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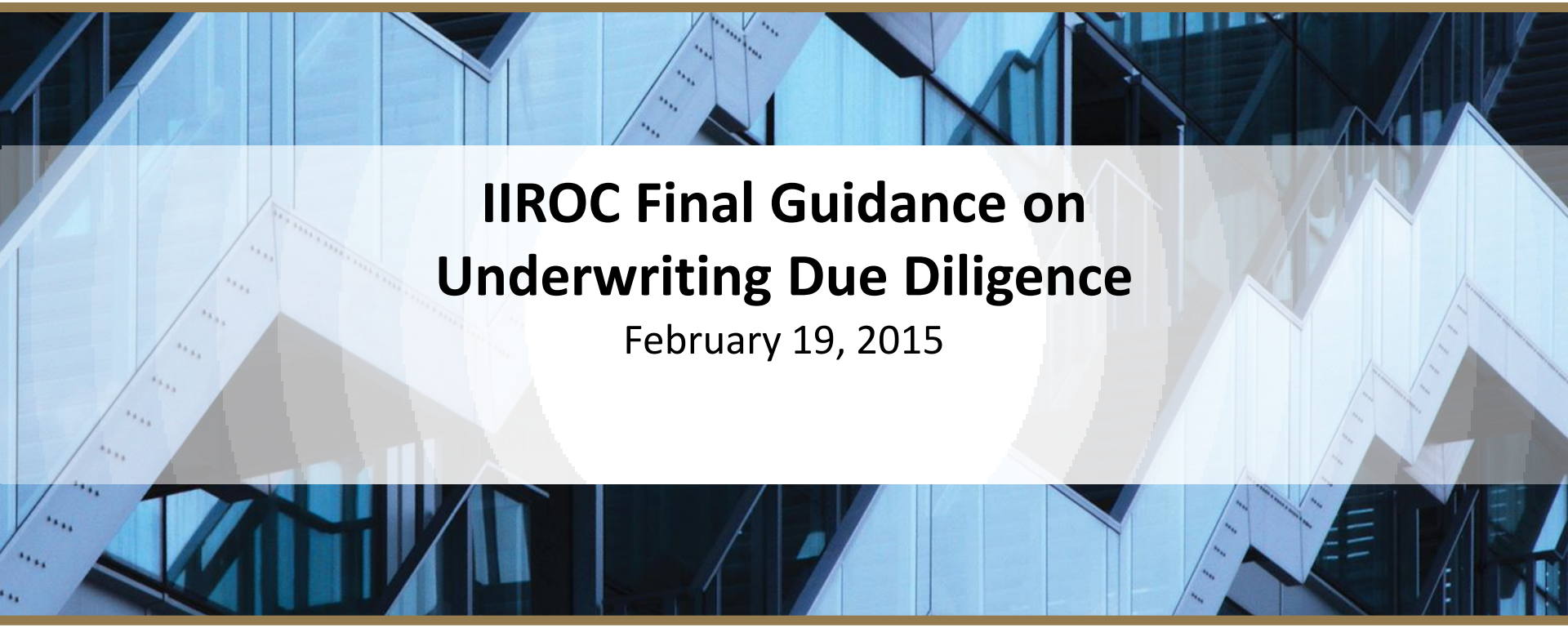

IIROC Final Guidance on Underwriting Due Diligence

February 19, 2015

Agenda

1. Background
2. IIROC Guidance
   - Overview
   - Principles of Due Diligence
3. Implications
4. Questions and Answers

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Background

Collapse of a number of foreign-based companies listed on North American exchanges – most notably the collapse of Chinese forestry company Sino-Forest Corp. turned focus of regulators to Emerging Market Issuers (EMIs)

- Growing importance of these issuers to global and Canadian capital markets:

EMI Issuers	All Others
108 Issuers	4000 listed reporting issuers
$40 billion market capitalization	$2.39 trillion market capialization

* As at April 30, 2011, based on TSX, TSX-V and CNSX listings. ^ 46 of the issuers had the OSC as their principal regulator.

Regulatory Focus on EMIs

OSC

Emerging Market Issuer Review
(OSC Staff Notice 51-719)

Of 24 issuers reviewed, 15 had material disclosure deficiencies

Announced July 2011

Published March 2012

OSC

Guide for Companies Operating in Emerging Markets
(OSC Staff Notice 51-720)

Resulted from EMI Review

Published – November 2012

Highlights risks and red flags, sets out questions directors and management should ask, outlines expectations, and provides direction as to continuous disclosure requirements. EMIR signals forthcoming guidance from IIROC

Identifies potential risks associated with listing EMIs and provides preliminary guidance with respect to applicable listing considerations

TSX/TSX-V

Consultation Paper on Emerging Market Issuers

Published Dec. 2012
Comment Period expired Feb. 2013

IIROC

Publishes Proposed Guidance on Underwriting Due Diligence

Comment Period expires June 4, 2014

IIROC

Publishes Final Guidelines

December 18, 2014

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IIROC Guidance

Overview

- Draft published on March 6, 2014 and final guidance published on December 18, 2014
- Takes effect immediately but likely will not factor into credit/compliance review for a few months
- IIROC established an industry advisory committee on underwriting due diligence standards (the "Industry Committee") and together, IIROC staff and the Industry Committee reviewed the Corporate Finance Due Diligence Guidelines prepared by the Investment Industry Association of Canada in 2006 (the "IIAC Guidelines")
- IIROC staff also consulted with the National Advisory Committee, the Executive of the Compliance and Legal Section advisory committee, a group of western IIROC Dealer Members with specific experience in the venture market, the IIAC Small Dealers/Introducing Firms Committee and a group of senior securities lawyers who represent IIROC Dealer Members in public offerings
- IIROC Guidance does not necessarily reflect the views of the Industry Committee

Overview

- Purpose of Guidance:
  - to promote consistency and enhanced standards amongst IIROC Dealer Members in the underwriting due diligence process
- Limitation:
  - IIROC Guidance is not intended as a minimum or maximum standard of what constitutes reasonable due diligence
  - does not, and is not intended to, create new legal obligations or modify existing ones
  - not intended to apply to IIROC Dealer Members participating in private placements (although some aspects may be helpful)

Overview

- Purpose of due diligence
  - Generally, purpose is to allow underwriters to establish a *due diligence defence* with respect to the disclosure in a prospectus, which requires full, true and plain disclosure of all *material facts*
  - Due diligence, being an investigation of the material facts underlying the disclosure in a prospectus, allows the underwriter to *responsibly* sign the certificate and to demonstrate it conducted an investigation sufficient to establish a due diligence defence in the event of a misrepresentation

Overview

- Purpose of due diligence
  - IIROC notes that:
    - as “gatekeepers” to the capital markets, for underwriters the role of due diligence should go beyond the avoidance of liability and mitigation of risk
    - underwriters play a role in protecting investors, fostering fair and efficient capital markets and creating and maintaining confidence in capital markets
    - underwriters have contractual obligations to issuers, and under provincial securities laws, are required to deal fairly, honestly and in good faith with their clients

Overview

- Due diligence is contextual
  - Due diligence is, by its nature, a fluid and evolving process
  - Due diligence must not put “form over substance”
  - Underwriters are expected to exercise *professional judgment* to determine the appropriate level of due diligence in each set of circumstances
  - Should be customized to be relevant to the particular issuer, the industry in which it operates, and the type of security being offered, etc.

Nine Principles

- IIROC's guidance is classified into various key areas that relate to all aspects of the underwriting due diligence process, which are articulated by IIROC in nine principles

1. Main principles:
   An underwriter has an obligation to establish, maintain and apply written policies and procedures relating to all aspects of the underwriting process

- The main principle is followed by 8 principles that, according to IIROC, should be considered in developing such policies and procedures

Nine Principles

2. An underwriter should have a due diligence plan that reflects the context of the offering
3. Due diligence Q&A sessions should be held
4. Business due diligence should ensure that the underwriter understands the business of the issuer
5. Legal due diligence should be clearly distinguished from business due diligence and adequately supervised

Nine Principles

6. The degree of reliance on third party expert should be contextual
7. Each syndicate member is liable and responsible for due diligence
8. The due diligence process should be documented to demonstrate compliance
9. A comprehensive and effective supervisory and compliance framework is required

Policies and Procedures

"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 the firm's behalf:
  - comply with IIROC rules and applicable securities laws
  - manage business risk in accordance with prudent business practices

Policies and Procedures (continued)

- As a general matter, the policies and procedures should reflect the following approach:
  1. due diligence is a process to (a) ensure all prescribed information is included in the prospectus, (b) investigate the information provided by the issuer for inclusion in the prospectus and (c) verify a prospectus contains full, true and plain disclosure of all material facts relating to the securities being offered
  2. what constitutes “reasonable” due diligence is contextual and requires consideration of the circumstances and exercise of professional judgment
  3. because of this contextual nature of due diligence, effective due diligence should go beyond prescriptive checklists alone

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"

- The Dealer Member should understand the business of the issuer and industry in order to determine the scope and objectives of the due diligence investigation
- The plan should:
  - be prepared in conjunction with underwriters' counsel (including foreign counsel, as applicable)
  - set out the lead underwriter's preliminary expectations of the scope of its due diligence investigation, which should be shared with the issuer's management, legal counsel and auditors
  - be subject to change as circumstances change

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"

- While the form will depend on practice, it will generally include a list and description of matters to be investigated
- If the Dealer Member's policies and procedures adequately set out matters to be considered, a formal written plan may not be required for each offering
- Each syndicate member needs not prepare a plan where the lead underwriter has done so

Due Diligence Plan (continued)

- Relevant contextual considerations (not exhaustive):
  - size, nature and sophistication of the issuer, type of offering (public vs. private)
  - type of securities to be offered
  - whether issuer has research analyst following; in the case of debt is there an assigned rating
  - timing of offering relative to most recently published financial statements
  - use of proceeds
  - potential for conflicts of interest
  - whether issuer is frequent participant in capital markets
  - who is lead underwriter

Due Diligence Plan (continued)

- Less extensive due diligence procedures may be reasonable for seasoned, significant and widely-followed issuers, in particular those with whom the underwriter is familiar as a result of an ongoing relationship (as lender, investor, financial advisor or financier), but should consider time elapsed since due diligence was last conducted
- Due diligence plan should reflect the type of offering
  - i.e. Heightened due diligence may be appropriate for:
    - IPOs (including by ROT)
    - offerings by smaller and/or infrequent issuers
    - equity offerings, including offerings of convertible debentures
    - public offerings by emerging market issuers
- Bought Deals
  - expected that reasonable due diligence will be completed before the underwriters certify the final prospectus notwithstanding a shorter timeline

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"

- Should be held at appropriate points during the offering
  - typically, one session prior to filing the preliminary prospectus and another update or "bring-down" session prior to filing the final prospectus
- Underwriters should:
  - participate with underwriters' counsel in the preparation of the list of questions to be posed to the issuer's management and auditors
  - provide the list of questions to the issuer's management, counsel and auditors sufficiently prior to the holding of the session
  - ensure that the individuals in the best position to have the necessary information participate in the session

Due Diligence Q&A Sessions (continued)

- all syndicate members should be given an opportunity to participate and should be represented by investment banking professionals with an appropriate level of seniority
- responses that appear incomplete or evasive should be considered a "red flag"
- follow up due diligence or enhanced disclosure arising out of a "Q&A" session should be completed before the underwriters certify the final prospectus

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 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 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)
- extent of appropriate business due diligence is contextual

Business Due Diligence (continued)

- The principal elements of business due diligence are:
  - visiting the issuer's head office and principal operations
  - reviewing:
    - business plans, budgets, and projections
    - public disclosure and comparing the issuer's disclosure to that of its peers
    - key operational data
    - material contracts (or summaries prepared by underwriter's counsel)
    - relevant sources of external information relating to the issuer and its business environment
  - conducting in-depth discussions with management and experts, subject to limitations imposed by governing rules (i.e. CPA for Canadian auditors)
- For equity offerings:
  - consulting 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

Business Due Diligence (continued)

- Independent verification of key material facts in the prospectus is required
  - 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
- The exercise of independent judgment and verification of material facts may require:
  - Independent background checks (including through local agents where necessary)
  - Interviewing the issuer's customers, suppliers and counterparties to material contracts
- It may also be appropriate to consult research analysts and other industry experts within a Dealer Member's affiliates

Business Due Diligence (continued)

- Dealer members may establish both quantitative and qualitative materiality thresholds ($ threshold with regard to the issuer's financial position and areas of business, operational risk, etc.) which may extend to the use of sampling for large and complex issues
- Policies and procedures should address how to deal with "red flags" where heighted due diligence and/or enhanced disclosure may be required
- Underwriters should follow up on any red flags with enquiries for additional information or involvement by independent experts or other third parties
- A red flag may require additional risk factor disclosure in the prospectus to adequately inform investors of the specific risks facing the issuer
- Certain red flags may require the issuer to take remedial action before the preliminary prospectus is filed
- Maintain a record of the process by which a red flag is resolved

Business Due Diligence (continued)

- Examples of red flags (not exhaustive):
  - significant changes in the issuer's business over the last 12-24 months
  - financial information or other disclosure that is inconsistent with its peers
  - high degree of reliance on a founder, CEO or government relationships
  - recent ratings downgrades or significant change in research analysts' target prices

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"

Legal Due Diligence (continued)

- Underwriters 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
  - communicate the results of legal due diligence to the entire syndicate
  - analysis of the scope of legal due diligence should include any enhanced due diligence that is appropriate in connection with foreign and/or emerging market issuers
  - instruct and supervise underwriters' counsel adequately and discuss any significant issues with counsel
  - require counsel to keep them apprised of any difficulty experienced in obtaining information from the issuer or legal opinions from issuer's counsel

Reliance on Experts and Other Third Parties

"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"

- consider whether an expert is qualified to give its report or opinion
- obtain reasonable evidence that such expert has consented in writing to its report or opinion
- with respect to experts resident in foreign (and especially emerging) markets, consider the experts' credentials, knowledge and experience and assess whether they are similar to what would be expected of a Canadian expert in the same field
- it may be appropriate for a Dealer Member to rely on the issuer's third party expert with appropriate checks and balances where the issuer operates in an industry requiring specialized knowledge

Reliance on Lead Underwriter

"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 syndicate member should:
  - be in a position to establish its own due diligence defence and to satisfy itself that the lead underwriter performed the kind of due diligence investigation that it would have performed on its own behalf as lead underwriter
  - receive, on request, copies of all letters, opinions or memoranda relating to the underwriters' due diligence investigation
  - be invited to and given the opportunity to ask questions of the issuer and its counsel and auditors during the Q&A session
- IIROC Guidance is not meant to re-allocate or result in duplication of the responsibilities for due diligence as between the lead underwriter and a syndicate member

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"

- Each underwriter 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, including:
  - followed its own policies and procedures
  - complied with IIROC requirements and record-keeping obligations under applicable securities laws
- While not necessary for all documents to be kept, policies and procedures should describe which documents must be kept
  - For example: record of any committee meetings (and attendance), as applicable and the Q&A session with issuer's management, auditors and legal counsel
- IIROC recognizes that the lead underwriter may keep more detailed documentation than syndicate members

The 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"

The Role of Supervision and Compliance (continued)

- Supervisory Framework
  - 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
  - there should be a senior investment banking professional who is involved throughout the due diligence process
  - If the individual who signs the prospectus on behalf of the underwriter was not the senior supervisor of the due diligence process, the individual signing the prospectus should seek confirmation from the senior supervisor
  - may involve one or more committees of the underwriter, typically composed of representatives of the Dealer Member's senior investment banking managers, internal counsel and/or compliance personnel

The Role of Supervision and Compliance (continued)

- Compliance Framework
  - may be performed by compliance department, in-house legal department, internal audit department or a combination of such departments
  - 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 policies and procedures
    - report and escalate such matters in accordance with such internal policies and procedures

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Implications

Implications

- IIROC's Guidance 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.
- Going forward, consistent with the top-down, risk-based approach adopted by IIROC compliance units, compliance examinations will focus on the adequacy of a Dealer Member's policies and procedures and whether the process has been followed in sampled files.
- The results of the examinations will inform further potential policy development by IIROC in this area.

Implications

While IIROC notes that the guidance is based on common practices and suggestions and not intended to expand existing obligations, some observations by way of implications include the following:

Implications

- Policies and procedures:
  - Written policies and procedures are required to address all aspects of the underwriting process
  - Must incorporate a contextual approach to due diligence that goes beyond checklists
  - Effective oversight of such policies and procedures is required (conceivably, would have to be demonstrable on a compliance review)
  - Will involve review or implementation of a policy and plan documentation and internal training

Implications

- Due diligence plan
  - Policies and procedures should set out guidelines to govern due diligence, recognizing that the specific plan for any offering must be iterative (i.e. the record should demonstrate that the plan evolves as necessary)
  - Use of professional judgment to determine whether a formal written plan is required for a particular offering
  - The due diligence process itself should be documented to demonstrate compliance with the underwriter's own policies and procedures as well as IIROC requirements and securities laws
  - Documents to be kept in transaction file should be described, along with an explanation where a document is missing
  - The extent to which documentation will be retained and the details thereof will be specific to each Dealer Member and each offering

Implications

- Q & A Sessions
  - At a minimum, appropriate records should be kept of the session such as date, list of questions, attendees, etc.
- Business due diligence
  - Should inform underwriter as to business of the issuer and key internal and external factors affecting its business
  - Professional judgment should come to bear in obtaining independent verification
  - Policies and procedures should be established to address red flags
  - A record should be maintained on how red flags were resolved
  - Professional judgment may be exercised to establish quantitative and qualitative materiality thresholds

Implications

- Legal due diligence
  - Results of legal due diligence should inform business due diligence, which means the due diligence plan may need to be tweaked based on results of legal due diligence
- Reliance on Lead Underwriter
  - Each syndicate member should satisfy itself as to discharge its own responsibilities
- Supervision and compliance
  - Policies and procedure as well diligence undertaken should reflect appropriate level of supervision throughout the process, including escalation of issues where appropriate

Conclusion and Q&A

- For more details see our client update on **www.canadiansecuritieslaw.com**
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