

# Allen & Allen Update on Securities Law

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## Approved:

### **Exempt Distribution Rule in Ontario - Amended**

Effective January 12, 2004, Ontario exempt distribution Rule 45-501 has been amended as follows:

The definition of "accredited investor" has been changed, so that:

- paragraph (q) includes brothers and sisters (of an officer, director or promoter of the issuer);
- paragraph (t) includes a limited liability company (with net assets of at least \$5 million);
- paragraph (w) includes a mutual fund or a non-redeemable investment fund that has previously distributed securities under a prospectus; and
- paragraph (y) includes trust corporations governed by the Trust and Loan Corporations Act (Canada) or under comparable legislation in any other jurisdiction.

The definition of "closely-held issuer" has been changed, so that:

- Former directors and officers do not count towards the limit of 35 non-accredited investors, regardless of how such directors and officers acquired their securities (formerly, they needed to acquire securities as compensation by, or under an incentive plan of, the issuer or an affiliated entity of the issuer)
- clause 2.1 (1)(b) has been deleted, which formerly restricted the use of the exemption in circumstances where a promoter is participating (formerly, no promoter could act as promoter of any other issuer in reliance on the same exemption during the last twelve months).
- section 2.8 clarifies that this exemption includes court-approved reorganizations under bankruptcy and insolvency legislation.
- a new section 2.15. This exemption allows trades in a security pursuant to an offer to acquire made by a person or company that would have been a take-over bid or issuer bid if the offer to acquire was made to a security holder in Ontario. This exemption will facilitate private company sales in circumstances where all of the selling shareholders are not resident in Ontario.
- a new section 2.16 allows for the purchase of "business assets" from a person or company if the fair value of the business assets purchased is not less than \$100,000. A new definition of "business assets" has been included in the Proposed Rule.

Part 7 has been amended to reflect the consequential amendments as a result of Rule 13-502 - Fees coming into force, and a new Part 9 has been added to provide the Director with the authority to grant exemptions from the requirements of Part 7 of the Proposed Rule, which deals with the required forms.

In addition to these proposed April 2003 amendments, there have been more recent clarifying amendments of a technical nature, as well as an amendment to paragraph 2.1(1)(a) to clarify the resale requirements applicable to security holders of a closely-held issuer.

The amendments do not address the more fundamental proposals outlined in the CSA's "Blueprint for Uniform Securities Laws for Canada".

### **Uniform four month Resale Rule to be in force March 30, 2004, with minor changes**

Minor changes have been made to proposed Multilateral Instrument 45-102, the Resale Rule, which is being adopted in all jurisdictions except Quebec, effective March 30, 2004.

Since November 2001, securities distributed under an exemption by a reporting issuer have been restricted from further trading for either four or twelve months, depending on whether the issuer is a "qualifying issuer". (A "qualifying issuer" is a reporting issuer or equivalent, who is an electronic filer under SEDAR, who has filed a current Annual Information Form, and who either has a class of equity securities listed or quoted on certain specified exchanges or markets, or outstanding securities that have received an approved rating.) With the introduction of new, harmonized, enhanced, continuous disclosure rules applicable to all reporting issuers (see 51-102 below), the CSA will eliminate the distinction between qualifying issuers and other reporting issuers, and impose a uniform four month hold.

### **New Continuous Disclosure Rule to be effective March 30, 2004**

The CSA expect the new Continuous Disclosure Rule 51-102 to be effective March 30, 2004. It will replace existing continuous disclosure obligations of reporting issuers, other than investment funds. It sets out requirements regarding financial statements, annual information forms, management discussion and analysis (MD&A), material change reporting, information circulars, proxies and proxy solicitation, restricted share disclosure, and other matters.

Companies with a fiscal year starting on or after Jan. 1, 2004 must report their first quarter interim financial statements earlier than before – within 45 days after the end of the quarter, reduced from the current 60 days. Only companies categorized as venture issuers (described below) will continue to have 60 days to file their interim reports. Venture issuers are not required to file an annual information form (AIF). MD&A must be prepared and filed according to the form prescribed by the new rule (Form 51-102F1) starting with first interim periods ending on or after March 31, 2004. The MD&A will have to be filed at the same time as the

financial statements. The regulators have also issued a notice indicating that issuers will have the option of filing their annual MD&A for fiscal years beginning before January 1, 2004 in the new form. If they do not use the new form for their annual MD&A, the first interim MD&A they file for fiscal years beginning on or after January 1, 2004 will have to contain all elements of the annual MD&A in Form 51-102F1.

A "venture issuer" means a reporting issuer that, as at the applicable time, did not have any of its securities listed or quoted on any of the Toronto Stock Exchange, a U.S.A. marketplace or a marketplace outside of Canada and the U.S.A.

### **Accounting Principles, Auditing Standards and Reporting Currency - National**

National Instrument 52-107, and its companion policy, will establish a harmonized set of accounting principles and auditing standards for preparing and auditing financial statements in filing a prospectus, continuous disclosure obligations, or otherwise required to be filed with the securities regulators.

### **Auditor Oversight Rule – to be accepted in all jurisdictions**

National Instrument 52-108 Auditor Oversight was first published for comment as a Multilateral Instrument. The BC Commission had been seeking further comment. BC has now decided to participate and the Instrument will take effect in all jurisdictions effective March 30<sup>th</sup> 2004.

Where a reporting issuer files its financial statements accompanied by an auditor's report, the Instrument will require the reporting issuer to have the auditor's report signed by a public accounting firm that is:

- a participant in the Canadian Public Accountability Board ("CPAB") oversight program for public accounting firms that audit reporting issuers (the "CPAB Oversight Program"), and
- in compliance with any restrictions or sanctions imposed by the CPAB.

Other than in Alberta, British Columbia and Manitoba, the Instrument will require a public accounting firm that prepares an auditor's report with respect to the financial statements of a reporting issuer to:

- be a participant in the CPAB Oversight Program;
- be in compliance with any sanctions or restrictions imposed by the CPAB, and
- provide notice, in certain situations, of any restrictions or sanctions imposed by the CPAB to their audit client and to the securities regulator in each jurisdiction in which the audit client is a reporting issuer.

## **Investor Confidence Rules in all jurisdictions effective March 30<sup>th</sup> 2004, except B.C.**

Multilateral Instrument 52-109 – “Certification of Disclosure in Issuers' Annual and Interim Filings”, and its companion policy and forms, is expected to come into force in all jurisdictions except British Columbia, effective March 30<sup>th</sup> 2004.

Chief executive officers (CEOs) and chief financial officers (CFOs) (or persons performing functions similar to a CEO or CFO) of all reporting issuers (including “venture issuers”), other than investment funds, will be required to personally certify that, among other things:

- their issuers' annual filings and interim filings do not contain any misrepresentations or omit to state any material facts;
- the financial statements and other financial information in the annual filings and interim filings fairly present the financial condition, results of operations and cash flows of their issuers for the relevant time period;
- they have designed disclosure controls and procedures and internal control over financial reporting (or caused them to be designed under their supervision);
- they have evaluated the effectiveness of such disclosure controls and procedures and caused their issuers to disclose their conclusions regarding their evaluation; and
- they have caused their issuers to disclose certain changes in internal control over financial reporting.

The filings required to be certified by CEOs and CFOs (or persons performing functions similar to a CEO or CFO) include: annual information forms; annual financial statements; annual MD&A; interim financial statements; and interim MD&A.

The Materials do not require a report of management on an issuer's internal control over financial reporting or auditor attestation on management's assessment of an issuer's internal control over financial reporting as envisaged by subsections 404(a) and (b) of the Sarbanes-Oxley Act of 2002 (SOX). The Securities and Exchange Commission (the SEC) recently adopted rules to implement the requirements of section 404. {1} As a separate initiative, the CSA are currently developing a proposed instrument which will require a report on management's assessment of an issuer's internal control over financial reporting. The CSA are also evaluating the extent to which auditor attestation of such reports should be required.

### **Audit Committee amendments for all jurisdictions effective March 30<sup>th</sup> 2004, except B.C.**

Multilateral Instrument 52-110 – “Audit Committees”, and its companion policy is expected to come into force in all jurisdictions except British Columbia, effective March 30<sup>th</sup> 2004.

The Instrument requires that every reporting issuer have an audit committee to which the issuer's external auditor must directly report. In addition, every audit committee must be responsible for:

- overseeing the work of the external auditor engaged for the purpose of preparing or issuing an audit report or related work;
- pre-approving all non-audit services to be provided to the issuer or its subsidiary entities by the issuer's external auditor; and
- reviewing the issuer's financial statements, MD&A, and annual and interim earnings press releases before they are publicly disclosed by the issuer.

Every audit committee must recommend to the board of directors the external auditor to be nominated for the purpose of preparing or issuing an auditor's report (or any related work), as well as the compensation to be paid to the external auditor.

The Instrument also establishes composition requirements for audit committees. Every audit committee must have a minimum of three members, and each member must be financially literate and independent. A member is independent if the member has no direct or indirect material relationship with the issuer. A material relationship is defined as a relationship that could, in the view of the issuer's board of directors, reasonably interfere with the exercise of a member's independent judgement. In addition, certain categories of persons are considered to have a material relationship with the issuer.

Venture issuers are from the requirements of Parts 3 (Composition of the Audit Committee) and 5 (Reporting Obligations) of the Instrument. As a result, the members of a venture issuer's audit committee are not required to be either independent or financially literate; however, venture issuers must provide, on an annual basis, the alternative disclosure required by Form 52-110F2. The Instrument also contains an exemption for issuers who are U.S. listed issuers.

## **Non-GAAP earnings measures must be clearly defined and not misleading - CSA Staff Notice**

The Canadian Securities Administrators (CSA) have issued a notice to provide guidance to issuers who disclose financial measures other than those prescribed by Generally Accepted Accounting Principles ("GAAP"). This notice supersedes Staff Notice 52-303 dealing with non-GAAP earnings measures.

Issuers are expected to clearly define any non-GAAP financial measure and to explain its relevance. Issuers presenting non-GAAP financial measures should present those measures on a consistent basis from period to period. Specifically, issuers should:

1. state explicitly that the non-GAAP financial measure does not have any standardized meaning prescribed by GAAP and is therefore unlikely to be comparable to similar measures presented by other issuers;
2. present with equal or greater prominence than the non-GAAP financial measure the most directly comparable measure calculated in accordance with GAAP;
3. explain why the non-GAAP financial measure provides useful information to investors and how management uses the non-GAAP financial measure;
4. provide a clear quantitative reconciliation from the non-GAAP financial measure to the most directly comparable measure calculated in accordance with GAAP, referencing to the reconciliation when the non-GAAP financial measure first appears in the disclosure document;
5. explain any changes in the composition of the non-GAAP financial measure when compared to previously disclosed measures.

In staff's view, it is not appropriate to present non-GAAP financial measures in the GAAP financial statements. Also, non-GAAP financial measures should not reflect adjustments for items identified as non-recurring, infrequent or unusual, when a similar charge or gain is reasonably likely to occur within the next two years or occurred during the prior two years. CSA Staff Notice 52-306

## Proposed:

### **Offering Memorandum and "qualifying issuer" amendments - proposed in all provinces except Ontario and Quebec.**

MI 45-103 permits "qualifying issuers", previously defined in MI 45-102, to use a shorter form of offering memorandum and to incorporate by reference an annual information form (an "AIF"). However, revised MI 45-102 no longer contains the concept of a "qualifying issuer" and therefore the definition of "qualifying issuer" in MI 45-103 is amended to refer to continuous disclosure documents filed under NI 51-102. In summary, to be a "qualifying issuer" under MI 45-103 the issuer

- must be a reporting issuer and SEDAR filer, and
- have filed an AIF, management's discussion and analysis ("MD&A") and annual financial statements under NI 51-102, and
- have complied with any applicable continuous disclosure obligations under National Instrument 43-101 Standards of Disclosure for Mineral Projects and National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities.

Under NI 51-102, venture issuers are not required to file AIFs. However to become a "qualifying issuer" under MI 45-103 a venture issuer must voluntarily file an AIF under NI 51-102.

There are other technical amendments to the Instrument. It will be effective March 30, 2004

### **CSA Release Proposed Uniform Securities Legislation**

The Canadian Securities Administrators (CSA) have released consultation drafts of legislation that proposes uniform securities laws, as part of the CSA's Uniform Securities Legislation (USL) Project. The CSA began this project in March of 2002 with the objective of developing uniform securities legislation within two years.

The drafts consist of a Uniform Securities Act and a Model Securities Administration Act. The Uniform Securities Act contains the core substantive provisions of securities law. The Model Securities Administration Act contains the procedural components of securities laws and is a companion to the Uniform Securities Act based on the law of Alberta. Each jurisdiction will prepare its own administration act based on this model.

The draft Uniform Securities Act and Model Securities Administration Act are the CSA's legislative proposals. They have not been reviewed or approved by any provincial or territorial government. Comments on the proposal are requested by March 16, 2004.

## **OSC Supports Call for Single National Securities Regulator**

The Ontario Securities Commission (OSC) supports the Wise Persons' Committee's (WPC) call for a single national securities regulator. (The Finance Minister of Canada appointed the Committee of "Wise Persons" to consider a national approach to securities regulation.)

"I'm certain it is no surprise that we support the call for Canada to move to a single securities regulator," said OSC Chair David Brown in a news release. Mr. Brown indicated that the OSC will review the report in detail before commenting on any specific issues and recommendations contained in the report. OSC News Release, December 17, 2003

## **New Corporate Governance Instrument proposed - Multilateral**

All securities regulators, except British Columbia and Quebec, have proposed new corporate governance standards. Proposed Multilateral Policy 58-201 "Effective Corporate Governance" and proposed Multilateral Instrument 58-101 "Disclosure of Corporate Governance Practices" would apply to all reporting issuers, other than investment funds, issuers of asset-backed securities, designated foreign issuers, SEC foreign issuers, certain exchangeable security issuers and certain credit support issuers.

Multilateral Policy 58-201 would encourage issuers to adopt best practice standards, including:

- maintaining a majority of independent directors on the board of directors (the **board**)
- holding separate, regularly scheduled meetings of the independent directors
- appointing a chair of the board who is an independent director, or where this is not appropriate, appointing a lead director who is an independent director
- adopting a written board mandate
- developing position descriptions for directors and the chief executive officer
- providing each new director with a comprehensive orientation, as well as providing all directors with continuing education opportunities
- adopting a written code of business conduct and ethics
- appointing a nominating committee composed entirely of independent directors
- adopting a process for determining what competencies and skills the board as a whole should have, and applying this result to the recruitment process for new directors
- appointing a compensation committee composed entirely of independent directors
- conducting regular assessments of board effectiveness, as well as the effectiveness and contribution of each board committee and each individual director

Multilateral Instrument 58-101 would require an issuer to SEDAR file its corporate governance practices and code of ethics. If a code of ethics is not adopted, the issuer must explain why. Similarly, if an independent compensation or nominating committee is not adopted, the issuer must explain why.

“Venture issuers” would only be required to disclose the specific items in Form 58-101F2. Comments are due April 15, 2004

### **BC, Alberta and Quebec studying corporate alternative Corporate Governance Practices**

BC, Alberta and Quebec commissions are considering whether securities regulators can or should try to determine the corporate governance practices and policies that are appropriate for all issuers. As stated in BC notice 2004/09:

“...while MP 58-201 indicates that issuers may flexibly apply the best practices, the format of the required disclosure in MI 58-101 could put pressure on issuers to adopt those practices whether or not they are appropriate for them. Rather than entering into a debate about what constitutes best practices, the Commissions are examining an alternative approach that would simply require issuers to disclose existing corporate governance practices without suggesting, explicitly or implicitly, what those practices should be.

“Various institutional investors, industry associations and coalitions, management consulting firms, exchanges and other securities regulatory bodies in North America and elsewhere have published or adopted divergent codes and guidelines. The Commissions question whether adding another package of "best practices" and applying them to more than 4,000 reporting issuers in Canada could have undesired side effects on the transparency of corporate governance practices and the overall behaviour of issuers in this regard.”

### **Insider Bid, Issuer Bid, Going Private and Related Party Transactions - further amendments proposed by Ontario Commission**

The OSC published proposed amendments to Rule 61-501 -- *Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions* (the "Rule") on February 28. The amendments were primarily intended to clarify grey areas, reduce applications for exemptive relief, make the Rule more “user friendly”, and reduce issuer costs that are not outweighed by securityholder benefits, particularly for junior issuers.

As a result of comments received, the OSC is proposing new amendments, some of which are:

1. Change in the definition of "collateral benefit". The 10% ownership exception is to be changed to a different materiality threshold that takes into account the significance of the benefit in relation to the consideration the related party recipient would receive in the main transaction.
2. The 2003 proposed Rule introduced a formal valuation exemption for issuers that were not listed or quoted on specified markets, including the Toronto Stock Exchange and the major U.S. markets. To further relieve junior issuers from regulatory burdens that may outweigh the benefits, a new minority approval exemption has been introduced for related party cash financing transactions of \$2.5 million or less, for issuers not listed or quoted on the same markets.
3. The definition of "insider bid" has been expanded in the new proposals to include a bid where the offeror was an insider of the offeree issuer (or had a similar connection with the offeree issuer, as described in the current definition) within 12 months preceding the bid. This change was made partly to prevent avoidance of the Rule (by, for example, resigning from the board of the offeree issuer shortly before launching a bid).

Comments received by February 11, 2004 will be considered.

## **Securities Regulators Propose Mutual Fund Governance Regime**

The Canadian Securities Administrators (CSA) has proposed National Instrument 81-107 for mutual funds. Under the proposed rule, each mutual fund manager would be required to establish an independent review committee (IRC) for its funds. The IRC would be charged with reviewing all matters involving a conflict of interest between the fund manager's own commercial and business interests and its fiduciary duty to manage its mutual funds in the best interests of those funds. These conflicts will include transactions with entities that are related to the manager, trades between mutual funds, certain changes which currently require an investor vote (referred to as fundamental changes), and situations when a reasonable person would question whether the manager is in a conflict of interest situation.

Where there is a conflict of interest, the fund manager must refer the matter to the IRC and obtain its recommendation. The manager would be allowed to proceed even where the IRC does not agree, but must disclose the IRC's position and the reason for not following the IRC's recommendations to the fund's unitholders.

The existing self-dealing and conflict of interest prohibitions in the Securities Act and National Instrument 81-102 Mutual Funds (NI 81-102) would be repealed, and the discretion of the IRC would effectively replace the prohibitions. The requirement for a securityholder vote on certain changes would be replaced by consideration of the matter by the IRC.

The proposed rule focuses on two of the three areas of reform described in the Concept Proposal 81-402: fund governance and product regulation. The proposed rule does not elaborate on the registration regime for mutual fund manager because a number of policy initiatives with a registration component are currently underway. These include the USL project, the OSC Fair Dealing Model, the BCSC Model, and the CSA's Registration Passport System. Public comment is due April 9, 2004

### **National Registration Database changes to allow for a principal regulator filing system**

The Canadian Securities Administrators (CSA) are publishing for comment proposed *National Instrument 31-101 -- Requirements under the National Registration System*, together with its companion policy.

Under the proposed Rule, a firm filer or individual filer may register with the National Registration System in any Canadian jurisdiction solely under the rules of its principal regulator. The principal regulator for a firm filer is determined by an analysis of connecting factors as set out in the National Policy Statement. For individual filers, the principal regulator is the regulator for the jurisdiction in which the individual filer's working office is located. The non-principal regulators are the regulators in the other jurisdictions where the firm or individual wishes to be registered.

The principal regulator will review the application for registration in accordance with its securities legislation requirements regarding suitability for registration (also known as fit and proper requirements). The non-principal regulators will rely on the principal regulator's review to accept or refuse the application. When the non-principal regulators opt in to the principal regulator's decision on registration, the filers will be exempt from the fit and proper requirements of the non-principal regulator. The filer will only have to satisfy the fit and proper requirements of the principal regulator.

Comments due no later than March 30, 2004.

### **CNQ seeking recognition as a stock exchange in Ontario**

The Ontario Securities Commission (OSC) recognized the Canadian Trading and Quotation System Inc. (CNQ) as a quotation and trade reporting system (QTRS) on February 28, 2003. CNQ is now applying for recognition as a stock exchange, pursuant to section 21 of the Act.

CNQ is a private Ontario corporation originally formed to own and operate an electronic marketplace for Ontario investment dealers to trade non-exchange listed equity securities of Ontario reporting issuers. CNQ is a new marketplace primarily for small issuers. It commenced trading operations on July 25, 2003.

CNQ is making the application to be recognized as a stock exchange so that issuers traded on CNQ will automatically become reporting issuers in Ontario upon acceptance to trading. As a QTRS, quoted issuers do not automatically become Ontario reporting issuers and those that are not must make separate application to the OSC. CNQ has indicated that this is an impediment to quotation.

CNQ is proposing to repeal section 1.1 of Policy 2, as previously amended. That section currently provides that only issuers that are reporting issuers under the securities legislation of Alberta, British Columbia, Ontario or Quebec are eligible for quotation on CNQ. In connection with their application for recognition as a stock exchange, CNQ is proposing that there be no limitations on which issuers are eligible for listing on CNQ. Staff are considering whether there should be limitations on eligibility for listing on CNQ, to ensure there is an existing disclosure record prior to listing, and request comments on this specific issue. .

**Please call if you have any questions - 416-865-0303**

## ALLEN AND ALLEN

**WILLIAM ALLEN:** A graduate of the University of Toronto, Bill was called to the Bar in 1954. He later obtained a Masters of Law (LL.M.) from Osgoode Hall. He has lectured for the Canadian Bar Association and the Law Society of Upper Canada. He is the author of the Estate Planning Handbook (with three editions, published in 1985, 1991 and 1999) and has worked in the area of securities law since the early 1960s.

**JOHN ALLEN:** A graduate of law from Queen's University, John was called to the Bar in 1991, clerked with the Ontario Superior Court, and has a Masters of Law in securities law from Osgoode Hall. He is a graduate of the "Canadian Securities Course", "Financial Planning Course", and is a Certified Financial Planner (CFP). He is also the author of a monthly securities "Netletter" available only on Quicklaw ([www.quicklaw.com](http://www.quicklaw.com)), a fee-based legal database service.