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Investment Industry Regulatory Organization of Canada
Organisme canadien de réglementation du commerce des valeurs mobilières

IIROC NOTICE

Rules Notice
Guidance Note
Dealer Member Rules

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Guidance respecting underwriting due diligence

1. Introduction

1.1. The Role of Underwriters in Public Offerings

Underwriters, together with auditors, issuers' and underwriters' legal counsel, other professional experts and exchanges, act as "gatekeepers"[1] to capital markets.

When acting as an underwriter for an offering of securities, IIROC Dealer Members and their officers, employees, with assistance from underwriters' counsel and other expert advisors, discharge their role by completing a due diligence investigation, participating in the preparation of a prospectus and certifying the contents of the prospectus – activities that are critical to fostering fair and efficient capital markets.

[1] This guidance note adopts the term "gatekeeper" from OSC Staff Notice 51-719, *Emerging Markets Issuer Review* (March 20, 2012) and other non-statutory sources to refer to Dealer Members' role as important controls on access to capital markets through the underwriting due diligence process.

In legal terms, each Dealer Member participating as an underwriter of a public offering must sign a prospectus in which the firm certifies that, *to the best of its knowledge, information and belief*, the prospectus constitutes full, true and plain disclosure of all material facts relating to the offered securities.[2] An investigation of the material facts underlying the disclosure in the prospectus – "due diligence" – allows the underwriter to responsibly sign the certificate in the prospectus, and further allows the underwriter to demonstrate that it conducted an investigation sufficient to establish a statutory "due diligence defence" in the event that the prospectus, in fact, contained a misrepresentation.

In the case of private placements, although the Dealer Member as placement agent has no statutory liability, effective due diligence mitigates potential common law liability and reputational risk. This Guidance Note is not intended to apply to Dealer Members participating in private placements.

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. Dealer Members, together with other gatekeepers, play a role in protecting investors, fostering fair and efficient capital markets and creating and maintaining confidence in capital markets.

1.2. IIROC Dealer Member Rules and Statutory Provisions Applicable to the Underwriting Function

IIROC Dealer Member Rule 29 sets out the general requirement that each Dealer Member and each partner, director, officer, supervisor, registered representative, investment representative and employee of a Dealer Member must observe high standards of ethics and conduct in the transaction of their business and must not engage in any business conduct or practice which is unbecoming or detrimental to the public interest. Other sections of Dealer Member Rule 29 set out more specific business conduct requirements for Dealer Members involved in a distribution of securities (for example Dealer Member Rule 29.13 on pre-marketing) and Dealer Member Rule 100.5 sets out certain margin requirements when engaging in underwriting activities. IIROC Dealer Member Rule 2500 requires each Dealer Member to supervise its business activities, including all dealings in securities such as public offerings and private placements.

Dealer Members are intermediaries with obligations to both issuers and investors. As underwriters, Dealer Members have contractual obligations to issuers and, under provincial and territorial securities legislation, Dealer Members are also required to deal fairly, honestly and in good faith with their investor clients. Other provisions, for example s. 59(1) of the *Securities Act* (Ontario), require underwriters to sign a certificate for each prospectus in the prescribed form. National Instrument 41-101 – *General Prospectus Requirements* ("NI 41-101") (and Form 41-101F1) set out the prescribed prospectus certificate as follows:

> "To the best of our knowledge, information and belief, this prospectus constitutes full, true and plain disclosure of all material facts relating to the securities offered by this

[2] Emphasis added. This is in contrast to the prospectus certificate signed on behalf of the issuer, in which the issuer certifies without qualification that the prospectus constitutes full, true and plain disclosure of all material facts relating to the offered securities.

prospectus as required by the securities legislation of [insert jurisdictions]."[3]

An issuer filing a prospectus is required to make full, true and plain disclosure of all material facts relating to the securities being distributed, and must ensure that the prospectus does not contain a misrepresentation. A misrepresentation means (a) an untrue statement of a material fact or (b) an omission to state a material fact that is required to be stated or (c) an omission to state a material fact that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

Provincial and territorial securities legislation also sets out a defence with respect to liability for misrepresentations in a prospectus where sufficient due diligence has been conducted. For example, section 122(1) (b) of the *Securities Act* (Ontario) provides that every person or company that makes a statement in any prospectus that, in a material respect and at the time and in the light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading is guilty of an offence and on conviction is liable to a fine and/or imprisonment. Section 122(2) provides a due diligence defence where the person or company did not know and in the exercise of reasonable diligence could not have known that the document contained a misrepresentation.

Similarly with respect to civil liability under the *Securities Act* (Ontario), section 130(5) provides that:

> "No person or company, other than the issuer or selling security holder, is liable under subsection (1) with respect to any part of the prospectus . . . unless he, she or it,
>
> (a) failed to conduct such reasonable investigation as to provide reasonable grounds for a belief that there was no misrepresentation; or
>
> (b) believed that there had been a misrepresentation.

Section 132 of the *Securities Act* (Ontario) indicates that the standard of reasonableness in determining what constitutes a reasonable investigation or reasonable grounds for belief is that of a prudent person in the circumstances of the particular case. Section 2.2 of the Companion Policy to NI 41-101 addresses the benefits of underwriter participation in prospectus offerings, stating that "the due diligence investigation undertaken by an underwriter in relation to the business of the issuer often results in enhanced quality of disclosure in the prospectus."

1.3. Underwriting Due Diligence

Due diligence in connection with a public offering is the process by which the underwriter takes reasonable steps to ensure that all prescribed information is included in the prospectus, to investigate the information provided by the issuer for inclusion in the prospectus and to verify key material facts. Due diligence is, by its nature, a fluid and evolving process. It should be customized to be relevant to the particular issuer, the industry in which it operates and the type of security being offered.

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[3] Alternate forms of underwriters' certificates, incorporating the same "knowledge, information and belief" standard, are set out in National Instrument 44-101 – *Short Form Prospectus Distributions*, National Instrument 44-102 – *Shelf Distributions* and National Instrument 44-103 – *Post Receipt Pricing*.

Underwriters must not put "form over substance" and are expected to exercise professional judgment to determine the appropriate level of due diligence in each set of circumstances.

As noted above, the due diligence defence is statutory, under section 130(5) of the *Securities Act* (Ontario) and the corresponding provisions of other securities legislation. Although securities legislation does not prescribe the form or substance of a reasonable due diligence investigation, court decisions and securities regulatory settlement agreements provide some guidance concerning the standards expected of underwriters.

The Ontario Securities Commission ("OSC") provided a number of recommendations regarding due diligence in its Emerging Market Issuer Review (the "EMIR").[4] The EMIR lists several considerations for underwriters when dealing with an issuer whose business operations are based in what is referred to as an "emerging market" jurisdiction and identified, as a central concern, an "apparent 'form over substance' approach to compliance with applicable standards for due diligence practices, and a lack of rigor and independent-mindedness". The EMIR noted that underwriters should participate in the offering process for an emerging market issuer with a "healthy amount of scepticism regarding management claims." Dealer Members should, therefore, perform due diligence with an open and questioning mind.

2. Guidance Respecting Underwriting Due Diligence

This Guidance Note describes common practices and suggestions which may not be relevant or appropriate in every case. It is not intended as a minimum or maximum standard of what constitutes reasonable due diligence. This Guidance Note does not, and is not intended to, create new legal obligations or modify existing ones.

Appendix A to this Guidance Note provides a summary of these common practices and suggestions.

2.1. Policies and Procedures for Underwriting Due Diligence

> **Principle:** Each Dealer Member is expected to have written policies and procedures in place relating to all aspects of the underwriting process and to have effective oversight of these activities. These policies and procedures should reflect that what constitutes reasonable due diligence involves, for each underwriting, a contextual determination.

Dealer Members have an obligation to establish, maintain and apply policies and procedures that establish an effective compliance system that provides assurance that the firm and individuals acting on its behalf comply with IIROC rules and applicable securities laws, and manage business risk in accordance with prudent business practices. As a general matter, a Dealer Member's policies and procedures applicable to underwriting due diligence should reflect the following approach:

1. Due diligence in connection with a public offering is the process by which the underwriter takes reasonable steps to ensure that all prescribed information is included in the prospectus, to investigate the information provided by the issuer for

[4] OSC Staff Notice 51-719, *Emerging Markets Issuer Review* (March 20, 2012).

inclusion in the prospectus and to verify key material facts; that is, that a prospectus contains full, true and plain disclosure of all material facts relating to the securities being offered.

2. What constitutes "reasonable" due diligence involves a contextual determination in the circumstances of each underwriting, requiring a careful consideration of the circumstances of the particular offering and the exercise of professional judgment by senior investment banking and other professionals within the Dealer Member.

3. Because of this contextual nature of the due diligence process, beyond certain basic elements, effective due diligence should go beyond prescriptive checklists alone, as such an approach would necessarily be superficial and often incomplete.

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

Dealer Members should consider the following matters in developing their policies and procedures for underwriting due diligence.

2.2.1. Due Diligence Plan

> **Principle**: The Dealer Member should have a due diligence plan that reflects the context of the offering and the level of due diligence that will be reasonable in the circumstances.

The Dealer Member should have an overall understanding of the business of the issuer and the industry in which it operates in order to determine the scope and objectives of the due diligence investigation. There should be a due diligence plan that reflects the context of the offering and the level of due diligence that will be reasonable in the circumstances. The form of the plan will depend on the Dealer Member's practice, and will generally include a list and description of the matters to be investigated. The decision to prepare a formal written due diligence plan for an offering is a contextual determination: if the Dealer Member's written policies and procedures adequately set out the matters to be considered, a specific written plan may not be required for all offerings. Similarly, as is discussed in Section 2.2.6 below, it is not necessary for syndicate members to prepare their own due diligence plans where the lead underwriter has done so.

The plan should be prepared in conjunction with underwriters' counsel (including local counsel in foreign jurisdictions, as applicable) and set out the lead underwriter's preliminary expectations of the scope of its due diligence investigation. Such expectations should be shared with the issuer's management, legal counsel and auditors so that they can be in a position to satisfy the underwriters' information and verification expectations. A due diligence plan will, by necessity, be iterative and subject to change as circumstances change, and may be tailored to reflect the Dealer Member's structure and operations.

In the process of creating a due diligence plan, the Dealer Member should consider contextual matters, examples of which are set out in the Appendix to this Notice.

The due diligence plan may reflect the fact that less extensive due diligence procedures may be reasonable for seasoned, significant and widely-followed issuers, in particular those with whom the

Dealer Member is familiar as a result of an ongoing relationship (as lender, investor, financial advisor or financier). Due diligence may, therefore, be an ongoing process, in which case Dealer Members who have knowledge of the issuer through an ongoing relationship may focus their transaction-specific due diligence investigation on recent events and results. Dealer Members should consider, however, what due diligence is appropriate even for seasoned, significant and widely-followed issuers, and issuers with whom the Dealer Member is familiar, such as where the issuer is undertaking an unusual, complex or significant transaction, or is a foreign and/or emerging market issuer.

The due diligence plan may also reflect the type of offering. For example, initial public offerings (or where an issuer became a reporting issuer by way of a reverse take-over ("RTO")) typically require more due diligence than offerings by existing reporting issuers. Public offerings by smaller and/or infrequent issuers typically require more due diligence than offerings by frequent issuers that that have larger market capitalizations and are followed by multiple research analysts and the financial media. Equity offerings, including offerings of convertible debentures, may require more due diligence than investment grade debt offerings and highly rated preferred share offerings, depending on the level of reliance on the rating that is appropriate in the circumstances. The due diligence plan may also reflect the fact that more extensive due diligence procedures may be required where the Dealer Member has not previously performed due diligence for the issuer or where significant time has passed since the Dealer Member last undertook a due diligence investigation. Finally, public offerings by emerging market issuers typically require enhanced due diligence, taking into account the considerations described in the EMIR and in this Guidance Note.

The due diligence plan may also reflect the Dealer Member's specific policies and procedures for "bought deals"[5]. Irrespective of the nature of the public offering, underwriters have a duty to make an investigation that provides them with a reasonable basis for a belief that the prospectus contains full, true and plain disclosure of all material facts relating to the offering. While the timing of such transactions may not, as a practical matter, allow for extensive, transaction-specific due diligence to be performed prior to the launch of the bought deal, it is expected that reasonable due diligence will be completed before the underwriters certify the final prospectus.

2.2.2. Due Diligence Q&A Sessions

> **Principle**: Due diligence "Q&A" sessions should be held at appropriate points during the offering process and are an opportunity for all syndicate members to ask detailed questions of the issuer's management, auditors and counsel.

The due diligence plan should contemplate due diligence "Q&A" sessions at appropriate points during the offering process (typically, for equity offerings, one prior to filing the preliminary prospectus and another update or "bring-down" session prior to filing the final prospectus). This in-person Q&A session is the underwriters' opportunity to ask detailed questions of the issuer's management, auditors, counsel and any other relevant subject matter experts in order to confirm the completeness and accuracy of the information contained in the prospectus. Given the importance of

[5] A transaction in which underwriters are permitted to solicit expressions of interest before a short form prospectus-eligible issuer files a preliminary prospectus, provided that the issuer and underwriters have entered into an agreement for the purchase and sale of the offered securities, announce the offering publicly and file the preliminary prospectus within certain time periods.

these sessions, the underwriters should participate with underwriters' counsel in the preparation of the list of questions to be posed to the issuer's management and auditors.

The underwriters or their counsel should provide the list of questions to the issuer's management, counsel and auditors sufficiently prior to the holding of the session in order to allow the persons being asked the questions to undertake such enquiries as are necessary for them to be able to answer the questions as thoroughly and accurately as possible. The underwriters should ensure that the individuals in the best position to have the necessary information participate in the session. All syndicate members should be given an opportunity to participate in, and ask questions at, each Q&A session, and should be represented by investment banking professionals with an appropriate level of seniority.

This session is also an opportunity for red flags that arose during the due diligence process to be noted by the issuer's management, counsel and/or auditors and to confirm, for the benefit of all syndicate members, that the issues have been addressed. Any responses that appear incomplete or evasive should be considered a red flag that triggers follow-up questions or other further review. It is also important that any follow up due diligence or enhanced disclosure arising out of these sessions be completed before the underwriters certify the final prospectus.

2.2.3. Business Due Diligence

> **Principle**: The Dealer Member should perform business due diligence sufficient to ensure that the Dealer Member understands the business of the issuer and the key internal and external factors affecting the issuer's business. A Dealer Member should use its professional judgment when determining which material facts will be verified independently depending on the circumstances of the transaction.

The due diligence plan should distinguish clearly between the matters that will be addressed in business due diligence – to be conducted by the underwriters – and the matters that will be addressed in legal due diligence – to be conducted by underwriters' counsel on the underwriters' behalf.

The extent of appropriate business due diligence is a contextual determination. The following sets out the principal elements of business due diligence:

- visiting the issuer's head office and principal operations sites;
- reviewing the issuer's business plans, budgets and projections to understand the issuer's strategy and competitive environment;
- conducting in-depth discussions with the issuer's management, financial and accounting personnel, independent auditors and external legal counsel, recognizing that limitations may be imposed on participants in the offering process by their governing rules (e.g., such as the parameters established by CPA Canada for auditors' comfort letters and due diligence Q&A responses);
- reviewing the issuer's publicly available disclosure documents (such as financial statements, MD&A, annual reports and annual information forms), and comparing the issuer's disclosure to that of comparable issuers to identify any anomalies that may warrant further investigation;

- reviewing the issuer's key operational data;
- reviewing the issuer's material contracts (or a summary of their terms prepared by underwriter's counsel), litigation, regulatory correspondence and other key documents relating to the issuer;
- reviewing relevant sources of external information relating to the issuer and its business environment, including any foreign jurisdictions in which the issuer has assets or does business, including industry surveys, trade journals, law firm publications, rating agency reports, research analyst reports, industry association/organization publications and internet searches.

Dealer Members may also consult research analysts and other industry experts relating to the issuer and/or its industry within the underwriters' affiliates, subject to applicable regulatory requirements and confidentiality walls.

Taking contextual factors into account, Dealer Members may choose to establish a materiality threshold in the due diligence plan from both a quantitative perspective (i.e. a dollar threshold considering the issuer's financial position) and a qualitative perspective (e.g., the areas of business, operations, risk, etc. most relevant to the issuer). This may extend to the use of sampling in the context of large and complex issuers where it may be relatively impracticable, if not impossible, to review all existing documentation.

A central element in the business due diligence process is independent verification of key material facts in the prospectus. The extent of independent verification for any offering depends on the particular circumstances. Dealer Members are expected to exercise professional judgment taking into account all relevant factors in determining which factual statements will be verified independently, including, the firm's familiarity with the issuer, the nature of the issuer's business, the issuer's history, size, complexity, financial position, management and reporting history and the type of security being offered. It is important for the Dealer Member to ensure that the files, documents or other information that are selected to be reviewed or verified by the Dealer Member are not chosen solely by the issuer's management.

Underwriters commonly conduct their own review, including background checks, of the issuer's board of directors, senior executives and other key members of the issuer's management, particularly in the context of initial public offerings. To the extent that an issuer has senior members of management or directors that are located outside Canada, Dealer Members should consider retaining local agents to conduct these checks. Dealer Members should note the potential limitations of background checks in some jurisdictions, where certain personal information may not be readily available. To the extent that Dealer Members also rely on the reputation and personal references of individuals, again this may not be possible or the information may not be reliable with respect to individuals in foreign jurisdictions. Dealer Members should consider whether such limitations should be disclosed as a risk of the offering and Dealer Members should factor these limitations into their determination of whether to complete the offering.

Underwriters should, where appropriate, interview the issuer's customers, suppliers and/or counterparties to material contracts to better understand the issuer's market, to confirm management's representations and to receive independent verification of certain aspects of the

business referred to in the prospectus (e.g. verifying terms of orders, how terms are adhered to in practice, etc.). The extent to which interviews are conducted and the identification of the third parties to be interviewed is a contextual determination; such interviews should particularly be considered as an element of business due diligence in the context of an initial public offering, an offering by a junior issuer, an offering where the issuer is materially reliant on a customer and/or supplier, or an offering where red flags exist with respect to customer and/or supplier relationships. Dealer Members should consider ways in which to engage in such inquiries taking appropriate measures to ensure that the information provided to such parties in the course of such enquiries does not violate the prohibition under securities laws against "tipping".

A Dealer Member's policies and procedures should establish the process to be followed where circumstances that may constitute "red flags" indicate that heightened due diligence and/or enhanced disclosure is required. Dealer Members should follow up on any red flags with enquiries for additional issuer information or involvement by independent experts or other third parties, as appropriate, and should maintain a record of the process by which the Dealer Member resolved the issue. A Dealer Member should consider whether a red flag requires that the prospectus include additional risk factor disclosure so that investors will have the opportunity to adequately inform themselves regarding the specific risks facing the issuer. In some cases, a red flag may require that an issuer undertake remedial action or implement safeguards before a preliminary prospectus is filed.

A red flag exists where, for example, an issuer's management provides oral information that is materially inconsistent with the issuer's written documentation or where an expert or other third party having apparent credibility expresses to the underwriters significant doubts, concerns or reservations about an issuer's public disclosure, financial statements, financial condition, accounting practices, management integrity, internal controls or compliance with laws. Other examples include:

- the issuer has experienced, during the preceding 12-24 months, one or more significant changes in its business, financial position, senior management, auditors and/or legal counsel;
- the presentation or accounting treatment of the issuer's financial information or other disclosure is inconsistent with that of its peers or competitors, including unusual year-over-year growth;
- the issuer displays a high degree of reliance on its founder, CEO, or government relationships;
- there has been recent controversy surrounding the issuer or any of its directors or senior officers, including issues raised by institutional shareholders or corporate governance advisory organizations, or the issuer's board of directors has recently established a special committee of independent directors to investigate allegations of fraud or other improper conduct;
- the issuer or any of its directors or senior officers or controlling shareholders has been the subject of criminal, regulatory or disciplinary investigations or proceedings relating to allegations of fraud or other improper conduct;
- significant shareholdings by the founder or senior management of the issuer, and related party transactions (transactions with other issuers in the same group of issuers, or with parties linked to an issuer's shareholders, directors or management) involving the issuer;
- the issuer has approved material grants of stock options that are not consistent with past practice, or there have been material sales of securities by insiders; or

- the issuer has experienced a recent ratings downgrade or significant changes to equity research analysts' target prices.

The responses that Dealer Members receive from the issuer or third parties during business due diligence may also constitute a red flag, for example, when:

- identical answers are given by customers and other third parties in due diligence interviews;
- respondents in due diligence interviews deflect or avoid direct questions;
- requested information is not provided; or
- there is undue delay or the issuer does not facilitate a site visit to a business location.

In respect of foreign issuers, and particularly emerging market issuers, the due diligence should also focus on ensuring that Dealer Members understand the political and cultural environment in which the issuer operates, local business practices affecting the issuer, local laws affecting the issuer, local experts (including legal advisors and auditors) and the extent to which the issuer relies on local management, particularly in the context of an initial public offering or a subsequent offering by a smaller or infrequent issuer. The Dealer Member should be prepared to deal with differences in time zones, language and/or cultural barriers which may affect the quality of the due diligence, co-ordination and timelines. It is important that any red flags be followed up on and escalated to senior investment banking professionals. Please refer to the EMIR which identified potential additional due diligence information requirements and examples of red flags in the case of emerging markets issuers. OSC staff also issued, in November 2012, Staff Notice 51-720 - *Issuer Guide for Companies Operating in Emerging Markets* which provides assistance to emerging market issuers and their directors and management on governance and disclosure practices.

2.2.4. Legal Due Diligence

> **Principle**: Dealer Members should clearly understand the boundary between business due diligence and legal due diligence, to ensure that matters that should be reviewed by the underwriters are not delegated to underwriters' counsel. Dealer Members should provide adequate supervision of the legal due diligence performed by underwriters' counsel.

Legal counsel also play a key role in the due diligence process – issuer's counsel on behalf of the issuer and its board of directors, and underwriters' counsel on behalf of the underwriting syndicate. Underwriters' counsel, including local counsel in foreign jurisdictions, as applicable, can provide valuable assistance to underwriters in preparing a due diligence plan and in executing a legal due diligence investigation on the underwriters' behalf. However, an underwriter will not be able to avoid liability to purchasers for a misrepresentation in the prospectus if that misrepresentation should have been discovered by counsel as part of the legal due diligence assigned to it (although counsel may be liable to the underwriter for negligence).

The lead underwriter should discuss with underwriters' counsel the scope of the legal due diligence that counsel will perform, and the due diligence plan should clearly delineate the respective roles of the underwriters and their counsel. The analysis of the scope of legal due diligence should include any enhanced due diligence that is appropriate in connection with foreign and emerging market issuers

(including how counsel proposes to address issues relating to local business practices affecting the issuer, local laws affecting the issuer, the issuer's government relationships and issues relating to asset ownership within the issuer's jurisdiction, and retaining local experts). If a material business is held in a subsidiary incorporated or organized under the laws of an emerging market country, this enhanced due diligence may include asking local counsel to explain how those laws differ from applicable Canadian law, including with respect to the issuer's effective control and management of the subsidiary and its assets.

Throughout the legal due diligence process, the Dealer Member should instruct and supervise underwriters' counsel adequately and discuss any significant issues with counsel. The results of legal due diligence should inform business due diligence and the Dealer Member should follow up on missing records and/or information discovered during the legal due diligence process that appears to contradict management's oral statements or the disclosure in the draft prospectus. Underwriters should require underwriters' counsel to keep them apprised of any difficulties counsel experiences in obtaining any information requested from the issuer as part of legal due diligence or in obtaining appropriate legal opinions from the issuer's counsel.

Absent any special limitations in counsel's retainer, underwriters' counsel will have professional obligations to all of the underwriters, and not just to the lead underwriter. Underwriters' counsel should therefore be prepared to communicate the results of legal due diligence to the entire syndicate. Where it is practical to do so, underwriters' counsel and the lead underwriter may wish to convene a meeting or conference call with underwriters' counsel and the entire underwriting syndicate, prior to the management Q&A session, to brief the syndicate on the scope of business and legal due diligence and to report on the status and results of any due diligence completed prior to such meeting or call. This permits syndicate members to have an opportunity, relatively early in the offering process and where practical, to assess the adequacy of the due diligence plan and to offer input.

2.2.5. Reliance on Experts and Other Third Parties

> **Principle**: The extent to which a Dealer Member should rely on an expert opinion is a contextual determination, having regard to the qualifications, expertise, experience, independence and reputation of the expert.

Securities legislation provides that underwriters are not liable for a misrepresentation with respect to any part of the prospectus purporting to be made on the authority of an expert or purporting to be a copy of or an extract from a report, opinion or statement of an expert, if the underwriter had no reasonable grounds to believe and did not believe that there had been a misrepresentation, or that such part of the prospectus did not fairly represent the report, opinion or statement of the expert or was not a fair copy of or extract from the report, opinion or statement of the expert. This is sometimes referred to as the "reliance upon experts defence." The term "expert" is not defined in the *Securities Act* (Ontario). NI 41-101 suggests that the term is intended to refer to solicitors, auditors, accountants, engineers, appraisers and others whose profession gives authority to their statements (for example, a geoscientist who is qualified to prepare a technical report).

While the underwriters' liability in respect of "expertised portions" of a prospectus is therefore limited, underwriters should consider whether any such expert is qualified to give its report or opinion and should obtain reasonable evidence that such expert has consented in writing to its report or opinion

(or any extract or summary) being used in the prospectus. Factors that may assist an underwriter in making this determination may include the reputation and qualifications of the firm or individual acting as an expert, whether the firm or individual has the relevant subject matter expertise and, if applicable, regional knowledge and expertise, the independence of the expert and whether any red flags have been identified in the due diligence process.

With respect to experts resident in foreign (and especially emerging) markets, the Dealer Member should consider the experts' credentials, knowledge and experience (with the assistance, where appropriate, of Canadian experts from the same field) and assess whether they are similar to what would be expected of a Canadian expert in the same field. The Dealer Member may also choose to assess the requirements of any professional governing bodies and the standard of care of experts in those jurisdictions, to determine the extent of reliance on such experts in these circumstances and, in some cases, consider whether corroboration by other experts is warranted.

The EMIR noted that the issuer's external auditor "has a unique role in the reporting process for annual financial statements which are relied upon by the board, audit committee and, most importantly, investors to provide an independent assessment of whether the information presented in the issuer's annual financial statements has been fairly presented."[6] The issuer's auditor is an "expert" for purposes of securities legislation, which makes an auditor's report an expert opinion that is subject to the reliance upon experts defence. However, underwriters should review an issuer's financial statements, particularly in the context of initial public offerings, offerings by smaller or infrequent issuers and offerings of unrated or below-investment-grade debt securities, and the issuer's auditor should be asked to provide a customary long-form "comfort letter" concerning the financial information contained in the prospectus. The auditors should participate in the Q&A sessions so there is an opportunity for underwriters to ask and for the auditors' to respond to questions.

Like auditors, some of the experts that may be involved in an offering are subject to specific provisions of securities legislation[7] and professional regulation. It may not be clear in other areas – such as life sciences or real estate – who constitutes an expert. The underwriter should take into account the expertise, experience and reputation of each such expert in determining the appropriate level of reliance.

Where the issuer operates in an industry requiring specialized knowledge, there may be inherent limitations on the Dealer Member's and its legal counsel's ability to conduct due diligence in areas requiring technical expertise. A Dealer Member may seek to retain its own experts or, where it is not reasonable or economically feasible for a Dealer Member to do so, it may be appropriate for a Dealer Member to rely on the issuer's third party experts, supplemented by appropriate checks and balances.

[6] *EMIR*, p. 5.
[7] See, for example, NI 51-101 – *Standards of Disclosure for Oil and Gas Properties* and the concepts of a "qualified reserves auditor" and "qualified reserves evaluator" set out therein.

2.2.6. Reliance on Lead Underwriter

> **Principle**: Each syndicate member is subject to the same liability for misrepresentation under securities legislation. A syndicate member should satisfy itself that the lead underwriter performed the kind of due diligence investigation that the syndicate member would have performed on its own behalf as lead underwriter.

Each member of the underwriting syndicate is liable for any misrepresentation in a prospectus (subject to provisions capping the statutory civil liability to the amount underwritten); each member of the underwriting syndicate must therefore be in a position to establish its own due diligence defence. The lead underwriter may bear additional reputational and regulatory risk.

The lead underwriter will typically assume primary responsibility for conducting and supervising the due diligence investigation, including preparing the due diligence plan in consultation with syndicate members, and for ensuring that syndicate members are updated on the status and results of the due diligence process. Each syndicate member should therefore be in a position to satisfy itself that the lead underwriter performed the kind of due diligence investigation that the syndicate member would have performed on its own behalf as lead underwriter. The recommendations in this Guidance Note are not meant to re-allocate or result in duplication of the responsibilities for due diligence as between the lead underwriter and a syndicate member. Each syndicate member should, however, receive on request copies of all letters, opinions or memoranda relating to the underwriters' due diligence investigation, and should be invited to and given the opportunity to ask questions of the issuer and its counsel and auditors during the Q&A session.

2.2.7. Due Diligence Record-Keeping

> **Principle**: A Dealer Member should document the due diligence process to demonstrate compliance with its policies and procedures, IIROC requirements and applicable securities laws.

Each Dealer Member should maintain records of its due diligence process in order to be in a position to demonstrate that it conducted a reasonable due diligence investigation, followed its own policies and procedures and complied with IIROC requirements and record-keeping obligations under applicable securities laws. This documentation may be kept by the Dealer Member or by its legal counsel. Dealer Members should ensure that such documentation is available for IIROC compliance examinations covering the relevant period. We recognize that the Dealer Member acting as lead underwriter may keep more detailed documentation than those Dealer Members acting as syndicate members.

There does not appear to be any file retention policy that is universally adopted by Dealer Members. IIROC's compliance examinations have found varying practices among Dealer Members with respect to documenting the due diligence process and retaining such documentation. Similarly, the EMIR also noted that "the amount and degree of due diligence documentation varied widely" and that "[i]n

some circumstances, the documentation did not reflect the process by which due diligence was undertaken and completed nor the risks identified in connection with the offering".[8]

We recognize that a file retention policy will balance the legitimate considerations in favour of "pruning" the due diligence file with the Dealer Members' need to document compliance with their own policies and procedures for underwriting due diligence. A Dealer Member's policies and procedures should describe which documents must be kept in the transaction file, typically called a "file list". For example, there should be a record of any committee meetings (and attendance), as applicable and the Q&A session with issuer's management, auditors and legal counsel. If a specified document is not contained in the file, there should be an explanation for its absence.

Alternatively, some Dealer Members' policies and procedures require confirmation from senior investment banking professionals that all aspects of the due diligence process have been completed and were in compliance with such policies and procedures, IIROC rules and applicable securities legislation. If taking this approach, it is expected that the Dealer Member's policies and procedures are comprehensive and set out a robust supervision and compliance process.

2.3. The Role of Supervision and Compliance

> **Principle:** IIROC Dealer Member Rule 38 requires each Dealer Member to have a comprehensive and effective supervisory and compliance framework in place to ensure compliance with policies and procedures, IIROC requirements and applicable securities laws. A Dealer Member's execution of the prospectus certificate should signify that the Dealer Member has participated in the due diligence process through appropriate personnel and internal processes.

Effective due diligence requires both effective supervision and effective compliance. IIROC Notice 12-0379 – *The Role of Compliance and Supervision* (December 17, 2012) sets out IIROC's general expectations regarding Dealer Members' supervision and compliance functions. IIROC recognizes that appropriate approaches to supervision and compliance for underwriting due diligence may differ among Dealer Members depending on the nature of the activities and/or the characteristics of the Dealer Member. The discussion below outlines some of the effective approaches that Dealer Members have taken.

The role of supervision in underwriting due diligence is to ensure that the business unit itself takes responsibility for the oversight of due diligence activity on an ongoing basis. While the specific activities that comprise due diligence may be performed by a range of personnel, including junior personnel as part of the team, external legal counsel and other experts retained by the underwriters, there should be a senior investment banking professional who is involved throughout the due diligence process (not just at the conclusion of the process) and is ultimately responsible for the quality and extent of the due diligence for each offering of securities underwritten by the Dealer Member. Any difficult or unusual disclosure issues should be escalated to this senior supervisor.

In some Dealer Members, the senior supervisor will often be the same individual who signs the

[8] *EMIR*, p. 16.

prospectus on behalf of the Dealer Member in the case of a public offering. If the individual who signs the prospectus on behalf of the Dealer Member was not the senior supervisor of the due diligence process, the individual signing the prospectus should seek confirmation from the senior supervisor and underwriters' counsel that the Dealer Members' policies and procedures have been followed and that all red flags and difficult or unusual disclosure issues have been appropriately addressed. Supervision may also involve one or more committees of the Dealer Member. Such committees are typically composed of senior investment banking managers, internal counsel and/or compliance personnel who can exercise independent judgment. The use of a committee structure depends on the size, nature and extent of the Dealer Member's business activity.

The underwriting due diligence compliance function may be performed by the Dealer Member's (or its parent company's) compliance department, in-house legal department, internal audit department or a combination of such departments. In some Dealer Members, the compliance role takes the form, during the due diligence process, of participating on one or more supervisory committees described above. An appropriate compliance framework may reflect the size and business model of the firm. IIROC is flexible on how the compliance function is undertaken so long as the applicable individuals have a clear mandate to identify and monitor issues relating to non-compliance with the Dealer Member's policies and procedures in respect of securities offerings, and to report and escalate such matters in accordance with the Dealer Member's internal policies and procedures.

3. Conclusion

This Guidance Note is intended to promote more consistent and enhanced underwriting due diligence standards, to assist Dealer Members to more effectively perform their role and to ensure the protection of the investing public.

Appendix A

Summary of Common Practices and Suggestions

- 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. Dealer Members, together with other gatekeepers, play a role in protecting investors, fostering fair and efficient capital markets and creating and maintaining confidence in capital markets.

- Due diligence must not put "form over substance" and Dealer Members are expected to exercise professional judgment to determine the appropriate level of due diligence in each set of circumstances.

- Policies and procedures for underwriting due diligence should reflect the following approach:

    - Due diligence in connection with a public offering is the process by which the underwriter takes reasonable steps to ensure that all prescribed information is included in the prospectus, to investigate the information provided by the issuer for inclusion in the prospectus and to verify key material facts; that is, that a prospectus contains full, true and plain disclosure of all material facts relating to the securities being offered.

    - Each Dealer Member is expected to have written policies and procedures in place relating to all aspects of the underwriting process and to have effective oversight of these activities. These policies and procedures should acknowledge that what constitutes "reasonable" due diligence involves, for each underwriting, a contextual determination.

    - Because of this contextual nature of the due diligence process, beyond certain basic elements, effective due diligence should go beyond prescriptive checklists alone, as such an approach would necessarily be superficial and often incomplete.

- Due Diligence Plan:

    - The Dealer Member should have a due diligence plan that reflects the context of the offering and the level of due diligence that will be reasonable in the circumstances.

    - A due diligence plan will, by necessity, be iterative and subject to change as circumstances change.

- Due Diligence Q&A Sessions:

    - Due diligence "Q&A" sessions should be held at appropriate points during the offering process and are an opportunity for all syndicate members to ask detailed questions of the issuer's management, auditors and counsel.

- The individuals in the best position to have the necessary information should participate in the Q&A session.

- All syndicate members should be given an opportunity to participate in, and ask questions at, each Q&A session, and should be represented by investment banking professionals with an appropriate level of seniority.

- Any responses that appear incomplete or evasive should be considered a red flag that triggers follow-up questions or other further review.

- Business Due Diligence:

  - The Dealer Member should perform business due diligence sufficient to ensure that the Dealer Member understands the business of the issuer and the key internal and external factors affecting the issuer's business.

  - A central element in the business due diligence process is independent verification of key material facts in the prospectus. Dealer Members are expected to exercise professional judgment taking into account all relevant factors in determining which factual statements will be verified independently.

  - Dealer Members should ensure that the files, documents or other information that are selected to be reviewed or verified by the Dealer Member are not chosen solely by the issuer's management.

  - To the extent that an issuer has senior members of management or directors that are located outside Canada, Dealer Members should consider retaining local agents to assist with their assessment of these individuals.

  - Dealer Members should, where appropriate, interview the issuer's customers, suppliers and/or counterparties to material contracts.

  - A Dealer Members' policies and procedures should establish the process to be followed when circumstances that may constitute "red flags" indicate that heightened due diligence and/or enhanced disclosure is required.

  - Dealer Members should follow up on any red flags with enquiries for additional issuer information or involvement by independent experts or other third parties, as appropriate, and should maintain a record of the process by which the Dealer Member resolved the issue.

  - Red flags arising during business due diligence may include significant changes in the issuer's business, financial information or other disclosure that is inconsistent with the issuer's peers or competitors, a high degree of reliance on certain individuals or relationships, or recent controversy, including criminal, regulatory or disciplinary proceedings, involving the issuer or any of its directors or senior officers.

  - In respect of foreign issuers, and particularly emerging market issuers, the due diligence

should also focus on ensuring that Dealer Members understand the political and cultural environment in which the issuer operates, local business practices affecting the issuer, local laws affecting the issuer, local experts (including legal advisors and auditors) and the extent to which the issuer relies on local management, particularly in the context of an initial public offering or a subsequent offering by a smaller or infrequent issuer.

- Legal Due Diligence:
    - Dealer Members should clearly understand the boundary between business due diligence and legal due diligence, to ensure that matters that should be reviewed by the underwriters are not delegated to underwriters' counsel.
    - Dealer Members should provide adequate supervision of the legal due diligence performed by underwriters' counsel. The results of the legal due diligence should inform business due diligence and the Dealer Member should follow up on missing records and/or information that appears to contradict management's oral statements or the disclosure in the draft prospectus.
    - Dealer Members and underwriters' counsel should consider any enhanced due diligence that is appropriate in connection with foreign and emerging market issuers.
    - Underwriters' counsel should be prepared to communicate the results of legal due diligence to the entire syndicate. Where practical, underwriters' counsel and the lead underwriter may wish to convene a meeting or conference call with underwriters' counsel and the entire underwriting syndicate, prior to the management Q&A session, to brief the syndicate on the scope of business and legal due diligence and to report on the status and results of any due diligence completed prior to such meeting or call.
- Reliance on Experts and Other Third Parties:
    - The term "expert" is not defined in the *Securities Act* (Ontario). NI 41-101 suggests that the term is intended to refer to solicitors, auditors, accountants, engineers, appraisers and others whose profession gives authority to their statements. Securities legislation provides that underwriters are not liable for a misrepresentation with respect to any part of the prospectus purporting to be made on the authority of an expert or purporting to be a copy of or an extract from a report, opinion or statement of an expert, provided certain conditions are met.
    - The extent to which a Dealer Member should rely on an expert opinion is a contextual determination, having regard to the qualifications, expertise, experience, independence and reputation of the expert.
    - Dealer Members should consider whether an expert is qualified to give its report or opinion, and should obtain reasonable evidence that such expert has consented in writing to its report or opinion being used in the prospectus.

- With respect to experts resident in foreign (and especially emerging) markets, Dealer Members should assess the requirements of any professional governing bodies and standard of care of experts in those jurisdictions.

- Dealer Members should review the issuer's financial statements, including reviewing a long-form "comfort letter" from the issuer's auditor concerning the financial information contained in the prospectus, as well as ensuring that the issuer's auditor participates in the Q&A sessions conducted by the underwriters.

- Reliance on Lead Underwriter:

  - Each syndicate member is subject to the same liability for any misrepresentation under securities legislation. A syndicate member should satisfy itself that the lead underwriter performed the kind of due diligence investigation that the syndicate member would have performed on its own behalf as lead underwriter.

  - Each syndicate member should, on request, receive copies of all letters, opinions or memoranda relating to the underwriters' due diligence investigation, and should be invited to and given the opportunity to participate in the Q&A session.

- Due Diligence Record-Keeping:

  - A Dealer Member should document the due diligence process to demonstrate compliance with its policies and procedures, IIROC requirements and applicable securities laws.

  - A Dealer Member's policies and procedures should describe which documents must be kept in the transaction file. If a specified document is not contained in the file, there should be an explanation for its absence.

- Role of Supervision and Compliance:

  - IIROC Dealer Member Rule 38 requires each Dealer Member to have a comprehensive and effective supervisory and compliance framework in place to ensure compliance with policies and procedures, IIROC requirements and applicable securities laws.

  - A Dealer Member's execution of the prospectus certificate should signify that the Dealer Member has participated in the due diligence process through appropriate personnel and internal processes.

  - There should be a senior investment banking professional who is involved throughout the due diligence process and is ultimately responsible for the quality and extent of the due diligence for each offering of securities underwritten by the Dealer Member.

  - Supervision may involve one or more committees of the Dealer Member, typically composed of representatives of the Dealer Member's senior investment banking managers, internal counsel and/or compliance personnel, each of whom can exercise independent judgment.

- Individuals responsible for the compliance function must have a clear mandate to identify, monitor, report and escalate issues relating to non-compliance with the Dealer Member's policies and procedures, IIROC rules and applicable securities laws in respect of securities offerings.

Appendix B

Matters to Be Considered in Creating a Due Diligence Plan

The process of creating a due diligence plan should consider the following contextual matters:

- Who are the issuer's key management and directors?
- What is the issuer's management structure and how does the issuer deal with management succession?
- How will the issuer use the proceeds of the proposed transaction (e.g., for general corporate purposes, to finance an acquisition, or to retire debt)?
- What type of security will be offered? (debt, equity, complex)
- Will the offering have a significant impact on the issuer (e.g., increased leverage, significant dilution, etc.)?
- In the case of an equity offering, is the issuer followed by research analysts and by the financial media?
- In the case of a debt offering, are the issuer's debt securities rated by an independent agency and, if so, what is that rating and what is the appropriate reliance that should be placed on the rating in the circumstances? What impact will the offering have on that rating?
- Is the issuer from an emerging market or other jurisdiction outside of Canada?
- Is the issuer a senior issuer with a large market capitalization and established reporting history or is it a less seasoned or smaller issuer?
- Is the issuer a frequent participant in capital markets transactions?
- To what extent are the underwriters already familiar with the issuer's management, business and financial position as a result of other relationships (including as an underwriter of previous offerings, as a lender, as a research provider, etc.)?
- Does the issuer operate in a highly regulated industry?
- Does the nature of the issuer's business, operations or corporate structure create any special tax, legal, accounting or regulatory risks?
- When will the offering be completed relative to the most recent audited financial statements or quarterly unaudited financial statements?
- Who are the issuer's external legal counsel and independent auditors and how long have they worked with the issuer? Is the issuer's independent auditor a participant in the oversight program of the Canadian Public Accountability Board?
- How does the issuer's financial results, including key financial drivers, compare to its peers?
- What is the nature, geographic scope and complexity of the issuer's business operations?

- What is the relative complexity of the issuer's corporate and capital structures?
- Does the issuer's business or industry involve any unusual risks or uncertainties?
- What is the relative complexity of the proposed transaction?
- What is the relative complexity of the accounting required for the issuer's business?
- Which firm(s) will be a lead underwriter manager for the transaction?
- How much time is available for the lead underwriter(s) and underwriters' counsel to complete their investigations?
- Are there any potential conflicts of interest between the Dealer Member, an individual who is a partner, director, officer, employee or agent of the Dealer Member and the issuer?
- Who are the intended investors (retail or institutional)? Is the offering suitable for the Dealer Member's investor base?
- Are there any "red flags" of the kind identified in this Guidance Note?