

Product Due Diligence in the Exempt Market

(Intended Audience: Exempt Market Dealers)

1. Registrant's obligations

- Securities Act of Alberta S. 75.2(1)...A registrant shall deal fairly, honestly and in good faith with its clients
- Securities Act of Alberta S. 75.2(2)...A registrant that manages the investment portfolio of a client through discretionary authority granted by the client shall act fairly honestly and in good faith towards the client and in the client's best interest
- Securities Act of Alberta S. 75.2(3)... Every investment fund manager shall
 - a) Exercise the powers and discharge the duties of its office honestly, in good faith and in the best interest of the investment fund, and
 - b) Exercise the degree of care, diligence and skill that a reasonably prudent person or company would exercise in the circumstances.
- NI 31-103CP S. 3.4...Registered individuals must understand the structure, features, and risks of each product they recommend as part of their initial and ongoing proficiency obligations

- NI 31-103 S. 13.3 (1) A registrant must take reasonable steps to ensure that:
 - Before it makes a recommendation to or accepts an instruction from a client to buy or sell a security, the purchase or sale is suitable for the client

Registrant liability

Where there is fraud or misrepresentation on the part of the issuer, clients and their lawyers, regulators and the investors will look to the registrants who offered the securities:

- Did the registrant perform adequate due diligence?
- Was each and every trade suitable?

Proper due diligence on products will help the registrant to:

- Detect and avoid potential problems
- Give adequate training on products to salespeople
- Avoid unsuitable recommendations

But if trouble arrives, evidence of proper due diligence will help in the defence of a registrant

Must a registrant meet the requirements?

- Can the registrant opt out of product due diligence?
- Can clients waive their expectations of adequate due diligence?
- Can the registrant outsource its due diligence to a parent company or third parties?

2. The Due Diligence Process

What products must be approved?

Products New
to the Registrant

Material
Changes

New
Conflicts of
Interest

Formal written procedures

- NI 31-103 S. 11.1 Compliance system
- NI 31-103 S. 11.5 Books and records

Formal written procedures

- I. Proposal or initial application
- II. Initial review
- III. Detailed review
- IV. Formal presentation and decision
- V. Monitoring and periodic reassessment

I. Proposal or application

- Description of product, size and timing
- Promoter
- OM, if any
- Reason for consideration/sponsorship of proposal
- Conflicts of interest, if any
- Special features

II. Initial review

- May be performed by designated staff person, CCO or working group
- May quickly dispose of products that may be too risky, too costly or with too little potential interest; or
- If the proposed product passes initial review, a detailed review may be undertaken

III. Detailed review

SROs have outlined the following areas of inquiry for product review, at a minimum:

- What investment need does the product fill? Are there less complex or less risky alternatives?
- What are the forecasts and what assumptions underlie the forecasts? How reasonable are the assumptions?

III. Detailed review

- What factors influence the investment outcome? What might be the outcomes in a range of market conditions?
- How transparent is the structure? Are there features that make the product difficult to analyze? Is there sufficient expertise to analyze assumptions and risks?

III. Detailed review

- Are there redemption features and what is the level of confidence in these? Is there a secondary market?
- What are the risks? How are these disclosed?
- What are the costs and fees? Are they in line with other offerings of the registrant? With competing products in the market?

III. Detailed review

- Any risks to the firm?
- Is the split of total investment returns between different stakeholders reasonable and fair, particularly from the investor's standpoint?
- Are there conflicts of interests, and if so, can these be managed?

III. Detailed review

- Regulatory concerns www.securities-administrators.ca
- What is the reputation and background of the promoter? Past offerings?
- Obtain financial statements of GP or promoter
- For whom is the product intended? Who should **not** invest in the product?

III. Detailed review

- Is the product unduly complex and if so, will this impact suitability considerations and sales training?
- How much training will be required and how will it be delivered?
- Are there any settlement or delivery issues to be resolved?

IV. Formal presentation and decision - Who decides?

Usually a committee:

- President ,VP Sales, VP Operations
- CCO
- May include independent representatives, outside consultants
- May include DRs, an internal analyst

Should CCO be on the committee?

- CCO will be conducting suitability reviews and dealing with the product's sales daily
- CCO will be involved with product training and procedures
- CCO has specialist knowledge
- Opportunity for CCO to get up to speed early and to provide compliance guidance

Maintain Records of:

- Attendance
- Materials presented
- Questions asked and answers given
- Decision
- Next steps

Materials provided by issuers

- Registrants are responsible for the information provided to their clients and their sales representatives
 - Do the materials supplied by the issuer/promoter adequately detail the risks as well as the attributes of the product?
 - Is the material fair, clear and not misleading? Is it overly promotional?

V. Monitoring and periodic reassessment

- Establish review points, e.g. 3 months
- Does what is occurring correspond to what was originally envisaged?
- If the product was designed to be held to maturity, is it being sold on that basis? Are investors holding it to maturity?
- Suitability issues detected? Client complaints?

Results of reassessment

- If positive, may be brought back to Committee, or may simply be reported to Management
- If negative, the results should be brought to Management and Committee for action
- Act quickly when there are concerns

Results of reassessment

- If review indicates that a product's performance will be significantly different from what was expected at the time of the sale, the registrant should consider what action to take
- At times, may need to consider whether to suspend or cease selling the product

Rollovers and decision events

- There should be mechanisms to ensure communication from promoter to registrant in the case of decision events
- Investors will need assistance with decision events
- Registrant will need to ensure client support and DR training

3. Related Product Vs Third Party Product

Products where the issuer is:

- The registrant itself
- An affiliate of the registrant
- A related issuer to the registrant
- A connected issuer to the registrant
- An associate of the registrant or related or connected party
- An entity in which the registrant has an ownership interest

Section 13.4 - Identifying and responding to conflicts of interest:

- Registrants must identify and respond to conflicts of interest
- Where disclosure is an appropriate response, registrants must make timely disclosure of the nature and extent of the conflict to the investor

Selling related party product

- Registrant may offer only related party product
- It may be harder to be objective, particularly in risk assessment, compared to a registrant that offers an array of third party product

Selling related party product

- Registrant may not feel free to reject a particular security
- Registrant may have a greater depth of knowledge of the product
- Registrant must disclose the relationship to clients

Third party product

- May be easier to treat third party product objectively:
 - If the assessment of the product changes, registrant can suspend and replace third party product
 - Registrant may have less detailed knowledge of the product and the promoter
 - Registrant may not be aware of subsequent events concerning the product, the promoter or other related issuers

Selling related party product

- With these considerations in mind, what different due diligence processes might serve in the Product Approval of related party product?

Review of related party product

- Rigorous and detailed process
- Enhanced level of scrutiny and discipline
- Qualified independent underwriter
- Ratings agency
- Independent analysts
- Appropriate disclosures
- Enhanced training

4. Product risk assessment

What is risk?

- Standard deviation of returns around the mean?
- Likelihood of financial ruin?
- Correlation between risk and return?

Why are exempt securities generally considered higher risk?

1. Re-sale and liquidity risk
2. Disclosure
3. Continuous disclosure
4. Read the OM

Common Misperceptions

- Lower risk than other exempt products
 - Some registrants/DRs compare the perceived risk of the security they are offering to the perceived risk of their competitors' offerings

Common Misperceptions

- “Negative correlation to the stock market”
 - If claim is made, it must be substantiated
 - Would refer to portfolio risk, not the risk of the security being sold

Common Misperceptions

- Low risk product considerations:
 - Is it government-guaranteed?
 - Prospectus vetted?
 - Seasoned issuer?
 - Investors legal rights at prospectus level?
 - Continuous disclosure by law?
 - Specific risks of the security

Potential outcome

ASC enforcement actions are brought for misleading claims, such as “low risk,” “secure” and “safety of capital” where such claims are inaccurate and cannot be supported

OM Risk Acknowledgement

- If relying on the OM exemption, OM Risk Acknowledgement must be obtained
- If the seller verbally contradicts the Risk Acknowledgement, it may;
 - Invalidate the exemption
 - May also constitute a misrepresentation
 - May be grounds for a later lawsuit

Summary

- High risk does not mean “bad” - although it does limit your potential buyers
- Be informed and realistic

Questions