

Corporate Securities Law

March 20, 2012

OSC Staff Reports on Concerns Identified in Review of “Emerging Market Issuers”

On March 20, 2012, the Ontario Securities Commission published Staff Notice 51-719 – *Emerging Markets Issuer Review*, which reports on the results of its confidential review of “emerging market issuers” that began in July 2011.

Staff focused its review on reporting issuers listed on Canadian exchanges “whose mind and management are largely outside Canada” and “whose principal active operations are outside of Canada, in regions such as Asia, Africa, South America and Eastern Europe”. The sample included issuers that accessed the Ontario capital markets through various methods, including initial public offerings, direct listing and “reverse take-overs”.

Staff’s review of emerging market issuers focused on:

- the quality and adequacy of the issuers’ governance and disclosure,
- the adequacy of the audit function,
- the adequacy of the due diligence process conducted by underwriters, and
- the nature of the exchange listing approval process

Staff identified a number of areas of concern, which appear to have been most evident where there was a separation between the issuer’s Canadian governance and local management functions for core operations in emerging market jurisdictions, where customs and procedures differ from those in North America and are not necessarily well understood by the issuer and its Canadian advisors. Many of those concerns Staff suggests arise from the parties involved – boards, auditors and underwriters – focusing on “form” to some greater degree than “substance” and not having applied a sufficiently thorough level of “rigour and independent-mindedness”.

Emerging Market Issuers

In the context of boards of directors, Staff suggests that boards of emerging market issuers have no less responsibility to understand the applicable marketplace and legal, business and political environment than do boards of reporting issuers operating in Canada. The Notice suggests that Staff observed cases where the engagement by boards and audit committees in their oversight of management and sense of responsibility for the stewardship of the emerging market issuer was “deficient”, with some combination of:

- very little contact with senior management running the business in the emerging market,
- complex corporate structures,
- significant or numerous transactions with related parties,
- insufficient knowledge of the cultural and business practices of the jurisdictions in which the business operated, and
- insufficient adjustment of the process of board oversight to reflect those practices.

Staff has provided recommendations for the development of what it characterizes as “guidance”, “best practices” or “enhanced vigilance” to address these deficiencies, including:

- guidance to improve corporate governance practices, particularly related to improving directors’ understanding of the business, operating environment and risks of operations in foreign jurisdictions (including perhaps language competency and residency requirements),
- clarification of the regulatory expectations of officers with respect to diligence supporting certifications for issuers with principal operations in foreign jurisdictions,
- requiring better disclosure of complex structures and their rationale and explanations of particular risk factors, and
- ensuring maintenance of appropriate books and records in Canada.

Auditors

In the context of auditors, Staff noted that its concerns with respect to auditing practices are largely consistent with the observations of the Canadian Public Accounting Board in the report it released earlier this

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year. With respect to audit practices and procedures, Staff commented that it observed circumstances suggesting:

- insufficient “professional scepticism” and independent verification of information and critical assessment of judgements made by management,
- a lack of knowledge of the local legal environment and cultural and business practices,
- insufficient interaction between the group auditor and component auditors and an undue reliance on the component auditors, and
- insufficient work to overcome language barriers, leaving concerns as to the understanding and sufficiency of information relied upon by the group auditors.

Staff similarly has provided a number of recommendations for further work – which it proposes to undertake together with the CPAB and other accounting and auditing professional bodies – in the context of auditors in areas including:

- suitability standards for auditors of reporting issuers,
- access by the Commission to audit working papers,
- situations where regulators cannot access foreign audit files,
- “sharing of information” with the CPAB in connection with the oversight of audit firms, and
- enhanced and improved auditing standards and practices.

Underwriters

In the context of underwriters, Staff observed that while there is some general guidance on due diligence for Canadian underwriters, there are no “explicit, standard requirements” and there is a “varied array” of policies, procedures and practices. Staff noted that this was evident in circumstances suggesting, among other things:

- an insufficient level of “professional scepticism and rigour” in respect of “red flags” that included unusual growth or other metrics relative to peers, significant reliance on government or senior management relationships and unsuccessful attempts to arrange site visits,

- little documentation or apparent discussion of the risks associated with the issuer’s operations and, where such risks were identified, limited incremental steps being taken, and
- lack of documentation of the diligence process and associated internal approvals, which in some cases diverged from the underwriters’ own internal process.

Staff also has provided a number of recommendations that focus on the establishment of:

- a “consistent and transparent” set of requirements for the conduct of due diligence by underwriters to ensure the process addresses, among other things, operational structure, internal controls and risk management, translation and foreign language issues, local business practices, cultural norms and government relationships, and the involvement of management and related and interested parties,
- best practices for the conduct of calls and site visits, and
- documentation of “all aspects” of an underwriter’s due diligence.

Exchanges

In the context of the exchanges, Staff observed that while the exchanges have supplemental procedures and policies geared to emerging market issuers, a re-examination of those procedures and policies may be warranted in light of the increased understanding of the risks associated with emerging markets, particularly to ensure:

- a meaningful “Canadian presence” for emerging market issuers – some combination of directors, key officers, employees, books and records and assets (such as cash) located in Canada,
- increased transparency to the market where the exchanges determine to exercise their discretion to waive listing requirements in respect of an emerging market issuer, and
- increased transparency to the market of the role of a sponsor in connection with the listing of an emerging market issuer, disclosure standards related to the terms of engagement and work product of sponsors.

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Next Steps

Staff has indicated that it intends to continue to work with other provincial securities regulators, the CPAB, IIROC, the exchanges and other interested parties on the issues it has identified. At least as significantly, as Staff has noted that “some of the policy issues we may pursue from the EMIR Review could have broader applications and a more general benefit to our markets”, and all market participants – and not just those involved with emerging market issuers – may benefit from a review of their practices in light of the “concerns” that Staff has focused on.

Please contact any member of Goodmans’ Corporate Securities Group to discuss Staff’s review and its implications.