



# Product Due Diligence

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# Product due diligence

Investment Industry Association of Canada  
2012 Fall Compliance & Operations Symposium

# History

- Conduct and Practices Handbook
- NASD Notice to Members 03-71: Non-conventional investment
- NASD Notice to Members 05-26, April 2005
- IDA Regulatory Analysis of Hedge Funds, May 2005
- Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial paper in Canada
- IIROC Guidance Note 09-0087: Best practices for product due diligence, March 2009
- IIROC Guidance Note 10-0234: New Product Due Diligence Regulatory Review – Common Deficiencies and Requirements for Written Policies, Procedures and Controls
- IIROC Guidance Note 09-0172: Sales Practice Obligations Relating to Leveraged and Inverse Exchange Traded Funds



# Conduct and Practices Handbook

Once a registrant is satisfied that all relevant information about the client is known, the client's needs must be matched to the risk/return attributes of the securities or mutual fund being considered for purchase. This could include a consideration of a number of the following variables:

- Is it a new issue (still in primary distribution)?
- How long has the product, company or fund been in existence?
- What are the normal fluctuations of the security's or fund unit's price?
- What is your research department's evaluation (technical and/or fundamental) of the security and how positive do you feel about it?



# NASD Notice to Members 03-71

This *Notice to Members* reminds members offering NCI of their obligations to:

- (1) conduct adequate due diligence to understand the features of the product;
- (2) perform a reasonable-basis suitability analysis;
- (3) perform customer-specific suitability analysis in connection with any recommended transactions;
- (4) provide a balanced disclosure of both the risks and rewards associated with the particular product, especially when selling to retail investors;
- (5) implement appropriate internal controls; and
- (6) train registered persons regarding the features, risks, and suitability of these products.



# NASD Notice to Members 05-26

Standardized process:

- assigns clear “ownership” of the product or concept to a particular business unit, product group, or department;
- is clearly communicated to, and has a high profile within, the firm; and
- is easily accessible to the business units, often through internal Web-based applications that encourage standardization and uniformity



# NASD Notice to Members 05-26

- A number of firms stressed the importance of involving legal and compliance personnel at the earliest possible stage
- When compliance is involved only at the end of the process, there may be less time or inclination to modify the product to address compliance concerns, and the sponsors of the product may have a more adversarial relationship with the compliance and legal teams.<sup>4</sup>



# The footnote

Nothing in this *Notice is intended to imply* that consultation with legal and compliance personnel in itself alters or shifts supervisory responsibilities within the firm.



# IDA Regulatory Analysis of Hedge Funds

Some Members restrict Registered Representatives (RRs) to selling hedge funds from their recommended list. This ensures that the fund has gone through a due diligence process. Other firms have dedicated hedge fund analysts to review and recommend hedge funds. Dedicating an analyst to hedge fund products provides RRs with product support and information. Given the difficulties of assessing hedge fund products, Members should establish sufficient internal controls designed to ensure that hedge funds offered for sale to their clients have undergone an appropriate due diligence process.



# IDA Regulatory Analysis of Hedge Funds

Members may be using material and marketing items prepared by the hedge fund companies themselves. Such literature may not have adequate disclosure or may not be a fair representation of the risks associated with holding hedge fund investments.

Of particular concern to the IDA is any lack of understanding of products being recommended by Approved Persons.

As part of proper controls and procedures over hedge fund products, a Member should educate and train the relevant Approved Persons about the characteristics, risks, and rewards of each product before they allow them to sell hedge funds to investors.



# IIROC ABCP Study

We expect registered representatives to understand the products they sell. Supervisors must understand the products sold by those under their supervision. This means that dealer members must inform them of the salient characteristics of products that have gone through the product review process, the factors to be considered in making suitability determinations with regard to such products.



# IIROC ABCP Study - Definitions

- They were too vague and general.
- They were limited to listings of a few types of products resulting in other types not being reviewed.
- They failed to include e-review of products where there was a material change to the nature of the product or its risks;
- They failed to include introduction of existing products to new types of customers.

# IIROC ABCP Study – Factors Considered

- Reviews that focused solely on the adequacy of the new product's disclosure documentation.
- Failure to compare new products against less complex and lower risk alternatives, ignoring the overall investment merits.
- Failure to consider conflict of interest issues as part of the review process.
- Failure to consider the compensation structure of products.
- Failure to consider how the product will be marketed.

# IIROC ABCP Study - Structure

- Some dealer members relied on processes at parents or affiliates in which they had limited involvement and did not independently assess the product risks to the dealer member and its clients.
- Some bank groups that include dealer members have complex and fragmented processes for reviewing new products and businesses. They have separate risk management committees, new activity committees, credit risk committees and retail new product committees that all assess different elements of risk, most housed in the parent bank. The dealer member was represented on some of the committees and not on others, making it difficult or impossible to bring the results of the different assessments together into a coherent dealer member assessment.

# IIROC ABCP Study - Structure

- Most processes involve committees but some were unbalanced, involving only business managers or financial risk management personnel, not compliance personnel or others responsible for investor protection;
- Some processes had diffuse or unclear assignment of responsibility for bringing proposals forward and taking action on results.

# IIROC ABCP Study – Record keeping

- Lack of evidence of the due diligence work conducted.
- Lack of information on the basis for decisions made in processes carried on outside the dealer member.
- Lack of records of conclusions regarding limitations on use of approved products.

# IIROC ABCP Study – Communication

- Some product due diligence processes did not include consideration of what should be communicated to supervisors and registered representatives to assist them in understanding the products reviewed and determining whether they were suitable for clients. The processes left it to the supervisors and registered representatives to educate themselves, having only the knowledge that the product had been approved
- Some did not identify important product characteristics that should be given to clients considering an investment.



# **Louis Bérard**

## **National Bank Financial**

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Building your financial future

# Wealth Management Product and Activity Review Process

IIAC 2012 Fall Compliance and Operations Symposium

Louis Bérard, VP client offering and transactional business  
November 08 2012

# Main points

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- Product review pre and post 2008
- 360° Stakeholder's approach
- The challenges of an open architecture

## Product review pre 2008

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- Underwriting Committee
  - Can we do it?
  - Reliance on disclosure
  - Retail clients responsible for reading disclosure
- No specific concerns with hedge funds, structured products, private placements
  - When in doubt have the client sign a liability waiver (weak)

## Product review post 2008

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- Global Risk Committee :
  - What are the risks if we do it?
- New Product Committee:
  - Can we do it? Operations, risk management , P&L etc
- FM PARC (Financial Markets Product and Activity Review Committee):
  - Should we do it?
- WM PARC (Wealth Management Product and Activity Review Committee):
  - Should we do it?
- Underwriting committee: Liability decision, value proposition

## Type of issues relevant for PARCs

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- Structural integrity/issues raised by products, re legal, accounting, tax, regulatory, compliance
- Disclosure issues and transparency
- Risk profile and return potential for clients
- Market, liquidity and counterparty risks
- Conflict of interests
- Reputational risks
- Capital requirements
- Market position/market share

# Highlights of WM PARC Structure and responsibilities

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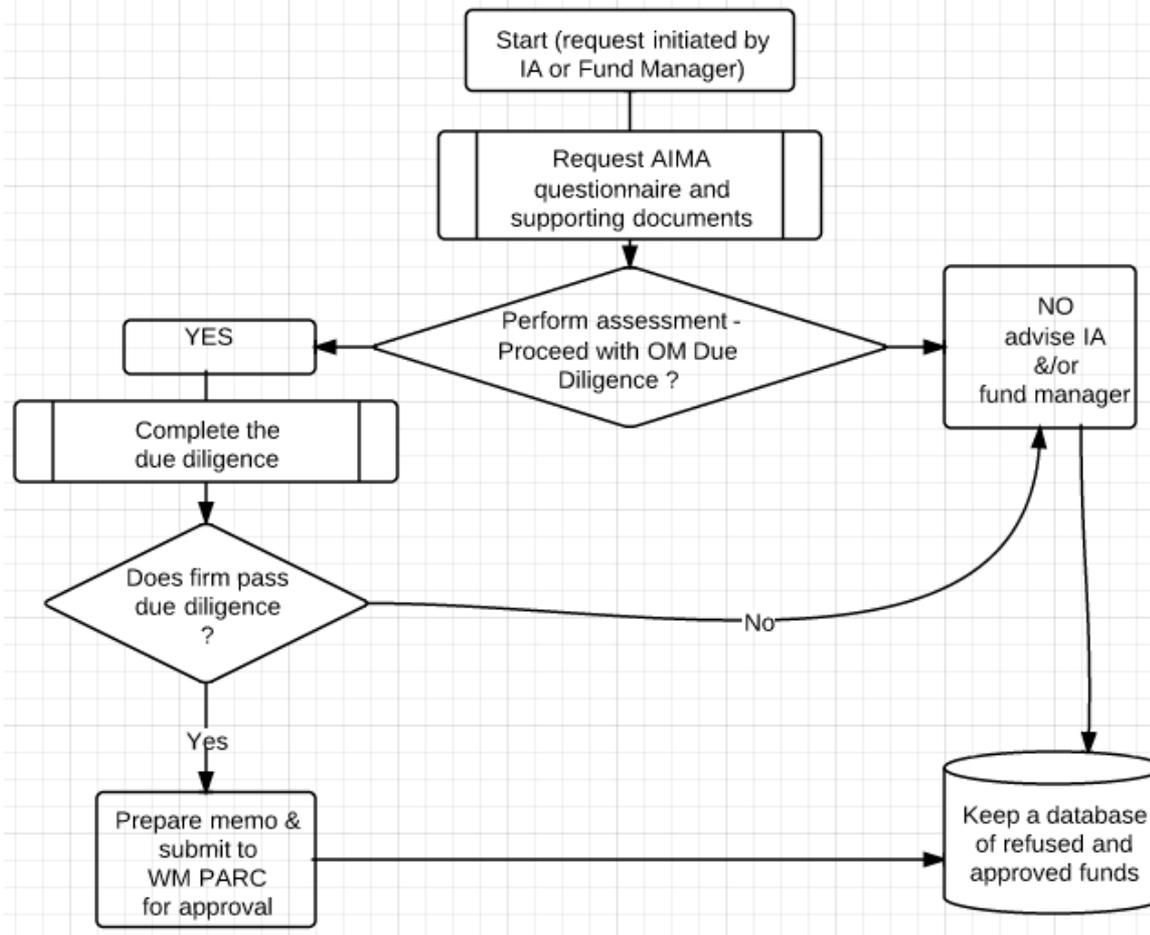
- Products offered by a Wealth Channel but not Manufacturing by NBFG
- Relationship to Product Review Process for Other Units of NBFG
- Committee Composition
- Timetable for Product Reviews
- Determinations
- Training
- Frequency of meetings
- Other Committees within Wealth Management

# The challenges of an open architecture

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- Minimum \$1M firm interest before undertaking a review.
  - Always preceded by Pre-assessment to verify if minimum requirements are met
- Requirement: reciprocal relationship between manufacturer and NBF for PPNs and PAR notes
- Non-brokered private placements
  - Certificate of independent legal advice by client's lawyer
- Transactions where NBF is not part of syndicate
  - Private placements – 3 tier - review of DD work
  - Prospectus offerings
    - If NBF declined invitation
    - If NBF was not invited

# OM Funds DD process



## Supporting Documents

- \* AIMA Hedge Fund Questionnaire
- \* Offering memorandum
- \* Financial Statement
- \* Marketing Material
- \* ADV (if registered with the SEC)
- \* Historical Performance (excel)
- \* Valuation Policy
- \* Service Agreement with Admin
- \* Compliance Manual (or it's Table of contents)

## OM Funds pre-assessment minimum requirements

<b>Viability</b>	<b>Minimum requirements</b>
Total Assets Under Management (AUM)	<b>\$100 M</b>
Fund Manufacturer Inception Date	<b>At least 5 years</b>
On-shore structure	<b>Must be Canadian</b>
<b>Compliance</b>	
Company and principals should not have been sanctioned by regulatory authorities	No
In the last 10 years, there should be no legal proceedings against the firm/employees and/or principals	No
<b>Oversight.</b>	
Funds need to have independent / renowned firms performing these functions'	
Administrator	Renowned and Canadian
Prime Broker	Renowned and Canadian
Custodians	Renowned and credit worthy - Credit rating of "A"
Auditors	Renowned and Canadian
Legal	Renowned and Canadian
Independent NAV calculation agent	Yes
<b>Fees and Performance</b>	
Fees	No excessive fees
Fund Performance (returns)	Satisfactory
Redemption	At least annually at the NAV

Thank you



# Gina Yee

# Fasken Martineau

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# Product Due Diligence Recent Developments

- Leveraged and Inverse ETFs
- Emerging Market Issuers
- Investment Fund Manager Registrations / Exemptions

# Leveraged and Inverse ETFs

- Double or triple leveraged / inverse
- Speculative short-term
- Sophisticated investors / day traders
- Complex

## Due Diligence

- Prospectus
- Trading history
- Online suitability-exempt

# OSC Staff Notice 51-719 Emerging Markets Issuer Review

March 20, 2012

## Underwriters

Establish a consistent and transparent set of requirements for the conduct of due diligence by underwriters

Ensure these requirements include a process that addresses:

- the issuer's operational structure
- internal controls and risk management
- translation and foreign language issues
- business practices and business environment in which the issuer operates
- government relationships
- asset ownership
- CEO/founder shareholdings and RPTs

- cultural norms that affect the issuer's structure, operations, governance and the ability to do business
- review of key documents
- review of key members of management
- review of customers, suppliers and others parties relevant to the issuer's business
- reporting on results of site visits
- develop best practices around documentation of all aspects of an underwriter's due diligence
- develop best practices for due diligence calls and site visits

## **Due Diligence**

IIAC Corporate Finance Due Diligence Guidelines - February 2006

Lead Underwriter(s) - cannot rely solely on leads

# Investment Fund Manager Registration Requirements / Exemptions

Effective September 28, 2012 [IFMs must apply by Dec 31, 2012]

- MI 32-102 Ontario, Quebec, Newfoundland & Labrador
- MP 31-202 all other provincial jurisdictions
- A person must not act as an IFM unless registered or an exemption applies – “directing, or managing the business, operations or affairs of an investment fund”
- “investment fund” means a mutual fund or a non-redeemable investment fund (i.e., trust, limited partnership, etc.)

# MP 31-202

- The IFM does not need to have an office or be physically present in the jurisdiction but the IFM activities must take place in the jurisdiction
- Presence of security holders, solicitation of investors or distribution of securities do not give rise to IFM registration unless they are directed from within the jurisdiction

# MI 32-102

## (Ontario, Quebec, Newfoundland & Labrador)

Non-resident IFMs must register unless an exemption applies:

### I. **No security holders or active solicitation**

An IFM with no place of business in the jurisdiction is exempt from IFM registration if there it has no security holders or there is no “active solicitation” in the jurisdiction after Sept 28, 2012.

“Active solicitation” includes... purchase recommendations being made by a 3<sup>rd</sup> party to residents if that 3<sup>rd</sup> party is entitled to be compensated for the recommendation itself or for a subsequent purchases by residents in response to the recommendation (i.e., dealers, EMDs, advisers, etc.)

# MI 32-102 (continued)

## II. Permitted Clients

An IFM with no principal place of business in Canada is exempt from IFM registration if the investment fund:

- only distributes to “permitted clients”
- provides prescribed disclosure
- submits a Form 32-102F1 *Submission to Jurisdiction and Appointment of Agent for Service for International IFM* and appoints an Agent for Service of Process in each jurisdiction; and
- submits a Form 32-102F2 *Notice of Regulatory Action* within 10 days of the date the fund began relying on the exemption or within 10 days of any change.

# Product Due Diligence

## Check IFM Registration / Exemption

### Prospectus

- Check SEDAR for registered IFM

### Canadian Non-Prospectus

- Check CSA and OSC website (after Dec 31, 2012)

### Non-Canadian Non-Prospectus

- Check CSA and OSC website (after Dec 31, 2012)
- Ontario, Quebec, Nfld & Labrador – IFM must be registered or have filed notice pursuant to the International IFM exemption
- Other provinces – IFM registration only required if conducting IFM activities in the jurisdiction

**Questions?**

**FASKEN  
MARTINEAU**

