THE UPDATE

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Corporate Securities

JANUARY 20, 2004

INVESTOR CONFIDENCE INITIATIVES - FINAL RULES

In our Corporate Securities Update dated July 2, 2003, we outlined three rules that the Ontario Securities Commission (OSC) introduced for comment in order to restore investor confidence in Canada's capital markets. The rules have now been finalized and will come into force on March 30, 2004.

Following the pattern set by the *Sarbanes-Oxley Act of 2002* in the United States, the rules contemplate:

- certification of annual and interim disclosures by an issuer's chief executive officer and chief financial officer,
- increased independence, competence and responsibility for audit committees, and
- support for the Canadian Public Accountability Board in its oversight of external auditors.

The rules differ from those originally proposed in the following areas:

- the final certification rule includes definitions for the terms "disclosure control and procedures" and "internal control over financial reporting" and provides guidance with respect to the meanings of "fair presentation" and "financial condition",
- pursuant to the final certification rule, CEOs and CFOs will not be required to provide certification in respect of (i) the evaluation of, and disclosure regarding the certifying officers' conclusions about, the effectiveness of internal controls over financial reporting or (ii) the disclosure of significant efficiencies and weaknesses in the design or operation of internal controls over financial reporting and fraud,
- the periods in respect of which an issuer can file "bare" annual and interim certificates have been extended,
- CEOs and CFOs can provide the required certification even where the controls and procedures of the issuer have been designed prior to the certifying officers assuming their offices,
- the exemption from the audit committee rule has been broadened to include certain issuers,
- the meaning of independence, as used in the audit committee rule, has been revised to more closely parallel similar provisions in the United States,
- the audit committee rule has been revised to clarify the audit committee's responsibilities regarding the pre-approval of non-audit services,
- certain audit committee members have been exempted from the independence requirements and temporary exemptions from the

independence requirements are available in limited and exceptional circumstances,

- the rule clarifies that an audit committee member who is not financially literate at the time of his or her appointment will be permitted a reasonable amount of time in which to become financially literate,

- an issuer is not required to disclose whether a financial expert is serving on its audit committee (though it is now required to describe each member of the audit committee's education and experience that relate to his or her responsibilities as an audit committee member), and

- certain conditions applicable to the exemption for issuers listed in the United States have been revised for clarification purposes.

With the exception of British Columbia (which has expressed some reservations about the need for the rules relating to certification and audit committees), the provincial and territorial securities regulators across Canada have joined the OSC in these initiatives.

The rules are, in large measure, similar to those adopted in the United States. Issuers that are already subject to (or otherwise have chosen to comply with) the U.S. regulatory regime will be largely unaffected by the new rules. They will, however, be required to:

- in respect of the certification requirements, file their signed certificates relating to their annual and quarterly reports on SEDAR, and

- in respect of the audit committee rule, disclose in their annual information forms if the board did not adopt a recommendation of the committee related to the nomination or compensation of the external auditor.

The measures will, however, require other reporting issuers in Canada to begin to address the procedural and substantive requirements that have occupied significant amounts of time and resources over the past year for issuers subject to *Sarbanes-Oxley*.

CEO and CFO Certification

The first of these rules (which is patterned on section 302 of *Sarbanes-Oxley*) will require CEOs and CFOs of all reporting issuers in Canada to certify, based on their knowledge, that their company's annual filings (i.e., annual information form, annual financial statements and MD&A) and interim filings (i.e., interim financial statements and interim MD&A) do not contain a misrepresentation and that the company's *financial condition* is *fairly presented*. Annual filings for fiscal years beginning on or after January 1, 2004 and interim filings for interim periods beginning on or after January 1, 2004 will be subject to this "bare" certification requirement. The annual certificate will have to be filed at the same time the issuer files the last of its annual information form and its annual financial statements and MD&A.

The Commission has provided guidance with respect to the meaning of both *financial condition* and *fair presentation*. Specifically, financial condition includes, but is not limited to, considerations such as:

- liquidity,

- solvency,

- capital resources,

- overall financial health of the issuer's business, and

- current and future considerations, events, risks or uncertainties that might impact the financial health of the issuer's business.

The Commission has advised that it believes that fair presentation includes, but is not necessarily limited to:

- the selection and proper application of appropriate accounting policies,

- disclosure of financial information that is informative and reasonably reflects the underlying transactions, and

- the inclusion of additional disclosure necessary to provide investors with a materially accurate and

complete picture of the financial condition, results of operations and cash flows of the issuer.

As under *Sarbanes-Oxley*, this certification will require financial information to be more than GAAP compliant and will require issuers to look more broadly at the financial information that they are presenting to the market. However, the certification is not intended to permit an issuer to depart from the issuer's GAAP recognition and measurement principles in the preparation of its financial statements.

Additionally, for financial years ending after March 30, 2005 and interim periods that occur after the end of an issuer's first financial year in respect of which it is required to file a "bare" certificate, CEOs and CFOs will be required to certify (again in a manner patterned on section 302 and section 402 of *Sarbanes-Oxley*) that they are responsible for establishing and maintaining disclosure controls and procedures and internal controls over financial reporting for their company, and they have:

- designed, or supervised the design of, disclosure controls and procedures (i.e., controls and procedures addressing the quality and timeliness of disclosure) and implemented those controls to provide reasonable assurances that material information relating to their company, including consolidated subsidiaries, is made known to them by others within those entities and that such material information is disclosed within the time periods specified under applicable securities legislation,

- designed, or supervised the design of, internal controls over financial reporting and implemented those controls to provide reasonable assurances that their company's financial statements are fairly presented in accordance with GAAP,

- evaluated the effectiveness of their company's disclosure controls and procedures as of the end of the period covered by the annual filings and have caused the company to disclose in the annual MD&A their conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by the annual filings based on such evaluation, and

- caused the company to disclose in the annual MD&A any change in the company's internal controls over financial reporting that occurred during the company's most recent interim period that has materially affected, or is reasonably likely to materially affect, the company's internal controls over financial reporting.

Pursuant to the final rule, CEOs and CFOs are not required to provide a certification in respect of:

- the evaluation of, and disclosure regarding the certifying officers' conclusions about, the effectiveness of internal controls over financial reporting, or

- disclosure of significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting and fraud.

These requirements, which were included in the proposed rule, were removed to harmonize the certification required under the rule with the certification required pursuant to the SEC rules implementing section 302 of *Sarbanes-Oxley*. The OSC has nevertheless indicated that it is developing, as a separate CSA initiative, a proposed instrument that will require a report on management's assessment of an issuer's internal controls over financial reporting.

Certain issuers, including those that comply with the annual and quarterly certification requirements prescribed by *Sarbanes-Oxley*, will be exempt from the certification requirements, provided they file their most recent annual report and signed SEC certifications on SEDAR. An issuer will be subject to the certification requirements under the rule if the issuer files financial statements prepared in accordance with Canadian GAAP, unless the issuer files those statements with the SEC in compliance with the certification requirements prescribed by *Sarbanes-Oxley*.

An officer providing a false certification could be subject to quasi-criminal, administrative or civil proceedings under securities laws as well as private actions for damages at common law or under the *Securities Act (Ontario)* when amendments to the *Securities Act* that create statutory civil liability for misrepresentations in continuous disclosure documents are proclaimed in force.

Under the rule, income trusts are subject to the same certification requirements as other reporting issuers. However, the CEO and CFO of the underlying business entity are not required to deliver annual certificates and interim certificates in addition to the certificates delivered by the executives of the income trust. The OSC has indicated that it may consider imposing such a requirement in the future.

Role and Composition of Audit Committees

Again following *Sarbanes-Oxley*, the Commission has finalized a rule (patterned on section 301 of *Sarbanes-Oxley*) dealing with the role and composition of audit committees. Most basically, the rule requires every reporting issuer to have an audit committee:

- to which the external auditors report directly, and
- that is comprised of a minimum of three members, each of whom is independent (with no direct or indirect relationship that could, in the view of the board, reasonably interfere with the exercise of such member's independent judgement) and financially literate (having the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that generally are comparable to the breadth and level of complexity of the issues that reasonably can be expected to be raised by the issuer's financial statements). An audit committee member who is not financially literate at the time of his or her appointment to the audit committee will be permitted a reasonable amount of time in which to become financially literate, provided that the issuer discloses the name of the member in question and the date by which the member expects to become financially literate.

The rule permits an independent director of a company to be a member of the audit committee of an affiliated entity, such that independent directors of a parent company would be permitted to serve as members of the audit committee of a subsidiary. The rule also deems certain persons (including those who have a relationship with the issuer pursuant to which they may accept any consulting or advisory fees) not to be independent.

Pursuant to the rule, an audit committee will be required to have a written charter that sets out its mandate and responsibilities, including recommending to the board of directors the external auditors to be nominated for the purpose of preparing or issuing an audit report as well as the compensation to be paid to such auditors. Each audit committee will also be responsible for, among other matters:

- overseeing the work of the external auditors,
- pre-approving all non-audit services to be provided to the issuer or its subsidiaries by the external auditors (other than non-audit services that constitute no more than 5% of the total amount paid to the external auditors, which must in any event be approved by the audit committee before completion of the audit), which approval can be satisfied through the adoption of specific policies and procedures for the engagement of non-audit services,
- reviewing the issuer's financial statements, MD&A and earnings press releases before they are publicly disclosed and being satisfied that adequate procedures are in place for the review of the issuer's other disclosure of financial information extracted or derived from the financial statements,
- establishing procedures for the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters, and
- reviewing and approving the issuer's hiring policies regarding employees and former employees of the present and former external auditors of the issuer.

Every reporting issuer will be required to disclose in its annual information form:

- the text of the audit committee's charter,
- the composition of its audit committee, and if a member is not independent, the reason why,

- if it is relying on certain exemptions contained in the proposed rule,
- any recommendation of the audit committee to nominate or compensate external auditors that was not adopted by the board, and the reason for that recommendation,
- a description of any specific policies and procedures adopted by the audit committee for the engagement of the external auditors to provide non-audit services, and
- the aggregate fees billed by the external auditors for each of the last two fiscal years for professional services on account of audit fees, audit-related fees (i.e., fees for assurance and related services by an external auditor that are reasonably related to the performance of the audit or the review of the financial statements and are not reported as audit fees), tax fees and all other fees.

The final rule (unlike the proposed rule) does not require an issuer to disclose whether a financial expert is serving on its audit committee. However, issuers are now required to describe each member of the audit committee's education and experience that relate to his or her responsibilities as an audit committee member.

The securities regulators have recognized that the rule would constitute an unfair burden on the resources of "smaller companies" and could pose an unacceptable barrier to their ability to access the public markets and compete. In this context, the rule exempts certain issuers (including those listed on the TSX Venture Exchange) from the requirement that members of the audit committee be independent and financially literate.

Recognizing the position of controlling shareholders, the rule exempts an audit committee member from the independence requirements where:

- the member would be independent, but for his or her status as an "affiliated entity" as a result of a defined connection with the controlling shareholder,
- the member is not an executive officer, general partner or managing member of a publicly traded affiliated entity, or an immediate family member of such a person,
- the member does not act as the chair of the audit committee, and
- the board determines in its reasonable judgement that (i) the member is able to exercise the impartial judgement necessary for the member to fulfill his or her responsibilities as an audit committee member, and (ii) the appointment of the member is required by the best interests of the issuer and its shareholders.

Issuers that are listed on a major U.S. exchange or quotation system will be exempt from all of the substantive requirements of the rule provided that the issuer complies with the requirements of the U.S. exchange or quotation system with respect to the role and composition of audit committees and discloses in its annual information form if the board did not adopt a recommendation of the committee related to the nomination or compensation of the external auditor. "SEC foreign issuers", "exchangeable security issuers" and "credit support issuers" are also exempt from the requirements of the rule.

All elements of the rule will apply to issuers after the earlier of: the first annual meeting of the issuer after July 1, 2004, and July 1, 2005.

Canadian Public Accountability Board Oversight of External Auditors

The OSC also has finalized a third rule, which it believes should enhance the quality of independent auditing, which will require financial statements of reporting issuers to be audited by an accounting firm that it is good standing with the Canadian Public Accountability Board (CPAB). The CPAB is a new independent public oversight system for accountants and accounting firms that audit reporting issuers. The CPAB is to develop and implement an oversight program with rigorous inspections of the auditors of public companies in Canada.

The effective date for the rule is March 30, 2004.

Practical Implications

The three rules effectively will require all Canadian issuers participating in the public markets to begin to address and respond to the basic requirements and practices that have arisen in the context of *Sarbanes-Oxley*, if they have not already done so. For some issuers, relatively few changes will be required to their existing governances structures and practices, while others will need to undertake a number of fundamental changes. Some of those changes, particularly those relating to audit committee composition, may take longer to implement than others.

In all instances it will be important that issuers, their directors and management adopt responses to these regulatory initiatives that work, and that will actually be followed by them. Adoption of "model" structures, charters and procedures that do not reflect the particular requirements of an issuer or that will fall out of use over time have the potential of subjecting issuers, their directors and management to increased costs without commensurate benefits and, potentially, enhanced liability.

Please do not hesitate to contact any member of the Goodmans corporate securities team to discuss these initiatives, possible responses by you and your business, and corporate governance more broadly as it continues to evolve in Canada.

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