

# IIROC NOTICE

## **Rule Notice Guidance Note**

Dealer Member Rules

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*Contact:*

Joe Yassi  
Vice President, Business Conduct Compliance  
416-943-6903  
[jyassi@iiroc.ca](mailto: jyassi@iiroc.ca)

Judy Long  
Director, Business Conduct Compliance  
416-943-5844  
[jlong@iiroc.ca](mailto: jlong@iiroc.ca)

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## **New Product Due Diligence Regulatory Review– Common Deficiencies and Requirements for Written Policies, Procedures and Controls**

### **Background**

In October 2008, IIROC published its regulatory report on the Canadian third party Asset-Backed Commercial Paper issue as it related to the manufacture and distribution by Dealer



Members. In Part III, the Findings & Recommendations section of that report<sup>1</sup>, IIROC stated that it would perform compliance reviews based on a New Products Guidance Note to be released. IIROC issued Guidance Note 09 – 0087 Best practices for product due diligence (“the Guidance Note”) on March 25, 2009. IIROC Rules (38.1; 2500-2700;) and National Instrument 31-103(s.11.1) require an IIROC Dealer Member to have, maintain and apply written policies and procedures acceptable to IIROC, that establish a system of internal controls and supervision in support of investment suitability advice and recommendations for both retail and institutional clients.

In addition when IIROC published its Strategic Plan one of the deliverables was that IIROC would “.....undertake periodic industry-wide compliance audits to assist IIROC and members to understand industry-wide compliance issues”<sup>2</sup>. In response to our commitment to undertake industry-wide compliance audits, IIROC undertook an examination to determine how Dealer Members were following the best practices described in the Guidance Note issued in March 2009.

## **Regulatory Review**

As suitability gatekeepers, Dealer Members must take a proactive approach to reviewing and monitoring “new products” before they are offered for sale to their clients. IIROC suitability rules require each Dealer Member to use “due diligence to ensure that the acceptance of any order from a customer is suitable for such customer based on factors including the customer’s financial situation, investment knowledge, investment objectives and risk tolerance”.<sup>3</sup> Each Dealer Member must make its own determination on how to implement “new product” due diligence at their own firm. Each must have an adequate written policy with appropriate procedures and controls underlying and evidencing that policy, and must be able to establish that this policy is applied. In addition they must ensure that their advisors understand the products that they are recommending.

From March to May of 2010, IIROC conducted targeted regulatory examinations at a representative sample of Dealer Members who distribute structured products. Specifically, the review tested for adequate written policies, procedures, and underlying operational controls on “new products” introduced for sale to retail and institutional clients. The objective of this New Product Due Diligence review was to determine whether, and how, Dealer Members have incorporated the Guidance Note into their business practice. This review is now complete and the results are summarized below.

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<sup>1</sup> Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial Paper in Canada, IIROC, dated October 2008, page 76.

<sup>2</sup> IIROC Strategic Plan dated December 2008, IIROC Goals and Strategies, Goal #1, page 6.

<sup>3</sup> Rule 1300(1)(p)



## Common Deficiencies

### 1. Written Policies and Procedures

The review found that two of the fourteen Dealer Members tested did not have written policies. Of those with written policies, many of the policies were deficient in some material aspect. Some had no meaningful written procedures to accomplish the intent of their policies. The following are some deficiencies in the written policies and procedures examined.

a) Absence of a clear definition of “new product”

It is critical for a Dealer Member to capture all products that need to go through the due diligence process. The definition of “new product” should include the criteria for determining when a product must be reviewed. The Guidance Note contains detailed guidance on the scope of a proper definition and criteria that should trigger a review of products for both retail and institutional clients. The more complex and non-transparent products having features such as embedded derivatives, variable maturities, complex fee structures or opaque assets, should be captured in the definition and be subject to a due diligence review. The definition should also include details on when a modification to an existing product should be subject to the due diligence review process.

b) Absence of appropriate level of internal review

As a minimum standard, the policy should call for a written “new product” proposal and provide for internal review by the Chief Compliance Officer. Best practice would dictate the involvement of subject matter experts from all relevant areas of the firm.

c) Absence of an adequate analytical framework for the consideration of whether the “new product” should be offered

The primary goal of every “new product” due diligence review should be to ensure that the right questions are asked by subject matter experts and satisfactorily answered. That framework identifies issues that might be pursued, and highlights matters for training and marketing. Please refer to the Guidance Note for a list of questions and considerations necessary for a proper analytical framework in the due diligence process.

d) Absence of consideration of possible conflict of interest scenarios and how they should be addressed

The following matters should be considered in the written policy and procedures document, and those procedures should be effectively implemented and supervised:

- Is the “new product” from a non-arm’s length manufacturer/issuer?
- Is it a product of a related or connected issuer?
- Is it a proprietary product?



- Are there additional incentives for sales staff?
- If so, what disclosures must be made?

e) Absence of consideration of proficiency, training and marketing issues

Proficiency issues should be reviewed as part of the due diligence process. Any specific training issues should be documented on “new product” features and risks. Advisors and supervisors must fully understand the product in order to support the suitability of any recommendations made to clients. The policy should address the need to reassess training requirements on a continuing basis and provide for a review of any marketing materials.

f) Absence of a process to monitor and review customer complaints regarding “new products”, and for monitoring compliance with any restrictions placed on the sale of the “new product”

A monitoring process that allows for customer, product or compliance issues to be escalated and acted upon at an early stage needs to be in place. This will allow the firm to become aware of and address, any systemic issues that may be identified through complaints of a similar nature.

## **2. Operational issues and controls**

The review of the controls underlying the firms’ policies and procedures found the following deficiencies.

a) Absence of adequate controls underlying written policies

Some Dealer Members did not have a sufficient evidentiary record of controls supporting a “new product” due diligence process. Dealer Members must be able to establish that they have a system of internal controls and supervision in support of investment suitability advice and recommendations for both retail and institutional clients, where applicable, with respect to “new products”. Please refer to the Guidance Note for details of an acceptable control system.

b) Absence of control methods to capture sources of “new products”

At some firms, the due diligence process is triggered only when an advisor brings forward a “new product”. Most firms have no controls for products that come in through transfer or client deposit. The policy should capture all sources of “new product”.

c) Absence of a standardized process requiring a written “new product” proposal for internal review

Not all Dealer Members send all potential “new products” to a product due diligence committee. The requirement for a written proposal would trigger a preliminary assessment of



whether the proposed product or concept is a “new product” (including a material modification of an existing product) requiring further internal review, and be the first document in the paper trail for “new product” due diligence.

d) Absence of Product Due Diligence Committees

Not all Dealer Members have a Product Due Diligence Committee. Best practice would be a committee or working group consisting of representatives from all relevant departments of the firm and include members of senior management. The legal, finance, marketing, sales and operations functions should be present, as well as the Chief Compliance Officer. All concerns: suitability, restrictions on the sale of product (e.g. proficiency), risks and training needs should be documented as part of the deliberation process, and approvals should be conditional upon the requirement for periodic reassessment.

### **Next Steps**

Each of the Dealer Members participating in the regulatory review has received a letter reporting on IIROC’s findings at that firm and IIROC’s proposed corrective action. IIROC will ensure that each of those firms undertake the necessary improvements to their product due diligence policies and procedures.

Effective immediately, IIROC Business Conduct Compliance will refer any significant and material deficiencies in the “new product” due diligence process encountered during examinations to IIROC’s Enforcement Department.

Dealer Members may refer any questions arising from this Guidance Note to the undersigned or the relevant IIROC Business Conduct Compliance Manager.