1.1.6 OSC Staff Notice 51-706 – Corporate Finance Report

OSC STAFF NOTICE 51-706 – CORPORATE FINANCE REPORT (2005)

Introduction

The Corporate Finance Branch (Corporate Finance or the Branch) of the Ontario Securities Commission is responsible for regulating reporting issuers. This includes overseeing public offerings of securities, through reviews of prospectuses and rights offering documents, and the ongoing dissemination of information by reporting issuers, through reviews of their continuous disclosure materials. The Branch also monitors compliance with securities laws in take-over bids and mergers and acquisitions, along with regulating the exempt market and taking a lead role in issuer-related policy initiatives.

This report discusses some key issues identified by Corporate Finance in the past year. This report is not an all-encompassing summary of the work completed by the Branch but, rather, highlights issues we believe are of interest to the issuer community. While the discussion in Part 1 on our risk-based reviews relates to our fiscal year ending March 31, 2005, the remainder of our report expands beyond that date to address more current issues.

A key theme underlying this report is that the majority of our resources were dedicated to improving integrity in financial reporting. We achieved this by pursuing perceived deficiencies in issuers' application of accounting requirements, improving disclosure rules and implementing new corporate governance guidelines. We will continue to reinforce all of these regulatory initiatives through our ongoing reviews of, and dialogue with, reporting issuers. For ease of reporting, our findings and recommendations have been structured into five areas, being risk-based reviews, continuous disclosure and prospectus findings, insider reporting issues, application issues and service standards.

Part 1: Risk-Based Reviews

A. Risk-Based Approach

We believe a risk-based approach is the most efficient way to focus our resources. This is consistent with the approach taken by other securities regulators and has become fundamental to the way we operate. We use various selection criteria to identify for review those issuers (i) whose disclosure is most likely to be materially improved or brought into compliance with securities laws or accounting standards as a result of staff review, or (ii) whose potential impact on the capital markets is significant. Our criteria for identifying risk continue to evolve in response to a variety of factors, including public prominence of disclosure requirements and consensus or controversy around accounting or disclosure practices.

An issuer's continuous disclosure (CD) and prospectus filings may be subject to full, issue-oriented, screening or targeted reviews. Generally, the level of review is determined using our risk-based approach, however, some prospectuses will be randomly selected for full review. The different types of reviews are discussed in more detail in Figure 1 below. For more information see OSC Staff Notice 11-719 *A Risk-Based Approach for More Effective Regulation*.

Figure 1: Types of Prospectus and CD Reviews

Level of Review	Description
Full Review	A full CD review consists of an examination of the issuer's disclosure record for at least the past year. This encompasses an issuer's financial disclosure (interim and annual financial statements and related management's discussion and analysis) as well as other types of corporate disclosure (annual information forms, material change reports, information circulars, business acquisition reports and press releases). In addition to all regulatory filings, we may examine trading activity, industry data and analyst reports. These reviews usually involve correspondence with the issuer. Full prospectus reviews involve a complete review of the prospectus and any documents incorporated by reference.
Issue-Oriented Review	Issue-oriented reviews focus on a specific legal, accounting or other regulatory issue.

Figure 1: Types of Prospectus and CD Reviews

Level of Review	Description
Screening Review	CD screening reviews are carried out to determine whether an issuer's CD record warrants further scrutiny through either a full or issue-oriented review. These reviews involve examining an issuer's disclosure record for the past year and do not usually result in any correspondence with the issuer. If the screening review leads to a full or issue-oriented review, the review will not be shown separately as a screening review. Senior lawyers and accountants screen prospectuses to determine whether the prospectus should be subject to a full, issue-oriented or basic review. A basic review is largely limited to an administrative processing of the file.
Targeted Review	Targeted reviews apply to a sample of issuers and generally relate to a particular industry or result from policy developments or accounting standard changes. These reviews could be either full or issue-oriented depending upon the specific subject matter targeted.

B. Types of reviews completed during our last fiscal year

We have summarized the types of reviews undertaken by Corporate Finance for the fiscal year ending March 31, 2005 in Figure 2 below.

Figure 2: Breakdown of Corporate Finance Reviews

Types of Reviews	Fiscal 2005	Fiscal 2004	% Change
Prospectus Reviews:			
Full	121	114	6%
Issue-Oriented	66	67	(1)%
Total	187	181	3%
CD Reviews:			
Full	108	94	15%
Issue-Oriented	47	12	292%
Screening	84	175	(52)%
Targeted	156	80	95%
Total	395	361	9%
*% of Ontario PR Issuers Reviewed**	29%	26%	12%
% of Issuers TSX Listed	67%	46%	46%

**Ontario PR issuers generally mean those issuers whose head office is located in Ontario.*

Prospectus Reviews

In fiscal 2005, we completed 187 full or issue-oriented reviews of preliminary prospectuses and rights offering documents. This was comparable with the previous year's level of 181 and, as Figure 2 shows, the composition of full and issue-oriented reviews remained fairly consistent. Our 187 reviews of prospectuses and rights offering documents were made up of 101 long form prospectus reviews, 71 short form prospectus reviews and 15 rights offering circular reviews. While not identified in the table above, we also completed approximately 300 basic prospectus reviews this year, which is consistent with the 332 basic reviews performed in fiscal 2004. Excluding basic reviews, the prospectuses reviewed by Corporate Finance accounted for approximately 36% of all prospectuses filed in Ontario.

Continuous Disclosure Reviews

This year we completed 395 CD reviews, up 9% from the prior year. This increase was primarily due to a strategic shift in Corporate Finance resources from policy-based projects to more operational initiatives. During fiscal 2004 the Branch was

mainly focused on investor confidence initiatives. This year we focused on overseeing implementation of the investor confidence initiatives and assessing compliance with a variety of regulatory requirements. During fiscal 2005, our reviews also shifted to more issue-oriented and targeted reviews as compared to the large number of screening reviews undertaken in 2004. These reviews are discussed in detail below.

Targeted Reviews

Targeted reviews generally focus on a particular industry or are initiated as a result of policy developments or accounting standard changes. In fiscal 2005 we performed a larger number of targeted reviews and focused on the following areas:

- We reviewed 100 issuers to monitor compliance with the disclosure requirements under National Instrument 55-102 *System for Electronic Disclosure by Insiders (SEDI).* Given that SEDI had been operational for over a year, we also directed resources to monitoring insider reporting compliance. A report summarizing our findings will be issued shortly.

- Eight audit reports were filed by accounting firms not registered with the Canadian Public Accountability Board (CPAB), as required by National Instrument 52-108 *Auditor Oversight* (NI 52-108).

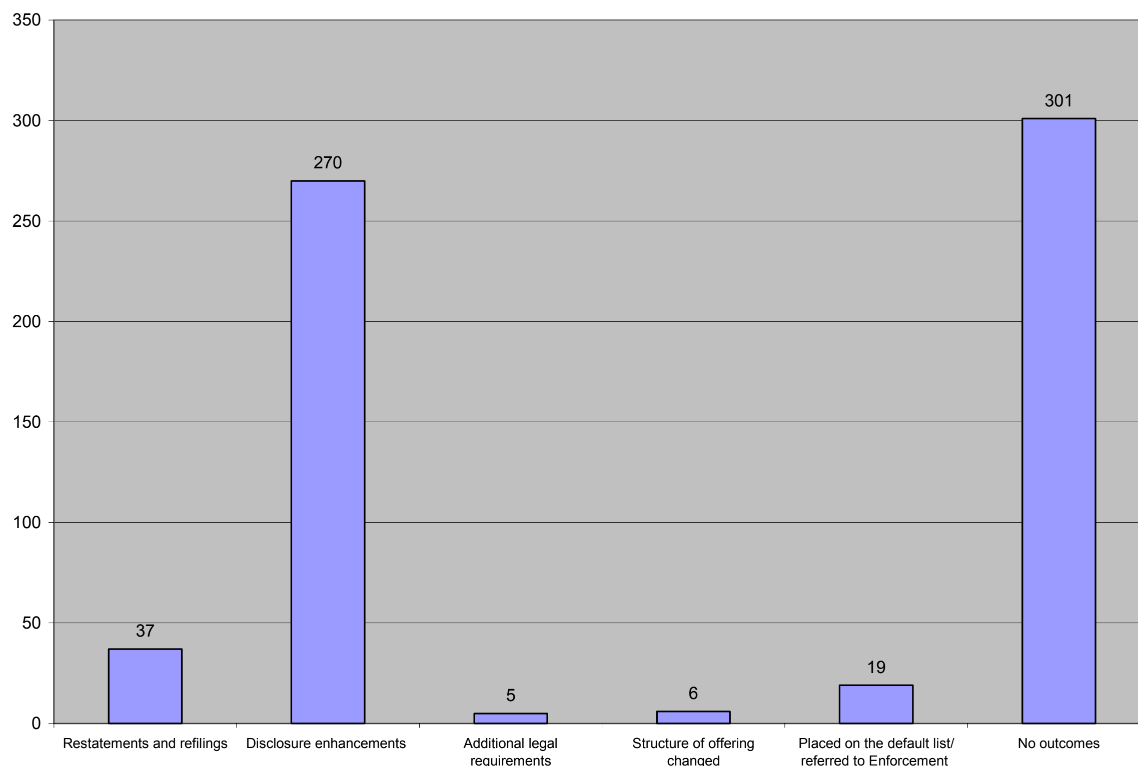
- 22 issuers were subject to a review of restructuring costs associated with exit and disposal activities (See Part 2).

- 17 issuers were reviewed for compliance with Section 13.2 of National Instrument 51-102 *Continuous Disclosure Obligations* (NI 51-102). This section allows an issuer to rely on a previously granted exemption from the CD requirements provided notice is given to the Commission.

- Nine issuers were subject to a review to assess compliance with the Business Acquisition Report (BAR) requirements of NI 51-102 (See Part 2).

C. Outcomes of completed reviews

The outcomes of our 582 completed reviews are summarized below. In some cases, multiple outcomes were generated by each review.



Approximately 80% of our outcomes were commitments by issuers to enhance some aspect of their disclosure in future continuous disclosure filings. A significant number of these commitments related to enhanced management discussion and analysis (MD&A) disclosures and amendments or additions to SEDI filings. Other disclosure enhancements included clarifications to accounting policies, modifications to technical mining reports, disclosure improvements surrounding non-GAAP (Generally Accepted Accounting Principles) earnings measures and updating of websites for financial reporting information. We selectively monitor issuer's commitments to ensure that all disclosure enhancements are appropriately addressed.

In 9% (18% during fiscal 2004) of our CD reviews, we identified filings that were so deficient that the issuers were required to restate and refile continuous disclosure materials, to make retroactive changes or to file materials that had not previously been filed. Our approach in this area is described in OSC Staff Notice 51-711 *Refilings and Corrections of Errors as a Result of Regulatory Reviews* (Staff Notice 51-711).

As set out in Staff Notice 51-711, we view such refilings and retroactive accounting changes as significant events. Where an issuer makes a refiling or retroactive accounting change as a result of our review, the issuer's name, date of refiling and a description of the deficiency is posted on our Refilings and Errors list (available at www.osc.gov.on.ca) for three years.

Some of the issues that led to restatements and refilings, and therefore inclusion on the Refilings and Errors list are noted below:

- *Management's Discussion and Analysis (MD&A)* – annual and interim MD&A were restated due to the issuers' failure to provide a detailed discussion of results of operations, liquidity and capital resources as required by NI 51-102. As well, issuers' annual MD&A were restated to include enhanced discussion of related party transactions and a more thorough analysis of the risks and uncertainties believed to affect future performance.

- *Auditor Oversight* – annual financial statements were refiled due to non-compliance with NI 52-108, which requires that an audit report be signed by a public accounting firm that is registered with CPAB.

- *Auditor Review* – interim financial statements were refiled to include the required notice stating that they had not been reviewed by the issuer's auditors.

- *Asset Retirement Obligations* – interim financial statements were restated to correct the assessed fair value of reclamation expenses. Specifically, the issuer had incorrectly calculated the undiscounted cash flow to settle the obligation as required by CICA Handbook Section 3110 *Asset Retirement Obligations*.

- *Functional Currency* – financial statements were refiled to use the U.S. dollar as the functional and reporting currency instead of the Canadian dollar, as required in their circumstances by CICA Handbook Section 1650 *Foreign Currency Translation*.

- *Future Tax Liability* – annual and interim financial statements were refiled to correct an overstated future tax liability by offsetting an unrecognized future tax asset against the balance, which is the treatment recommended by CICA Handbook Section 3465 *Income Taxes*.

- *Information Circular* – an information circular was amended to correct a disclosure omission related to Item 6.5 of Form 51-102F5, which sets out the disclosure obligations relating to the principal holders of an issuer's voting securities.

- *Lease Termination Costs* – financial statements were refiled to correct the accounting for lease termination costs, which had been incorrectly deferred to a future period. Emerging Issues Committee (EIC) 135 *Accounting for Costs Associated with Exit and Disposal Activities* requires that the liability be recognized and measured at fair value in the period in which the liability is incurred which, in the case of a lease termination, is at either the point of termination of the contract or at the cease-use date.

- *Discontinued Operations* – financial statements were refiled to correctly reflect the sale of all assets. This sale had been inappropriately accounted for as a discontinued operation where no continuing operations existed. EIC 45 *Discontinued Operations* states that discontinued operations accounting should not be adopted when, as a result of the adoption of a formal plan of disposal, the entity has no substantial continuing operations.

- *Going Concern* – financial statements were refiled to include a detailed going concern note relating to a significant working capital deficit. The note in the financial statements had failed to discuss the impact on the

issuer's financial condition and results of operations if the assumption that the enterprise was able to realize assets and discharge liabilities in the future was no longer applicable.

- *Earnings Per Share (EPS)* – financial statements were refiled as the earnings per share numbers were not calculated using the current and comparative year's net losses. CICA Handbook Section 3500 *Earnings Per Share* requires issuers to present basic earnings per share and diluted earnings per share for net loss on the income statement. Instead, the issuer calculated EPS using a subtotal labelled "net loss from operations."

- *Business Combinations* – financial statements were refiled as an issuer incorrectly accounted for the acquisition of a subsidiary by valuing part of the consideration at face value instead of fair value. CICA Handbook Section 1581 *Business Combinations* requires that the cost of the purchase be determined by the fair value of the consideration given.

Part 2: Continuous Disclosure and Prospectus Findings

This section of our report highlights some of the issues identified or addressed by Corporate Finance through our ongoing reviews. The topics identified are not exhaustive of the issues addressed, but do highlight some of the areas we believe are of interest to market participants.

A. Income Trusts

During early 2005, the income trust structure remained the preferred structure for initial public offerings. In addition to a large number of income trust prospectus reviews, approximately 12% of our CD reviews related to income trusts. Some of the more significant issues identified are highlighted below.

Goodwill Impairment Losses

This year we continued to focus on the application of CICA Handbook Section 3062 – *Goodwill and Other Intangible Assets* by issuers, especially in the context of goodwill impairment assessments for income trusts. We have identified some situations where it appears that the goodwill impairment testing required by Section 3062 may not have resulted in the impairment provision being identified in a timely fashion. Specifically, external factors, such as the deterioration in the underlying entity's business climate or the loss of significant customers, suggested that impairment was likely. We strongly encourage issuers to use multiple valuation methods to assess the fair value of reporting units whenever goodwill impairment testing is performed, especially when an approach based on quoted market prices does not appear to generate results consistent with indications from external factors.

We will also continue to focus on potential goodwill impairment losses by reviewing the processes and assumptions used by management to support the proposition that the fair value of its reporting units exceed the related carrying value of goodwill. This may include a detailed review of supporting schedules used for the assessment, determination of how the fair value for the reporting unit was derived and the allocation process of goodwill to the reporting unit.

Distributable Cash

The information that an income trust provides about its estimated distributable cash is central to an investor's assessment of the income trust's future prospects. This figure often contains significant estimates and assumptions with little supporting information.

Given our concerns, we reviewed the distributable cash disclosure of several income trust prospectuses. We found that most income trust prospectuses contain a narrative description of how distributable cash is calculated followed by a reconciliation to the most comparable GAAP measure. We also noted that some income trust issuers were including adjustments in the reconciliation that appeared to be forward-looking and that were not sufficiently transparent with respect to underlying assumptions. Comprehensive disclosure of the assumptions, estimates and bases used to determine the adjustments in arriving at distributable cash allows investors to determine whether the amount of estimated distributable cash is reasonable and sustainable. In some circumstances, this level of transparency and objectivity may only be achievable by including a forecast prepared in accordance with the CICA Handbook Section 4250 *Future-Oriented Financial Information*. For more information see Canadian Securities Administrators (CSA) Staff Notice 41-304 *Income Trusts: Prospectus Disclosure of Distributable Cash*.

Liquidity Disclosure in MD&A

As discussed above, distributable cash is a key element for income trust investors. It is important for unitholders to understand what they are receiving when paid a cash distribution, including whether the issuer financed the distribution through borrowings or other than through cash generated from operations. Our reviews indicated that many income trust issuers fail to provide this information in sufficient detail. We remind issuers that NP 41-201 recommends that MD&A provide a breakdown between return

on and return of capital for distributable cash. As well, an issuer's MD&A should provide a comparison between the expected distributable cash figure disclosed in the most recent public offering document or circular and actual cash distributed.

B. Management's Discussion and Analysis

When preparing MD&A, an issuer should provide a balanced discussion of the results of operations and financial condition, including, an in-depth analysis of liquidity and capital resources. MD&A should also present a balanced picture of the company, openly addressing bad news as well as good news. Specifically, the MD&A should:

- help current and prospective investors understand what the financial statements do and do not show;
- discuss material information that may not be fully explained in the financial statements, such as contingent liabilities, defaults under debt obligations, off-balance sheet financing arrangements and other contractual obligations;
- discuss important trends and risks that have affected the financial statements, and trends and risks that are reasonably likely to affect them in the future;
- discuss the impact critical accounting estimates would have on the financial statements if future experience differs from that assumed; and
- provide information about the quality, and potential variability, of earnings and cash flow in order to assist investors in determining if past performance is indicative of future performance.

MD&A disclosure is now required for all reporting issuers, regardless of their size. Failure to file MD&A that complies with NI 51-102 may result in a refiling. During the year many issuers were placed on our Refilings and Errors list for MD&A disclosure issues. Some of the issues that commonly led to our requiring MD&A refilings or prospective changes were:

- *Overall Performance* - issuers failed to provide an analysis of their financial condition, results of operations and cash flows. This required analysis includes a comparison of the performance in the most recently completed financial year to the prior year's performance and an explanation of why changes have occurred or expected changes have not occurred. This discussion should also describe and quantify material variances. We noted that many issuers simply provided a superficial discussion rather than providing a detailed analysis of overall performance that would allow a reader to understand the events of the year.
- *Select Annual Information and Summary of Quarterly Results* - many issuers failed to disclose factors that caused variations over the periods in question. This information gives investors an understanding of general trends of the business and the overall direction of the issuer.
- *Results of Operations* - many issuers failed to provide an analysis of the cost of sales and gross profit. Issuers are required to analyze all material variances and discuss all significant factors that caused these changes, including factors that led to a change in the relationship between costs and revenue, such as, changes in costs of labour or materials, price changes or inventory adjustments.
- *Trends and Risks* - many issuers either did not disclose risks at all, or simply provided a list of risks and uncertainties that failed to include an in-depth analysis of how these risks may impact their financial condition, changes in financial condition and results of operation.
- *Liquidity* - many issuers simply repeated financial statement disclosure. Issuers should provide a detailed discussion of how they intend to generate sufficient cash flow in the short and long term to meet obligations or to sustain planned growth. Any consequences of anticipated shortfalls should be given maximum clarity.
- *Off-Balance Sheet Arrangements* - some issuers failed to discuss the business purpose of off-balance sheet arrangements and the potential effects of terminating those arrangements.
- *Transactions with Related Parties* - many issuers did not provide a discussion of both the qualitative and quantitative characteristics of related party transactions. It is important that MD&A provide an understanding of the exact nature of the relationships involved, along with the business purpose of, and economic substance behind, these transactions.

C. Business Acquisition Reports

This year we also performed a targeted review of compliance with the new requirement to file a Business Acquisition Report (BAR) upon the completion of a significant acquisition. A completed acquisition is determined to be significant if it satisfies one of the asset, investment or income tests of significance outlined in NI 51-102.

The BAR provides investors with information that enables them to determine the impact of the acquisition on the existing business. Information in a BAR includes a discussion of the nature of the business acquired, historical financial statements of the acquired business and pro forma financial statements giving effect to the acquisition as at the beginning of the financial year of the issuer.

Our targeted review involved identifying potential significant acquisitions by first reviewing a large number of issuers' press releases and material change reports. Next, we confirmed that the BAR, if required, was filed and that the filing was within the appropriate deadline. As well, we reviewed each of the BARs filed to determine whether the content requirements set out in NI 51-102 were met. Our results showed a high degree of compliance in this area.

D. Revenue Recognition

We continued to pay particular attention to this area during our continuous disclosure and prospectus reviews. During our continuous disclosure reviews we raised a significant number of comments on revenue recognition policies. We found that many issuers fail to clearly identify the specific triggers for revenue recognition that relate to the various aspects of their operations. Issuers' policies should include disclosure of each type of revenue earned, how it is recognized, whether or not the issuer retains any risks or obligations upon sales/services, whether there are any rights of return or warranties and any other uncertainties or matters which require particular judgement or estimation.

The most recent guidance with respect to revenue recognition is contained in Emerging Issues Committee (EIC) Abstracts – EIC 141 *Revenue Recognition* (EIC 141), EIC 142 *Revenue Arrangements with Multiple Deliverables* (EIC 142) and EIC 143 *Accounting for separately priced extended warranty and product maintenance contracts* (EIC 143).

In addition to reviewing revenue recognition policies, we examined the implications of these policies to assess whether there are any measurement and recognition issues, and we frequently raised these issues in our reviews. During the year the most often recurring sources of measurement and recognition issues were the recognition of up-front fees and the treatment of right of return arrangements. Issuers improperly recognized up-front fees in income upon receipt rather than deferring the fees as required by EIC 141. We are also concerned with right of return arrangements, when the existence of such a right casts doubt over whether an issuer has assurance that consideration is fixed or determinable.

E. Stock-based Compensation

Under the revised CICA Handbook Section 3870 *Stock-Based Compensation and Other Stock-Based Payments*, public companies are required to expense all stock-based compensation awards for fiscal years beginning on or after January 1, 2004. While this standard sets out the recognition, measurement and disclosure requirements for all stock-based transactions issued in exchange for goods and services, of particular interest is the fair value accounting for employee stock option expenses.

Given that stock options have been a popular way of compensating employees, the issuance of this standard has had a material effect on many issuers' financial statements. Under this fair value based method, issuers must measure the cost of the option when it is granted and then amortize this cost over the estimated employee service period. The fair value is determined using an option pricing model, such as Black-Scholes or a Binomial Pricing Model, that takes into account various factors including the grant date, exercise price, expected life of the option, current price of the underlying stock and its expected volatility.

We assessed issuers' compliance with these requirements as part of our regular reviews. Specifically, we reviewed the accounting for stock-based compensation in financial statement filings, focusing on accounting policy and note disclosure, compensation expense booked, reasonableness of the assumptions used to value the stock options granted and the consistency of application of the valuation model chosen**.** As a result of our reviews, two issuers refiled their interim financial statements because they did not correctly account for compensation expense. Several issuers committed to enhancing their future disclosure with respect to stock-based compensation.

F. Restructuring Costs

We continued to focus on restructuring costs for two reasons. Firstly, the accounting requirements for recording these costs changed for exit and disposal activities initiated after March 31, 2003 with the introduction of EIC 134 *Accounting for Severance and Termination Benefits* and EIC 135 *Accounting for Costs Associated with Exit and Disposal Activities (Including Costs Incurred in a Restructuring)* (individually EIC 134 and EIC 135, respectively, and together, the new Standards). Secondly, overstated restructuring charges can result in a false impression of improved operating results in subsequent periods. As part of

a targeted review, we analyzed restructuring costs to determine if these costs were being recognized, measured and disclosed appropriately.

While our reviews did not identify deficiencies in the recognition and measurement of restructuring costs, we noted that issuers were deficient in meeting certain disclosure requirements in both their interim and annual financial statements. Most issuers failed to provide an adequate description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date. For example, a phrase like "the need to scale back expenses to be in line with management's expectations" does not adequately explain the facts and circumstances that led to a restructuring, nor does it explain the reason why each type of cost was incurred. We also noted the absence of a reconciliation of the beginning and ending liability balances for each restructuring activity or of specific reportable segment disclosures, as required.

We also found that many issuers did not provide a robust discussion of restructuring activity in interim and annual MD&A. Issuers should provide a discussion and analysis sufficient to allow the reader to understand why management decided to restructure operations. The initial discussion should address the types of costs that will be included in the restructuring charge and how they will be funded, the anticipated quantitative impact on future operations and liquidity of the issuer, where the restructuring will occur (operating segment and geographical location) and when it is anticipated to be completed. This discussion and analysis should be updated in the MD&A for subsequent interim periods and should serve as a status report for restructuring activities that span more than one reporting period.

G. Intangible Assets

Under CICA Handbook Section 3062 *Goodwill and Other Intangible Assets*, issuers are required to separately recognize, measure and present goodwill and other intangible assets. We expect issuers to attempt to allocate the purchase price to goodwill and indefinite and finite life intangible assets at the time of preparing pro forma financial statements for inclusion in a prospectus or a BAR. The combination of goodwill and intangible assets disclosed as a single line item on the balance sheet is not acceptable and is not in accordance with GAAP.

We also expect the disclosure to distinguish between indefinite and finite life intangible assets, including the amortization and estimated useful life associated with the finite life intangible assets. While we acknowledge that the purchase price allocation process may not have been finalized at the time pro forma financial statements are being prepared, this should not preclude management from making good faith estimates to allocate the purchase price, and to calculate the amortization of finite life intangible assets.

H. Executive Compensation Disclosure

Over the past few years, there has been a heightened focus on the transparency and completeness of executive compensation. Some of our findings in this regard are highlighted below.

Supplementary Retirement Benefit Plans

During our reviews of executive compensation, we noticed that a number of issuers provide supplementary retirement benefit plan disclosure that goes beyond current securities law requirements. As a result, on January 14, 2005, we published, together with the other CSA jurisdictions (except British Columbia), CSA Staff Notice 51-314 *Retirement Benefits Disclosure*. The purpose of the notice is to provide guidance to issuers with respect to retirement benefit disclosure. Issuers should review this notice when preparing retirement benefit disclosure to ensure that this additional disclosure is clear and meaningful to investors.

External Management Companies

We have reviewed prospectuses and continuous disclosure filings of issuers where the issuer's executive management is employed by an external management company. This executive management is then contracted to the issuer. The definitions of "senior officer" and "executive officer" in securities legislation include any individual who performs functions for an issuer similar to those normally performed by a variety of named positions. We would generally consider the officers of the external management company to be persons performing functions in respect of the reporting issuer similar to those normally performed by senior officers of a company, including policy-making functions. Consequently, any requirements of securities legislation that apply to senior officers or executive officers of a reporting issuer would generally apply to the executive officers of the external management company.

In particular, in addition to disclosing any management fee, incentive fee or other amounts payable by the reporting issuer to the external management company, we would expect any long form prospectus, management information circular or annual information form to include the executive compensation disclosure required by Form 51-102F6 *Statement of Executive Compensation* for the executive officers of the external management company. In this regard, we expect the reporting issuer to disclose any compensation payable directly by the reporting issuer to the executive officers, as well as any compensation payable by the external management company to the executive officers that can be attributed to the management fee or other

payments from the reporting issuer (e.g. any salary, bonus, dividends, distributions or other payments paid by the external management company to the executive officers).

I. Other Disclosure Regarding External Management Companies

When interpreting form requirements for prospectuses, management information circulars, annual information forms and MD&A requirements for a reporting issuer where the issuer's executive management is provided through an external management company, we expect the reporting issuer to provide full disclosure of material facts relating to the external management company and its executive officers in the relevant document. In particular, we expect the reporting issuer to disclose any direct or indirect interest of its insiders in the external management company and any risks relating to the external management company. For example, risk disclosure in a prospectus or annual information form should include a discussion, if applicable, of whether the external manager's services are exclusive to the issuer and of potential conflicts of interest, along with material financial repercussions of terminating a long-term management agreement for unsatisfactory performance.

J. National Instrument 43-101 Standards of Disclosure for Mineral Projects

This year we continued to see significant improvements in the scientific and technical disclosure provided by issuers in technical reports under National Instrument 43-101 *Standards of Disclosure for Mineral Projects* (NI 43-101). Our reviews did, however, continue to identify the following disclosure issues:

- *Inferred Mineral Resources* – we continue to see inferred mineral resources totaled with other categories of mineral resources. As there is a low reliability level associated with inferred resources, these must not be totaled with indicated and measured resources.

- *Preliminary Assessments* – cautionary language about the preliminary nature and lack of certainty of an economic analysis using inferred resources must occur in the same paragraph that discloses the results of this type of economic analysis, or in the following paragraph. The cautionary statement about the use of inferred resources should not be placed at the end of a press release.

- *Historical Resources and Reserves* – we continue to see issuers disclosing historical estimates of mineral resources and mineral reserves that omit the supporting disclosure required under Section 2.4 of NI 43-101, such as the date of the historical resource estimate or the discussion of the relevance and reliability of these historical estimates. Where these historical estimates are not being treated as NI 43-101 defined mineral resources or reserve estimates, as verified by a qualified person, issuers should clearly state this fact and indicate that such historical estimates should not be relied upon.

K. Corporate Disclosure Policies

We have continued to request information on issuers' corporate disclosure policies and practices as part of our CD reviews, and we are now providing a further report on our observations in this area.

In general, we find that an increasing number of issuers have prepared formal corporate disclosure policies. In many cases, these are closely modeled on the guidance contained in National Policy 51-201 *Disclosure Standards* (NP 51-201). This is a positive development and we encourage issuers who still lack a formal policy in this area to consider creating one. As stated in NP 51-201, the process of creating a policy is itself a benefit because it forces a critical examination of current disclosure practices.

In some specific areas, we observe that the percentage of issuers taking a progressive approach to disclosure has clearly increased. For example, significantly more companies now broadcast their conference calls in an open forum, where interested parties can listen in on the call by telephone or via a webcast on the internet.

However, it sometimes appears that issuers apply the guidance contained in NP 51-201 with little specific consideration of the company's own circumstances or challenges. We noticed several recurring areas in which we believe that disclosure policies could be made more effective and these are discussed below:

- *Materiality* – although the great majority of disclosure policies address how to decide what information is material, in many cases the policy merely incorporates Securities Act definitions without any attempt to clarify how and by whom those definitions will be applied to the company's own circumstances. In other cases, companies provided a list of events or information which may be material; however, we found that these lists simply reflect the list contained in paragraph 4.3 of NP 51-201, sometimes to the letter. NP 51-201 is not exhaustive and is not a substitute for companies exercising their own judgment in making materiality determinations.

- *Disclosure Committees* – many disclosure policies indicated that the company's disclosure practices are overseen by a disclosure committee. In the majority of cases, these committees consisted only of two senior executives, such as the CEO and CFO. In one case, the disclosure "committee" consisted of a single person. A broader cross-section of representation, with identified duties and responsibilities for each member, helps to ensure both that the disclosure committee has a full understanding of the range of disclosure issues within the company and that its decisions take into account the full range of possible impacts and consequences.

- *Updating and Communication* – many of the disclosure policies we received had apparently not been updated for some time, and it was often not clear what processes the company had in place to ensure that the policy was effectively communicated and well understood within the organization, or that it was amended when necessary to address evolving circumstances. The disclosure policy should be seen as one aspect of an ongoing dynamic process. We believe it would be prudent for an issuer's board of directors to review and approve the policy on an annual basis.

- *Disclosure Controls* – few of the disclosure policies evidenced the controls that the company had established to support the effective working of the disclosure policy. Although we realize that these controls may be documented elsewhere, the process of developing and implementing a disclosure policy appears likely to us to be particularly effective when the policy's design and review is carried out in conjunction with an assessment of the procedures that will support it in practice.

- *Confidentiality* – securities legislation permits a company to file material change reports on a confidential basis where immediate release of the information would be unduly detrimental to the company's interests. Few of the disclosure policies reviewed addressed the company's procedures for containing confidential information, where confidentiality is necessary for the company's compliance with disclosure obligations.

L. Material Contracts

Material contracts filed in connection with a prospectus must be filed in their entirety. We note that some issuers have omitted to file schedules to material contracts. A schedule to a material contract is a part of the contract and must be included unless exemptive relief has been granted.

M. Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings (MI 52-109)

MI 52-109 requires that CEOs and CFOs personally certify annual and interim filings. This year, we reviewed the certifications filed and in general we found compliance with the requirements of the instrument. However, in certain circumstances we had to remind issuers that when interim or annual filings are refiled, the relevant certificate must be refiled as well. We expect to continue our review of the certifications and in some cases where we identify disclosure deficiencies relevant to the fair presentation of the financial statements, we may ask issuers to provide in writing their processes underlying the certification.

Part 3: Insider Reporting Issues

A. SEDI Late Filing Fees

We want to remind insiders that OSC Rule 13-502 *Fees* (Rule 13-502) imposes a fee for the late filing of an insider report on SEDI. The fee amounts to $50 per day, per insider, per issuer, subject to a yearly maximum of $1,000.

The purpose of the fee is to encourage timely reporting by insiders and is not meant to be punitive. We do not view the late filing fee as a "penalty" imposed by a regulatory authority. Consequently, these fees do not trigger disclosure requirements under section 10.2 of Form 51-102F2 *Annual Information Form* or under the prospectus rules.

Part 4: Application Issues

A. ABS Issuers (NI 51-102 and MI 52-109 Relief)

Over the past year, we have received a number of applications from issuers of asset-backed securities (ABS issuers) seeking relief from the continuous disclosure requirements contained in NI 51-102 and the certification requirements contained in MI 52-109.

Historically, we have generally been prepared to recommend continuous disclosure relief for ABS issuers of "pass-through" certificates. "Pass-through" certificates typically evidence an undivided co-ownership interest in a pool of assets and do not represent debt obligations of the issuer. The certificateholders do not have an interest in, or claim on, the assets of the issuer

but only in a discrete pool of related securitized assets. In these circumstances, the information contained in the issuer's interim and annual financial statements is not relevant to the certificateholders.

In some cases, an ABS issuer may issue "pay-through" notes in addition to or instead of pass-through certificates. "Pay-through" notes typically evidence limited-recourse, secured debt obligations of the issuer. Where an ABS issuer issues "pay-through" notes, that information about the financial position of the issuer may be relevant to the noteholders. In an application for continuous disclosure relief by an ABS pay-through issuer, the filer should demonstrate that:

- as a result of the contractual limitation on recourse to a specific asset, the noteholders only have a claim against that specific asset and not the assets of the issuer generally; and

- in the event of a bankruptcy or insolvency, noteholders will have a first claim on the assets in the pool in priority to other potential creditors of the issuer.

Where an ABS pay-through issuer is unable to demonstrate that both of these conditions are satisfied, we may recommend more limited continuous disclosure relief, such as relief from the interim filing requirements but not the annual filing requirements.

Where an ABS issuer is granted relief from the continuous disclosure requirements in NI 51-102, we will generally be prepared to recommend relief from the certification requirements in MI 52-109.

B. Deeming issuer to be a reporting issuer following reorganization

Historically, issuers have applied to be deemed reporting issuers following certain reorganizations and plans of arrangement. Recently we have asked issuers to withdraw these applications where the issuers involved intended to list their securities on the TSX. We remind issuers and their advisors to review paragraph (c) of the definition of reporting issuer. That paragraph provides that a reporting issuer includes any issuer whose securities are listed and posted for trading on any stock exchange in Ontario recognized by the Commission.

Part 5: How Issuers Can Help Us Achieve Our Service Standards

We recognize that regulation must be balanced so that it does not cause inefficiencies or unnecessary costs. In response to these challenges, our Service Commitment was published in the OSC's 2004 Annual Report. These service standards set out our commitment to deliver dependable, prompt and high-quality services. We continue to monitor our performance against these standards with the view to ongoing improvement and have highlighted some areas that issuers can help us in this regard.

A. Prospectus Filings

Technical deficiencies may delay the issue of a prospectus receipt and often result in additional communication between us, issuers and/or their advisors. We believe that most of these "errors" are avoidable and remind issuers and their advisors of the following:

- *Ensure that red herrings comply with legal requirements* - name each jurisdiction in which the prospectus is being filed, unless it is being filed in all jurisdictions (in which case "all provinces" or "all provinces and territories" is acceptable). We will ask an issuer to resubmit a prospectus which simply states "certain of the provinces/territories".

- *Ensure that the language on certificate pages complies with applicable requirements and the correct form of certificate page is used.*

- *Where appropriate, modify the section 7.2 letter required under National Policy 43-201 Mutual Reliance Review Systems for Prospectuses and Annual Information Forms* - section 7.2 requires an issuer to provide written confirmation of certain matters upon filing a preliminary prospectus. Specifically, paragraph 2(c) requires confirmation that an underwriter/agent/distributor "is registered or has filed an application for registration or an application for exemptive relief from the requirement to be registered" in each jurisdiction where securities will be offered to purchasers. This paragraph should only refer to "applications for registration or exemptive relief" where such applications have been made.

- *Ensure that auditor's comfort and consent letters refer to the correct date of the preliminary prospectus or prospectus.*

- *Do not file blacklined documents on SEDAR as "amendments"* - blacklined documents to reflect changes made to a document previously filed (other than the blackline of the final prospectus) should be filed on SEDAR under filing subtype "other correspondence". (see SEDAR Filer Manual s 9.7)

- *Do not file multiple subtypes under one submission on SEDAR* - filers often include several documents under a SEDAR subtype. For example, filers often file a first response letter together with other correspondence under the filing subtype category "other correspondence". Filers should file only one filing subtype under each submission. (see SEDAR Filer Manual s. 8.3(e))

- *Check off all appropriate procedures on SEDAR* - when filing a prospectus be sure to check off all appropriate filing procedures (i.e. NI 44-102 Shelf/MJDS/MRRS) before submitting the project.

- *Use appropriate SEDAR fee codes* - ensure that the SEDAR fee code corresponds with the filing type and description.

- *SEDAR Profiles* - keep issuers' profiles up to date (i.e. head office address, principal regulator and basis for determining principal regulator under MRRS).

B. Exemptive Relief Applications

Each year we receive and review applications for exemptive relief that contain deficiencies. These deficiencies often impede the processing of the application and may consequently delay the granting of the requested relief. The following are some of the steps that applicants can take to support the timely processing of their applications:

- *Ensure that timing constraints are promptly and clearly communicated to us* - in the event that an applicant requires expedited review of their application or otherwise has certain timing requirements, it is imperative that this is brought to our attention in the initial application package or as promptly as possible. Further, any requests with respect to timing should clearly convey to us the reasons for such request.

- *Respond to our requests* - the processing of an application is greatly assisted by the timely response by the applicant to our questions. Where an applicant knows that they will not be able to respond promptly, they are encouraged to inform us and, where possible, provide an anticipated response time.

- *Cite relevant precedent decisions* - to the extent possible, applicants should refer to relevant precedents in support of their request for relief. Where the requested relief is similar to previously issued decisions but includes deviations from the representations or conditions contained in the prior decisions, applicants are encouraged to highlight and provide explanations for those requested variations.

- *Ensure that the draft decision document is in the prescribed form* - applicants are reminded that National Policy 12-201 *Mutual Reliance Review System for Exemptive Relief Applications* specifies the forms for decisions rendered under MRRS and Multilateral Instrument 11-101 *Principal Regulator System*. Draft decision documents that do not conform to these requirements delay application processing.

- *Provide draft decision document in electronic format* - the application package should include an electronic copy of the draft decision document in Word format.