

Corporate Securities Law

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IIROC's Proposed Guidance on Best Practices for Underwriting Due Diligence

The Investment Industry Regulatory Organization of Canada (IIROC) is requesting comments on proposed guidelines outlining certain principles, key points and best practices for underwriting due diligence in connection with public offerings.

IIROC emphasizes in its release that:

- The guidelines are not designed to prescribe a “one size fits all” solution, define minimum (or maximum) standards for due diligence, or create or modify legal obligations.
- Due diligence is, by its nature, a process requiring a bespoke approach depending on the issuer, the industry and other factors.
- The guidelines are designed to promote consistency and enhanced standards and, more generally, to outline the considerations that should inform the approach to due diligence in particular circumstances.
- Fundamentally, the diligence process should not be conducted by rote, with form prevailing over substance. The critical requirement is for underwriters to exercise professional judgment to determine the appropriate level of due diligence in each set of circumstances.

Key Principles and Recommendations

The guidelines focus on these key principles:

- *Written Policies and Procedures:* Underwriters are expected to have written policies and procedures relating to all aspects of the underwriting process, and to have effective oversight of these activities. The policies and procedures should go beyond

prescriptive checklists, and reflect that the appropriate diligence approach should be based on careful consideration of the specific context.

- *Due Diligence Plan:* For each offering, underwriters should develop a due diligence plan that reflects (i) an understanding of the issuer's, its industry and the markets in which it operates, (ii) the type of offering and (iii) the nature of the issuer (e.g., how widely it is held, if it is well “seasoned” and/or widely followed). The guidelines detail the factors to be considered in developing due diligence plans.
- *Due Diligence “Q&A” Sessions:* At appropriate times during the offering process Q&A sessions should be conducted with the issuer's management, counsel and auditors. Questions should be provided in advance and all syndicate members should be invited to participate.
- *Business Diligence:* Underwriters should perform business due diligence sufficient to ensure an understanding of the business, and of the key internal and external factors affecting the business. The guidelines provide detailed practices and suggestions focused on (i) independent verification of key material facts, (ii) direct contact with key parties such as customers and suppliers, (iii) safeguards to ensure the issuer does not exclusively control the scope of the review process, (iv) retention of local agents for offshore businesses and executives and (v) critically, procedures for addressing “red flags”. There are additional guidelines for emerging markets issuers, reflecting issues that have arisen with them in recent years.
- *Legal Diligence:* The delineation between business due diligence and legal due diligence should be clearly understood to ensure proper allocation and to ensure there are no gaps or overlap. The legal due diligence process should be adequately supervised by the underwriters and the work product of the underwriter's legal counsel should be available to all syndicate members.

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- *Documentation:* Proper records of the due diligence process should be maintained to demonstrate compliance with the underwriter's due diligence policies and procedures, IIROC requirements and applicable securities laws.

Practical Considerations

The guidelines raise a number of practical considerations, including:

- *The Role of Non-Lead Underwriters:* The guidelines acknowledge the role of the lead underwriters in an offering. However, they emphasize that underwriters' responsibilities are borne by all members of an offering syndicate, which may require more direct and regular involvement of non-lead underwriters in the due diligence process.
- *The Uniformity of the Underwriting Standard:* The guidelines emphasize that diligence processes must be sensitive to the unique circumstances of each offering. Accordingly, the guidelines are not prescriptive, but speak instead of relevant considerations and recommended approaches. On the underwriter side, the guidelines impose the same standards and obligations on all IIROC-member underwriters, from large bank-owned underwriters to small, independent firms. Accordingly, the guidelines may have very different effects on different market participants.

- *The Risks of Good Procedures:* The guidelines contemplate the development and documentation of due diligence processes, which should provide a useful discipline on the due diligence process and a good record of what underwriters have done in fulfilling their role in an offering. Like any record, however, documentation of the due diligence process creates additional risk to underwriters and their counsel, by creating (i) a dynamic where the underwriters' own standards may be used to challenge alleged failures in a diligence process, and (ii) a record which invites criticism, in hindsight, of the nature and level of review undertaken in completing the due diligence.

Requested Feedback

Specific feedback is sought by IIROC on, among other things:

- whether there are considerations unique to specific types of offerings, or to issuers in specific industries, that warrant different approaches; and
- whether the extension of the guidelines to private placements is necessary to afford investors in such transactions the same level of protection as investors in public offerings.

For more information on the proposed guidelines and other rules and guidance relevant to underwriters, please contact any member of our Corporate Securities Group.