

66 Wellington Street West
Suite 4200, Toronto Dominion Bank Tower
Box 20, Toronto-Dominion Centre
Toronto, Ontario, Canada M5K 1N6



416 366 8381 Telephone
416 364 7813 Facsimile

December 16, 2008

VIA EMAIL to lboyce@iiroc.ca

Larry Boyce
Vice-President, Business Conduct Compliance
Investment Industry Regulatory Organization of Canada
Suite 1600, 121 King Street West
Toronto, Ontario
M5H 3T9

Dear Mr. Boyce:

**Re: Comments on draft guidance note “Best practices for product due diligence”
IIROC Notice 08-0149 (October 17, 2008)**

We regularly act as Canadian legal counsel to many dealer members (“**Members**”) of the Investment Industry Regulatory Organization of Canada (“**IIROC**”) and our clients also include various institutional investors as well as IIROC itself. We have prepared some comments for you to consider in regard to IIROC Notice 08-0149 (the “**Notice**”). We are providing these comments in a desire to assist IIROC and its Members with their review and development of new policies in regard to product due diligence. We are neither acting for, nor have we consulted, any Members or any other clients in regard to our comments. These comments reflect the views of the authors and not necessarily the views of Fasken Martineau DuMoulin LLP.

1. What are the expectations for “best practices” guidance?

The Notice is entitled “Best practices for product due diligence” and it is described in its cover materials as a “guidance document.” We wonder what IIROC’s expectations are in regard to this guidance; specifically, if implemented are the statements made in the draft notice to be considered as requirements?

The Notice includes the following statements:

Written procedures for vetting new products

As part of the obligation to have effective internal controls, all dealer members that sell new products must have formal written policies and procedures appropriate to their business to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted

from regulatory, risk management and business perspectives. At a minimum, those procedures must identify what constitutes a new product, and ensure that the right questions are asked and answered before one is offered for sale.

Although the quotation above purports to provide guidance in regard to existing requirements regarding internal controls, these statements above appear to include certain new requirements.

We note that IIROC Rule 17.2A requires that Members establish and maintain adequate internal controls in accordance with the internal control policy statements in IIROC Rule 2600. IIROC Rule 2600 contains a list of policy statements in regard to: General Matters; Capital Adequacy; Insurance; Segregation of Clients' Securities; Safekeeping of Clients' Securities; Safeguarding of Securities and Cash; Pricing of Securities; and Derivative Risk Management.

Nowhere in IIROC Rule 2600 does it expressly state that as part of the obligation to have effective internal controls, all Members that sell new products must have formal written policies and procedures appropriate to their business to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from regulatory, risk management and business perspectives. Nowhere in IIROC Rule 2600 does it expressly state that at a minimum those procedures must identify what constitutes a new product, and ensure that the right questions are asked and answered before one is offered for sale. We are aware that a Member has a “know your product” due diligence obligation; however, this appears to be derived from: (i) the Member’s general obligation to ensure that any transaction is suitable for the investor;¹ (ii) a general supervisory obligation;² or (iii) a requirement not to engage in conduct or practice which is unbecoming or detrimental to the public.³ This know your product obligation does not appear to be derived from any express internal control requirements. Therefore, the Notice arguably appears to be creating a new express requirement, as opposed to only providing guidance on existing rules.

¹ A proper assessment of suitability will generally require a two-phase process: (i) consideration of such factors as a client’s income, net worth, risk tolerance, liquid assets and investment objectives; and (ii) an understanding of particular investment product being considered. See Appendix “A” for a description of the suitability requirements.

² See IIROC Rule 29.27 and IIROC Rule 2700.

³ See IIROC Rule 29.1 and see *Re Aloni* (April 11, 2008 - IDA Hearing Panel, Pacific District Council) where Ron Aloni was found to have failed to recognize “red flags” and make diligent further inquiry that a reasonable registrant would have made in order to uphold the high standards of ethics or conduct in the profession. It was held that Aloni’s conduct was contrary to IDA Bylaw 29.1 and was detrimental to the public interest.

From the perspective of both a Member attempting to ensure compliance and a regulator seeking to enforce its rules, it seems that the development of an express general rule in regard to minimum standards for new product due diligence may be most useful. We note that minimum standards are described in regards to the requirements found in rules such as Rule 2500 “*Minimum Standards for Retail Account Supervision*” and Rule 2700 “*Minimum Standards for Institutional Account Opening, Operation and Supervision*”. Similarly, IIROC Rule 29.27(a) contains a list and description of the *minimum* requirements for a supervisory system. We believe it may be better for IIROC to develop an express and specific rule entitled “Minimum standards for due diligence in regard to new products” and then provide guidance notices in regard to: (i) best practices for compliance with new product due diligence obligations generally; and (ii) due diligence guidance in regard to specific products (e.g. principal protected notes (such guidance already exists), ABCP, hedge funds, income trusts, etc.).

Recommendation 1-1: If the Notice is to contain requirements that are not specifically found in the current IIROC Dealer Member Rules, then such requirements should be also added to the IIROC Dealer Member Rules.

Recommendation 1-2: IIROC may want to consider developing a rule entitled “Minimum standards for due diligence in regard to new products” where this rule could expressly require that at a minimum, a Member must have and follow written policies and procedures for developing and vetting new products. The rule could expressly require that these written policies and procedures should include clear, specific and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are distributed without a prospectus. IIROC should then prepare guidance notices in regard to: (i) best practices for compliance with new product due diligence obligations generally; and (ii) due diligence guidance in regard to specific products.

2. **Definition of a “new product”**

We note that the approach taken by IIROC in allowing dealer members to determine for themselves what constitutes a new product is consistent with the approaches taken in the UK and the US.⁴ While the Notice offers a more extensive list of criteria for new product identification than does the UK or US guidance, we believe the first item in IIROC’s list

⁴ See, for example, “NASD Recommends Best Practices for Reviewing New Products”, available (online): <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013755.pdf>; “Structured Products: Principles for Managing the Distributor-Individual Investor Relationship”, available (online): http://www.sifma.org/private_client/pdf/GlobalRSP-Distributor-PrinciplesFinal.pdf

of characteristics of a new product (“The product is new to the Canadian marketplace or to the dealer member”) could still benefit from further clarity. Several questions with regard to that item come to mind:

- Is a “new product” intended to mean a new type of security (i.e. a novel security)?
- Is a “new product” intended to mean primary market securities as opposed to secondary market securities?
- Is a “new product” intended to mean any class of security not previously sold by the Member (e.g. ABCP) or is it also to include any security within a class of securities where such specific security has not previously been sold by the Member (e.g. specific ABCP). The first suggestion seems too narrow, while the second suggestion may be broader than intended from a policy perspective. The second suggestion would arguably even catch common shares trading in the secondary market of an issuer whose shares have not been previously sold by the Member.

In addition, the Notice suggests that the criteria for new product identification should differ depending on whether the product will be offered to an institutional client or a retail client. The Notice first provides a list of criteria indicating potential new products from the perspective of institutional clients. Then, there is a list of criteria indicating potential new products from the perspective of retail clients. The list of considerations for products to be offered to retail clients includes by reference all of the considerations that were included in the list for institutional clients. It is not clear why some considerations would be applicable to only retail clients. Indeed, it seems that all of the considerations would be relevant to both institutional and retail clients.

In regard to distinguishing between institutional and retail investors, our review of the IIROC rules leads us to believe that the “know your product” due diligence obligations for institutional investors and retail investors have no impact on the identification of what might be considered to be a new product. As stated in the Notice:

The dealer’s suitability obligation in recommendations to clients requires knowledge of the products sold to those clients. Even in the institutional setting, the dealer member must make a determination that the assessment of new and different products falls within the client’s expertise.

The current “know your product” due diligence obligations principally arise from the suitability obligations. The difference in the suitability obligations as between institutional and retail investors may influence the amount or scope of a due diligence

investigation,⁵ but it would not likely influence whether a product could be considered as new or not.

Recommendation 2-1: IIROC may want to consider further clarifying the scope of the following new product identification criterion: “the product is new to the Canadian marketplace or to the dealer member.”

Recommendation 2-2: IIROC may want to consider using one set of criteria to identify new products regardless of whether the client is an institutional or retail investor.

3. **Impact on Ethical Wall policies and procedures**

The Notice states that:

Dealer members should consider the following components of an effective product due diligence program: ... For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales, and operations.

If a Member is to adopt such guidance, a Member should also be reminded about how the adoption of such a suggestion may impact or fit with its Ethical Wall system as referred to in Ontario Securities Commission Policy 33-601 “Guidelines for Policies and Procedures Concerning Inside Information”. The use of a committee composed of the persons suggested in the Notice may have consequences which would result in a limitation on the Member’s trading and advisory abilities.⁶

Recommendation 3-1: IIROC should remind Members that they must be mindful of Ethical Wall systems and the implications of sharing any material information that has not been generally disclosed as this may impact the Member’s trading and advisory abilities in regard to certain issuers.

⁵ Other than in regard to “discount brokers”, IIROC imposes a standard of due diligence in regard to ensuring the suitability of an investment product, including potential risks. When dealing with an “institutional customer” where the Member has reasonable grounds for concluding that the institutional customer is capable of making an independent investment decision and independently evaluating the investment risk, IIROC recognizes that a Member’s suitability obligation is fulfilled for that transaction. IIROC provides an outright exemption from the suitability requirement for trades executed on the instructions of another Member, a portfolio manager, investment counsel, limited market dealer, bank, trust company or insurer.

⁶ See paragraph 167 of the OSC’s decision in *Re Piergiorgio Donnini* (decision dated: September 12, 2002). Available online at:

http://www.osc.gov.on.ca/Enforcement/Proceedings/RAD/rad_20020912_donnini.pdf

4. **The “Ask the right questions!” section of the Notice: (i) does not contain specific guidance in regard to certain generally known due diligence fundamentals; and (ii) does not remind dealers that, as gatekeepers to both the distribution and acquisition of investment products, they are in a position to demand answers from issuers.**

(i) Due Diligence Fundamentals

Case law in both Canada and the United States⁷ has established several principles that courts consider as important components of the due diligence process. We believe that the guidance provided in the Notice could be improved if it included guidance with respect to these fundamentals.

The fundamental due diligence principles include the principles that a dealer should tailor its inquiries to the specific issuer and product, should play an adversarial or devil’s advocate role in regard to information about the issuer and the investment product and then must perform some independent verification of the material facts, as discussed in *Escott v. BarChris Construction Corporation*.⁸ According to the independent verification principle, when a dealer receives information about a material fact about an issuer or product from the issuer’s management (or some other party that is not independent of the issuer) and that fact can be independently verified with reasonable efforts, it should be verified.⁹ This approach is consistent with the due diligence guidelines on principle protected notes (“PPNs”) prepared by the IDA in March, 2007.

Another fundamental due diligence principle is that dealers should investigate further when an issue, concern or red flag is discovered. Such further investigation should ultimately lead to a resolution of the issue, concern or red flag to the investigator’s satisfaction, even if the fact is presented by an expert or the fact is being investigated by a third party. While dealers are generally permitted to rely on other parties, such as experts or certain other dealers, such reliance must not be blind. With respect to experts, it is not unreasonable to rely on the opinion of an expert, unless there is a “red flag,” meaning a

⁷ US case law is not a binding precedent in a court or tribunal in Canada. However, decisions concerning the due diligence defence and related principles are few and far between and therefore US decisions and opinions may be referred to as persuasive authorities.

⁸ *Escott v. BarChris Construction Corporation*, 283 F. Supp. 643 (S.D.N.Y. 1968)

⁹ Also see the 1972 Ontario Securities Commission (“OSC”) decision of *A E Ames & Co Ltd* (1972) OSCB 98 (“*Ames*”) where the OSC ruled that an underwriter must conduct an independent investigation of the issuer and cannot simply rely on the issuer for information disclosed in a prospectus. In *Ames*, the underwriter had consulted with the issuer’s lawyers and requested responses to certain questions, but had signed the prospectus before receiving those responses. The OSC found that the underwriter must seek out and question all relevant and material facts and cannot simply rely on the statements and opinions of the issuer, its directors, officers and counsel.

piece of information that causes a person to lose confidence in the expert’s report or opinion.

When red flags are present, they (i) require an investigator to “drill down” further in regard to its investigation and disclosure, as discussed in *Re YBM Magnex*¹⁰ and *Re Aloni*;¹¹ and (ii) prevent the dealer from relying on the expert’s opinion, as discussed in *WorldCom*.¹² The existence of a red flag requires a Member to have a higher or more thorough level of due diligence as compared to a situation where no red flags exist.

The same is true with respect to relying on other dealers in certain circumstances. If a dealer is a member of a syndicate that is offering a product for sale, then it is not unreasonable for a dealer positioned lower in the syndicate to rely on the due diligence efforts of the lead member(s) of the syndicate.¹³ A syndicate member should take reasonable steps to ensure that the lead dealer is conducting an adequate due diligence investigation so that the participating dealer can satisfy itself that it is reasonable to rely

¹⁰ *Re YBM Magnex International Inc.* (2003), OSCB 5285 (“*Re YBM Magnex*”)

¹¹ *Supra* note 3.

¹² See generally *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004) (“*WorldCom*”). In the *WorldCom* securities litigation, the Court denied the underwriter defendants’ motion for summary judgment on their two affirmative defenses to liability. In a formidably long opinion filed on December 15, 2004, the Court held that the underwriter defendants’ mere reliance on comfort letters and unaudited financial statements, absent reasonable investigation of the statements’ accuracy, would not establish a due diligence defense. The Court further held that the underwriter defendants’ mere reliance on audited financial statements – at least where the underwriter faces a red flag concerning the accuracy of those statements – would not establish a reliance defense and that the red flag triggered a duty to investigate.

¹³ See the case of *Re Gap Stores Securities Litigation*, 79 F.R.D. 283 (N.D. Cal. 1978) (“*Gap Stores*”) which involved alleged misrepresentations in the IPO of common stock of the Gap Stores, Inc. where plaintiff investors sought to certify a class of 91 defendant underwriters. In *Gap Stores*, the Court stated, “All of the underwriters are exonerated if the registration statement is proven to contain no material representations or if the plaintiff is proven to have purchased the security with knowledge of any material misrepresentation; and if neither of these defenses is successful, proof of the due diligence of the managing underwriter will most likely exonerate the participants as well. It is only after the managing underwriter is found culpable that the interests [of the various underwriters] diverge in separate defenses.” Similarly, the OSC in *Re YBM Magnex* stated “In principle, we see no reason why one member of an underwriting syndicate cannot or should not rely on another, but where a co-lead underwriter falls down in the conduct of its due diligence, the other co-lead may have to bear the risk of its reliance” (see para. 450). Also see E.L. Folk “*Civil Liabilities Under the Federal Securities Acts: The BarChris Case*” (1969) 55 *Virg L Rev* 1 where Prof. Folk argues that the legislative objective of imposing liability on underwriters is satisfied through the lead underwriter undertaking investigations.

on the lead dealer's investigation.¹⁴ This concept of appropriate reliance on a third party should be stated in the Notice. Specifically, it should be stated that Members may engage or rely upon a third-party to assist in performing due diligence reviews of new products. However, the responsibility to "know-your-product" in order to perform a suitability assessment for clients remains with the Member and cannot be delegated. Members that engage third-party service providers to assist with due diligence should review the due diligence process of the service provider to ensure that the provider has taken appropriate steps to properly assess the product. The Member should also carefully review the qualifications of the service provider to ensure that it has the necessary expertise and resources to properly assess the product.

(ii) Dealers' Gatekeeper Function

It has been commonly recognized that dealers are the gatekeepers to the securities industry with respect to both: (i) the distribution or sale of investment products by issuers or selling security holders; and (ii) the purchase of investment products by investors. As a result of this position, dealers are relied on by both issuers and investors. US courts have commented on the reliance investors place on dealers in regard to the distribution of securities. In *Chris-Craft Industries, Inc. v. Piper Aircraft Corporation*¹⁵ the Court stated:

No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter. He is most heavily relied upon to verify published materials because of his expertise in appraising the securities issue and the issuer, and because of his incentive to do so. He is familiar with the process of investigating the business condition of a company and possesses extensive resources for doing so. ... Prospective investors look to the underwriter -- a fact well known to all concerned and especially to the underwriter -- to pass on the soundness of the security and the correctness of the registration statement and prospectus.

In 1992, the American Bar Association's Committee on Federal Regulation of Securities issued a report entitled "Report of the Task Force on Sellers' Due Diligence and Similar Defenses under the Federal Securities Laws." The committee reviewed the liability of underwriters under U.S. securities laws and concluded that underwriters' liability for

¹⁴ See Securities Exchange Commission ("SEC") Release No. 33-5275 "The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities" (July 26, 1972) where the SEC indicated that reliance on a managing underwriter is reasonable if the participating underwriter is satisfied that: (i) the managing underwriter made the kind of investigation that the participant would have performed if it were the manager; and (ii) that the manager's due diligence investigation program and actual investigative performance were adequate.

¹⁵ *Chris-Craft Industries, Inc. v. Piper Aircraft Corporation*, 480 F.2d 341 (2d Cir. 1973)

misrepresentations in a prospectus could be justified for three reasons. First, underwriters have, or are presumed to have, access to extensive information about the issuer of securities that the underwriters are bringing to market. Second, underwriters are in a position to cause the issuer to disclose all material facts in a prospectus. Third, investors rely on underwriters because of the first two reasons. We believe the regulatory “know your product” obligation can be justified for the same reasons.

Dealers are equally relied upon by issuers in regard to the dealer’s role as a gatekeeper who can provide access to investors. This reliance provides dealers with the power to demand adequate disclosures from the issuer and entitles dealers to not take “no” for an answer in regard to access to information or a due diligence inquiry. During the recent ABCP crisis and its aftermath, it was learned that ABCP originators did not always disclose adequate information about the structure and underlying assets associated with ABCP.¹⁶ Certain ABCP originators presumably would not allow access to certain information concerning the securities and their underlying collateral and structures as this information was deemed by them to be confidential. We believe the “Ask the right questions!” section of the Notice could be improved by including guidance that dealers do not have to take “no” for an answer if or when an issuer claims that any material information is confidential or is otherwise not made available to the Member for review. Dealers are uniquely positioned, and relied upon, in the distribution system to demand and obtain this disclosure and ensure that it meets with their satisfaction.

Recommendation 4-1: The “Ask the right questions!” section of the Notice should be revised to include guidance regarding due diligence fundamentals such as: tailoring inquiries to suit the issuer; independent verification of material facts; reasonable reliance on experts and other dealers and the limitations of that reliance; the process to follow when relying on the due diligence efforts of a third party; and the requirement to drill down and follow-up on red flag items.

Recommendation 4-2: Members should be reminded of their gatekeeper roles and that this provides them with a position to insist on disclosure if or when an issuer claims that any material information is confidential and is not available to the Member for review.

5. Members should be aware that the due diligence standards set out in the Notice may not be sufficient to establish the due diligence defence in the event a prospectus contains a misrepresentation.

While the Notice sets out many important factors to consider when conducting product due diligence, we believe it is important for Members to be aware that the Notice’s

¹⁶ See: CSA Consultation paper “Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada” (October 2008) at page 9.

guidance regarding best practices for due diligence may fall short of what is required for a dealer to successfully establish a due diligence defence in regard to a civil claim involving a misrepresentation in a prospectus.

Section 130(1) of the *Securities Act* (Ontario) (the “Act”) imposes liability on underwriters for a misrepresentation in a prospectuses unless the underwriter can demonstrate, pursuant to section 130(5) of the Act, that it conducted such “reasonable investigation as to provide reasonable grounds for a belief that there had been no misrepresentation.”

While no Canadian court decisions are available to provide clear guidance as to what type or scope of investigation would amount to a “reasonable investigation” in accordance with section 130(5) of the Act,¹⁷ there are US court decisions and other regulatory materials available that provide guidance in regard to the type and level of investigation that would be required to establish a due diligence defence. This guidance leads us to believe that the investigation required to successfully establish a due diligence defence in regard to a civil claim made pursuant to section 130(1) of the Act is an investigation that would typically exceed the scale and scope of the investigation that is described in the Notice as being best practices. Accordingly, we believe the Notice should inform Members that IIROC’s guidance in regard to due diligence is guidance only in regard to a Member’s regulatory due diligence obligations arising from IIROC’s suitability and account supervision obligations and is not guidance in regard to best practices in the establishment of a due diligence defence in a civil claim pursuant to section 130(1) of the Act. Similarly, the Notice should also inform Members that a Member’s compliance with IIROC’s guidelines in regard to best practices for due diligence may not be sufficient to establish satisfactory defences to civil claims based upon common law causes of action such as a breach of contract or negligence in regard to the distribution of a flawed investment product or a misrepresentation found in offering materials.

Recommendation 5-1: The Notice should advise Members that the best practices guidelines set out therein may not constitute a “reasonable investigation” in regard to establishing a due diligence defence against liability under section 130 of the Act for a misrepresentation in a prospectus. Furthermore, Member’s should be advised that compliance with the Notice’s recommendations may not necessarily lead to a satisfactory defence in a civil action where a breach of contract or negligence is alleged in regard to

¹⁷ Section 132 of the Act provides guidance of limited practical use in regard to the standard of a reasonable due diligence investigation. Section 132 states “In determining what constitutes reasonable investigation ... for the purposes of sections 130 ..., the standard of reasonableness shall be that required of a prudent person in the circumstances of the particular case.”

the distribution of a flawed investment product or a misrepresentation being found in the offering materials.

6. The Notice does not indicate that the requirements found therein are not applicable to “discount brokers”

The Notice includes the following statement (which was already quoted above in #1):

Written procedures for vetting new products

As part of the obligation to have effective internal controls, all dealer members that sell new products must have formal written policies and procedures appropriate to their business to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from regulatory, risk management and business perspectives. At a minimum, those procedures must identify what constitutes a new product, and ensure that the right questions are asked and answered before one is offered for sale.

As mentioned in topic #1 above, this portion of the Notice appears to *require* that *all* Members must have in place a new product review process as part of their internal controls. If this is correct, then this would also apply to “discount brokers” who are exempt from the suitability obligations found in IIROC Rule 1300.1(p). IIROC should expressly state whether it expects discount brokers to follow the requirements and guidance that are found in the Notice regarding new product due diligence policies and practices.

Recommendation 6-1: The Notice should indicate whether its requirements and guidance are applicable to discount brokers.

7. Generalized guidance vs. product specific guidance

We note that IIROC has published extensive due diligence guidelines in regard to PPNs (the “**PPN DD Guidelines**”).¹⁸ FINRA (formerly, the NASD) also regularly provides product-specific guidance, although typically in a less extensive manner as compared to the PPN DD Guidelines.¹⁹

¹⁸ André Fok Kam, "Due Diligence Guidelines on Principal-protected Notes" (Investment Dealers Association of Canada, March 28, 2007).

¹⁹ See, for example, Notice to Members (Informational), "NASD Reminds Members of Obligations When Selling Hedge Funds" (NASD, February 2003); Notice to Members (Guidance), "Life Settlements: Member Obligations with Respect to the Sale of Existing Variable Life Insurance Policies to Third Parties" (NASD, August 2006); Notice to Member (Guidance), "Structured Products: NASD Provides Guidance Concerning the Sale of Structured Products" (NASD, September 2005); and Notice to Members

Perhaps it would be better for IIROC to prepare a notice reminding Members of their suitability obligations generally and then separately provide Members with various specific “know your product” due diligence guidance notices in a timely manner whenever a new product is identified and gains acceptance in the marketplace (e.g. PPNs, income trusts, third party ABCP, hedge funds, private equity funds, etc.). This appears to be the approach that has been taken by FINRA in regard to certain products and by IIROC in regard to PPNs. This approach may provide better results than providing generalized due diligence guidance that may be difficult to apply in a future circumstance when the next novel security or investment product is developed and gains acceptance in the marketplace.²⁰

The PPN DD Guidelines thoroughly address a number of issues and topics concerning PPNs. The PPN DD Guidelines cover the motives of different parties to the transaction and possible conflicts of interest; the different components of risk associated with a product and its variations; important variations between similarly structured products (including those variations that should be disclosed to the client); material information that should be requested from the issuer if not disclosed; common misconceptions of investors; common investor concerns (including redemption rights); and the draw-backs of the product for certain investment purposes (including a comparison of other investment products that can be utilized for similar investment objectives). Although the PPN DD Guidelines are lengthy, this product specific guidance is, in our view, clearly useful for Members.

FINRA’s product-specific guidance is significantly more brief than the PPN DD Guidelines. FINRA’s product-specific guidance consists of a generalized reminder of members’ regulatory obligations supplemented with specific examples or concerns related to the specific product. We believe the strength of FINRA’s approach is in regard to raising product specific issues of concern with Members in a timely fashion.

Recommendation 7-1: Because the Notice arose out of a study of Members’ distribution of third-party ABCP, IIROC should consider providing product-specific guidance with respect to third-party ABCP. Chapter IX “Investors and Principle-protected Notes” of the PPN DD Guidelines, together with the comprehensive due diligence questionnaire appended to Guidelines, provides a good model. FINRA’s product-specific guidance is

(Guidance) "Equity-Indexed Annuities Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities" (NASD, August 2005).

²⁰ MFDA Member Regulation Notice MR-0048-“Know-Your-Product” dated October 31, 2005 provides generalized guidance to MFDA members on their due diligence obligations when approving and offering a product for sale. However, MFDA members only have one class of investment product that they generally offer—mutual funds. See: <http://www.mfda.ca/regulation/notices/MR-0048.pdf>

another example of the form of a guidance notice that IIROC may want to follow in regard to due diligence guidance with respect to third-party ABCP.

Recommendation 7-2: IIROC should provide additional product-specific due diligence guidance to Members as significant new products or new product categories are developed and gain acceptance in the marketplace.

We would be pleased to speak with you about these matters at your convenience.

Respectfully submitted,

Geoff Clarke

tel: 416-868-3524

email: gclarke@fasken.com

Daniel Fuke

tel: 416-865-4436

email: dfuke@fasken.com

Patrick Dolan (student-at-law)

tel: 416-868-3539

email: pdolan@fasken.com

Laura Fetter (student-at-law)

tel: 416-865-4450

email: lfetter@fasken.com

Appendix “A” IIROC’s Suitability Requirements

IIROC’s suitability obligations are generally found in IIROC Rule 1300 “Supervision of Accounts”²¹ and IIROC Rule 2700 “Minimum Standards for Institutional Account Opening, Operation and Supervision.”²²

IIROC Rule 1300.1 states:

Suitability Generally

(p) Subject to Rule 1300.1(r) and 1300.1(s), each Dealer Member shall 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.

Suitability Determination Required When Recommendation Provided

(q) Each Dealer Member, when recommending to a customer the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such customer based on factors including the customer’s financial situation, investment knowledge, investment objectives and risk tolerance.

Suitability Determination Not Required

(r) Each Dealer Member that has applied for and received approval from the Corporation pursuant to Rule 1300.1(t) [a “discount broker”], is not required to comply with Rule 1300.1(p), when accepting orders from a customer where no recommendation is provided, to make a determination that the order is suitable for such customer.

(s) Each Dealer Member that executes a trade on the instructions of another Dealer Member, portfolio manager, investment counsel, limited market dealer, bank, trust company or insurer, pursuant to Section I.B (3) of Rule 2700 is not required to comply with Rule 1300.1(p).

[emphasis added]

²¹ A related obligation is found in Rule 1800.5(b) in regard to futures contracts and futures contract options and a related obligation is also found in Rule 1900.4 in regard to options.

²² IIROC Rule 2800 “Code of Conduct for IDA Member Firms Trading in Wholesale Domestic Debt Markets ” also makes reference to a Member’s suitability obligations and confirms that the suitability obligation and IIROC Rule 2700 are applicable in the debt market.

Section I(B) of IIROC Rule 2700 states:

Customer Suitability

1. When dealing with an institutional customer, a Member must make a determination whether the customer is sufficiently sophisticated and capable of making its own investment decisions in order to determine the level of suitability owed to that institutional customer. Where a Member has reasonable grounds for concluding that the institutional customer is capable of making an independent investment decision and independently evaluating the investment risk, then a Member's suitability obligation is fulfilled for that transaction. If no such reasonable grounds exist, then the Member must take steps to ensure that the institutional customer fully understands the investment product, including the potential risks.

2. In making a determination whether a customer is capable of independently evaluating investment risk and is exercising independent judgment, relevant considerations could include:

(a) any written or oral understanding that exists between a Member and its customer regarding the customer's reliance on the Member;

(b) the presence or absence of a pattern of acceptance of the Member's recommendations;

(c) the use by a customer of ideas, suggestions, market views and information obtained from other Members, market professionals or issuers particularly those relating to the same type of securities;

(d) the use of one or more investment dealers, portfolio managers, investment counsel or other third party advisors;

(e) the general level of experience of the customer in financial markets;

(f) the specific experience of the customer with the type of instrument(s) under consideration, including the customer's ability to independently evaluate how market developments would affect the security and ancillary risks such as currency rate risk; and

(g) the complexity of the securities involved.

3. No suitability obligation shall exist pursuant to Section B(1) nor is a determination required under Section B(2) where a Member executes a trade on the instructions of another Member, a portfolio manager, investment counsel, limited market dealer, bank, trust company or insurer.

[emphasis added]

Therefore, in summary, IIROC imposes a standard of due diligence in regard to ensuring the suitability of an investment product for a client (other than in regard to "discount brokers"). When dealing with an "institutional customer" where the Member has

reasonable grounds for concluding that the institutional customer is capable of making an independent investment decision and independently evaluating the investment risk, IIROC recognizes that a Member's suitability obligation is fulfilled for that transaction. IIROC provides an outright exemption from the suitability requirement for trades executed on the instructions of another Member, a portfolio manager, investment counsel, limited market dealer, bank, trust company or insurer.

Suitability is to be assessed prior to any investment recommendation by a Member to its client. Suitability determinations will always be fact specific. A proper assessment of suitability will generally require a two-phase process: (i) consideration of such factors as a client's income, net worth, risk tolerance, liquid assets and investment objectives; and (ii) an understanding of particular investment product being considered. IIROC Rule 2500 "Minimum Standards for Retail Account Supervision" imposes a duty on Members to supervise their employees in carrying out the suitability requirements.