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

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Dear Mr. Peter:

Re: Proposed Guidance Respecting Underwriting Due Diligence (the "Proposed Guidance")

The Investment Industry Association of Canada ("IIAC" or the "Association") appreciates the opportunity to comment on the Proposed Guidance. We note that, although much of the Proposed Guidance reflects many of the processes and considerations currently undertaken by member firms, we have a number of general and specific concerns relating to the language, intent and application of the Proposed Guidance.

General

While section 2 of the Proposed Guidance states that it is not intended to create a "standard of what constitutes reasonable due diligence" or create new, or modify existing legal obligations, we are concerned that at least some elements of the Proposed Guidance will be construed as prescriptive compliance benchmarks and used as the basis for IIROC's regulatory audit findings. It is important to note that the prospectus is in itself a documentation of the due diligence process. We are concerned that the Proposed Guidance, which purports to document best practices, will change firms' legal liability by enshrining practices that are not practical or necessary.

The Proposed Guidance contains several "key principles" that are intended to express IIROC's regulatory expectations regarding underwriter due diligence generally, however, some of those principles may not be appropriate in many circumstances. By characterizing certain due diligence procedures as key principles, we believe it is very likely that firms will be audited against those principles, even where, based on Dealer Members' experience and the exercise of their professional judgment, firms may have reasonably determined that such steps are not warranted in the context of particular transactions. By articulating these principles in an IIROC publication, we are concerned that, despite IIROC's express intention that the Proposed Guidance not create or modify legal obligations, they may form the basis for civil claims if they are not specifically followed in every public offering.

IIAC has received communications from at least one of our member firms that, contrary to stated intention of the Proposed Guidance, a recent audit of its due diligence procedures read like a checklist based on the Proposed Guidance. It is essential that a firm's judgment and expertise be respected on these matters, and that the Proposed Guidance not be construed as a prescriptive checklist. IIAC members are subject to, and prepared to defend the nature and extent of their due diligence under provincial Securities Acts.

Specific Provisions

Section 1.1 – The Role of Underwriters in Public Offerings

The IIAC notes the repeated use of the term "gatekeeper" in the Proposed Guidance. IIAC's concern with the term is that it is not ascribed any particular meaning in the Proposed Guidance and could be misconstrued as creating incremental responsibilities and civil liability for underwriters. This is of particular concern given the language IIROC included in the introduction to the Proposed Guidance. Specifically, it states that "[i]n their role as gatekeepers to the capital markets, Dealer Members and individuals performing due diligence investigations on their behalf should take an approach to due diligence that goes beyond the avoidance of liability and mitigation of risk to Dealer Members." This appears to suggest that the role of an underwriter as a "gatekeeper" encompasses more than being a signatory to a prospectus certificate (and undertaking the associated liability), which is inconsistent with liability under Securities Acts.

In our view, using the term in the Proposed Guidance is unnecessary, as it serves no particular policy purpose, and potentially exposes Dealer Members to additional risks that were not contemplated by regulators, and that are not fairly within the contemplation of the parties when pricing underwritten public offerings. If IIROC determines to retain the use of the term in the Proposed Guidance, we recommend that language be added to clarify that it is used as convenient shorthand to describe underwriters' pre-existing statutory obligations and is not intended to create any new legal obligations or regulatory expectations.

This section states that the Proposed Guidance is not intended to apply to Dealer Members participating in private placements, although some aspects of it may be helpful to Dealer

Members. We are concerned that the inclusion of this statement may lead to the application of the Proposed Guidance to private placements during IIROC reviews. We recommend that if the Proposed Guidance is not intended to apply to private placements, the provision be removed or the statement be modified to state that intention only.

Section 1.3 – Underwriting Due Diligence Standards

The IIAC supports the wording used in section 1.3, which states that due diligence, is, by its nature, a fluid and evolving process, and should be customized to the particular issuer, the industry in which it operates and the type of security being offered. We are concerned that other elements of the Proposed Guidance, particularly those stated in section 2.2, *Matters to be Addressed in Policies and Procedures for Underwriting Due Diligence* are inconsistent with this statement, as it appears to impose certain procedural requirements on Dealer Members, without regard to the Dealer Members' assessment, and the exercise of their professional judgment, as to whether such procedures are necessary or required in any particular offering. In addition, the IIAC is concerned about the use of the word "Standards" in the heading for section 1.3 because that word is inconsistent with the content of section 1.3 and implies that IIROC is imposing prescriptive requirements for demonstrating a reasonable due diligence investigation.

Section 2.2 Matters to be Addressed in Policies and Procedures for Underwriting Due Diligence

Although the introduction to section 2.2 states that Dealer Members should consider the following matters in developing their policies and procedures for underwriting due diligence, the specific subsections within this section could be misconstrued as making these policies and procedures mandatory for every public offering.

Subsection 2.2.1 Due Diligence Plan

The subsection begins with a principle that the Dealer Member should have a due diligence plan. The implication might be that a stand-alone written due diligence plan is necessary for every public offering. We note that in certain circumstances (for example, a follow-on offering or routine and recurring financings for an established client that is well known to the firm), firms may determine that it is not necessary or efficient to prepare a written due diligence plan, as the due diligence process is well known and understood by the firm. In other circumstances, firms may use general checklists as a starting point and undertake additional steps as the deal progresses, as it is often not possible to anticipate what due diligence must be taken until the basic steps are undertaken and uncover areas for further exploration. In circumstances where the elements of the transaction are less established and there are unknown variables, (such as an initial public offering or a financing related to a significant transaction) a formal due diligence plan may form an important part of the process. As noted above, the plans may start as a general checklist and evolve as more information about the issuer and the transaction is uncovered. Factors including the type of security, the industry and political conditions will impact the level of diligence that an

underwriter deems appropriate. However, in our view, it would be inappropriate for the Proposed Guidance to require, expressly or by implication, that a due diligence plan be developed and written for all transactions.
The language of the Proposed Guidance seems to imply that all syndicate members are expected to prepare a due diligence plan. This is not consistent with existing practice, in Canada or elsewhere. In general, syndicate members review and participate in due diligence calls, but rely on the lead underwriter to lead the due diligence process, which may include the preparation of a written due diligence plan where the nature of the transaction reasonably requires one. Consistent with securities laws, IIAC members are aware of, and will undertake, in consultation with the lead underwriter, any additional due diligence procedures as required in order to satisfy themselves that due diligence is complete.

Underwriters, along with the issuer, its directors and others, share the burden for ensuring that the prospectus constitutes full, true and plain disclosure of all material facts relating to the securities. If a prospectus is determined to contain a misrepresentation and the underwriters are unable to establish that they conducted a reasonable due diligence investigation in respect of the securities offered in the prospectus, the purchasers of those securities have powerful statutory and civil remedies. Firms conduct their due diligence within this context, using their professional judgment as to what due diligence investigation is reasonably required for them to responsibly sign the certificates in the final prospectus, taking into account many of the factors noted in Appendix B to the Proposed Guidance. Mandating the creation of another internal document to provide evidence to auditors rather than investors will add unnecessary costs, and does not provide investors with any additional protection. The evidence of a well managed due diligence review ought to be a well drafted prospectus, rather than a lengthy and confidential due diligence file.

Subsection 2.2.3 Business Due Diligence

The Proposed Guidance should provide a clear distinction between IPOs and follow-on financings, as the degree of due diligence will be considerably different, depending on the timing of the follow-on financing after the IPO, the factors noted in Appendix B to the Proposed Guidance and the existence of any “red flags” as described in section 2.2.3. Where a follow-on financing occurs within a reasonable time period and the nature of the issuer’s business and operations have not materially changed in the interim period, a reasonable due diligence investigation will be substantially less involved than the one undertaken in connection with the IPO. Additionally, standards for investment grade debt and preferred share offerings from seasoned issuers are materially different from small capitalization IPOs.

The IIAC is concerned that the statement recommending independent verification of key material facts in a prospectus could be misconstrued as changing the liability standard for Dealer Members from relying on expertized portions of the prospectus where such experts have reviewed the appropriate facts and have not identified any problems, to one that makes the Dealer Member responsible for verifying the facts relied upon by experts and second guessing the experts’ professional opinions. This is impractical, as Dealer Members do not have the expertise to undertake all aspects of a due diligence investigation, which is

why subject experts are retained. Under existing securities laws, underwriters already have the obligation to certify that, to the best of its knowledge, the prospectus constitutes full, true and plain disclosure of all material facts. Requiring a second level of due diligence beyond the expertized portions of a prospectus is impractical and unnecessary.

Subsection 2.2.5 Reliance on Experts and Third Parties

The IIAC is concerned that this section may create an impractical and costly regime where Dealer Members would be expected to not only assess the credentials of the particular expert retained to provide their expertise, but investigate the standards of each governing body or professional organization that provides accreditation. This is extremely onerous and impractical, as Dealer Members would not have the expertise or resources to make such a determination. This provision could undermine the Dealer Members' ability to rely on experts, which is expressly permitted, and in certain cases, required, under securities legislation, and would result in prohibitive costs if double verification of expert opinions is required. It is unclear from the Proposed Guidance under what circumstance such independent verification of experts would be expected.

The Association agrees that, if there are apparent "red flags" in respect of any particular expert, it would be reasonable to expect underwriters to conduct further investigations, however, the language in the Proposed Guidance suggests that underwriters should undertake further investigation and verification of the expert and the accrediting body even in the absence of any red flag. Further, where standards between comparable governing bodies vary between jurisdictions, we question whether the Dealer Member would be expected to determine what would be the appropriate standard, thus potentially introducing the imposition of foreign standards on accreditation bodies. This is unreasonable and extremely impractical. Dealer Members would still bear the burden in a court of law that reliance on such experts was permitted under the various provincial Securities Acts or prudent in the circumstances.

Subsection 2.2.6 Reliance on Lead Underwriter

The provision in this section that indicates that each syndicate member should receive copies of all letters, opinions or memoranda relating to the underwriters' due diligence investigation is impractical and does not reflect existing practice. While syndicate members should be able to request any documents relating to the due diligence process, creating a positive obligation for the lead underwriter to provide such material to all syndicate members is unreasonable, costly and inefficient. We recommend that this section be amended to indicate that such materials should be available on request.

Subsection 2.27 Due Diligence Record Keeping

As noted in the Proposed Guidance, firms currently have record keeping obligations under IIROC regulations and securities laws. Firms establish their policies and procedures in

accordance with these requirements. It is not necessary to introduce different standards in respect of underwriting due diligence.

Conclusion

The IIAC appreciates that IIROC intends to assist firms in providing suggestions and guidance relating to due diligence practices for underwritten offerings. We are concerned, however that the intended character of this "guidance" will evolve to become perceived as regulatory requirements, which will fail to take into account the considerable firm expertise and judgment in conducting these offerings. The resulting inefficiencies and costs that will be introduced into the process would be significant, and the potential for civil liability when such procedures are not followed (even when they are not necessary) is also of concern to the industry. Existing securities legislation provides for strong remedies for inadequate disclosure, and by extension, inadequate diligence. Adding another possible course of civil liability is unnecessary, duplicative and ultimately, a foreseeable and avoidable consequence of the proposed guidance policy.

If the Proposed Guidance is published by IIROC, we suggest that some of the language that make certain due diligence practices appear mandatory, such as the due diligence plan and other steps identified in this letter, be amended to ensure that they are suggestions to be accepted or rejected by firms based on the context of the transaction.

Thank you for considering our comments. If you have any questions, please to not hesitate to contact me.

Yours sincerely,

Susan Copland