturing member, and the selling member relies upon this information, the selling member should not be penalized where the manufacturing member provides erroneous information about the product, or where information is withheld from the selling member. While sellers cannot hide by relying solely upon the due diligence of manufacturers, they should not be reprimanded where they have completed a satisfactory due diligence process that necessarily depends upon receiving accurate information from another party.

This is also applicable, for example, to the use of credit ratings, which should not be the sole determinant in a new product approval process, but should comprise one part of the due diligence process carried out by the member. IIROC should make it clear that where erroneous information or ratings comprise an otherwise acceptable due diligence process, especially where the member has no reasonable belief that the information or rating being provided is inaccurate, that the member will still be considered to be in compliance with IIROC requirements and guidance.

Best Practices

We agree that members should strive to include as many of the best practices outlined in the Guidance Note into their new product review policies and procedures as is feasible, reasonable and practical, given the variation in size, structure and operations between firms. However, members have recommended that where a “preliminary assessment of a proposed product” takes place, that this preliminary assessment should not be solely limited to “compliance and/or legal personnel”, but should broadly include those with financial risk management expertise, or any other personnel qualified to assess whether the product is “new” or “modified”, and to determine the appropriate level of internal review. We ask that in the final Guidance Note, that the language in the component describing the “preliminary assessment” be revised to be similar to that of the “committee or working group” component, which would broadly consist of representatives from “all relevant sectors of the firm.”

General Concerns

In general, while we agree that implementation of the best practices contained in the Guidance Note will improve the new product due diligence reviews of member firms and that effective due diligence is essential, we also would like to re-iterate that many smaller and independent firms may be disproportionately negatively affected by the Guidance Note, as they do not have sufficient resources to conduct broadly ranging and extensive due diligence on a wide variety of products, as may be envisioned in the Guidance Note. In addition, larger dealers may also come to the conclusion, after conducting cost-benefit analyses, that they cannot justify the expense of due diligence to sell a particular product. Innovation is a fundamental requirement for competitive and efficient capital markets, and we are concerned that overly expansive and costly requirements may unintentionally

result in a loss of innovation, creating significant barriers to entry for new products, and leading ultimately to a loss of choice for the investor. Best practices must provide sufficient flexibility to ensure that new products are properly scrutinized, and yet do not create an inappropriate disincentive to issue the products.

We ask that IIROC adopt a reasonable and balanced approach to interpreting and applying these best practices, and work with the members in defining which new products merit enhanced due diligence, and to avoid unnecessary duplication of efforts and resources during the due diligence process. Processes, policies and procedures should be appropriate for the size and business of each firm, and should not create such a disproportionately large burden for firms that competition and choice for the investor is sacrificed unnecessarily.

Yours sincerely,

A handwritten signature in black ink, appearing to read "J. Mann". The signature is written in a cursive style with a long, sweeping underline that extends to the right.