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Update on Ontario Securities Commission Staff Notice 51-720 — *Issuer Guide for Companies Operating in Emerging Markets*

By Michael Feder, Rene R. Sorell, and Caroline Zayid
McCarthy Tetrault LLP, Vancouver

The Ontario Securities Commission (OSC) recently issued Staff Notice 51-720, *Issuer Guide for Companies Operating in Emerging Markets* (the Guide).[1] The Guide should be of interest to all companies that have operations or business in China (or any other emerging market) and that are listed on a Canadian exchange. It should also be of interest to officers and directors of such companies.

In March 2012, the OSC published Staff Notice 51-719, *Emerging Markets Issuer Review*, following a review of Ontario reporting issuers listed on Canadian exchanges with significant business operations in emerging markets (emerging market issuers).[2] The purpose of the review was to assess the quality and adequacy of the issuers' compliance with disclosure and other regulatory requirements, as well as the adequacy of the gatekeeper roles played by auditors, underwriters, and the exchanges.

The OSC identified several changes required to address the concerns outlined in the review. On November 9, 2012, the OSC published the Guide. The Guide is aimed at providing detailed guidance to emerging market issuers.

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Editor-in-Chief:

Lazar Sarna
4473 rue Ste Catherine Ouest
Montréal, Québec
H3Z 1R6
Phone: (514) 842-4550
E-mail: lsarna@sprint.ca

LexisNexis Editor:

Alexander Wiebe
LexisNexis Canada Inc.
Tel.: (905) 479-2665 ext. 334
Fax: (905) 479-2826
E-mail: csflr@lexisnexis.ca

More specifically, the Guide highlights eight key areas that should be considered by emerging market issuers and their directors and management. The Guide also sets out questions that should be considered by directors and management when deciding how to address risks of doing business in emerging markets. Lastly, the Guide outlines the OSC's expectations for directors and management regarding compliance with existing disclosure requirements.

EIGHT AREAS OF RISK FOR EMERGING MARKET ISSUERS

1. Business and Operating Environment

The Guide recognizes that Canadian directors of an emerging market issuer may have limited knowledge and experience regarding its operating environment. An issuer's board and management must have a thorough understanding of the company's political, cultural, legal, and business environments. Therefore, they must be cognizant of the need to exercise additional diligence to close any knowledge gap. Regardless of the location of its operations, an issuer is required to adhere to Canadian regulatory requirements. Issuers must ensure that their directors and management have the appropriate orientation to and training on Canadian capital markets' requirements.

A company is required to describe its business and operations. The disclosure should:

- highlight those operating conditions applicable to the company as a result of operating in an emerging market; and
- capture issues, risks and characteristics unique to operating in the emerging market.

2. Language and Cultural Differences

The board of an emerging market issuer should include members who have appropriate experience in the emerging market. One challenge is that the language and culture of the emerging market may be different from those of North America. Boards should devise appropriate practices, such as the use of an independent translator, to overcome these language and cultural barriers. Boards should also be careful about placing full reliance on local management or local board members who are not independent of the company.

3. Corporate Structure

The Guide recognizes that in emerging markets there may be important reasons to use complex corporate structures, such as (i) structures with multiple layers and numerous subsidiaries and (ii) control through a special purpose entity. However, boards should consider the risks that may flow from complex structures, such as obscuring the misappropriation of assets or other fraudulent activities. Boards should assess whether a simpler structure could also achieve the company's objectives.

The disclosure of an emerging market issuer should:

- contain a clear description of a company's structure, and an explanation of how the structure facilitates the company's business and aligns with the parameters of its operating environment;
- describe the risks associated with the structure and how the risks are managed;
- include a diagram depicting the corporate structure with the narrative disclosure; and
- explain how that structure is necessary or desirable given the company's operating environment.

4. Related Parties

Related party transactions (RPTs) may represent a heightened risk for emerging market issuers. Boards should ensure that policies and procedures are in place to identify, monitor, and independently evaluate and approve RPTs. Boards should also ensure that the company complies with Form 51-102F1.[3] In addition, certain RPTs are subject to Multilateral Instrument 61-101,[4] which requires a formal valuation and minority shareholder approval.

Companies are required to disclose the review and approval process adopted by the board and the special committee involved, as well as the material factors on which directors relied in assessing the fairness of the transaction. Issuers are also expected to consider the materiality of RPTs (see Item 13 of Form 51-102F2). Comprehensive disclosure encompassing both quantitative and qualitative information is essential for investors to understand and evaluate RPTs. To achieve that goal, a company should disclose:

- the relationship and identity of the related person or entities;
- the business purpose of the transaction;
- the recorded amount of the transaction and the measurement basis used; and
- any ongoing contractual or other commitments resulting from the transaction.

5. Risk Management and Disclosure

Boards should be sensitive to any risks associated with operations in a particular emerging market and how they impact operations. Boards are required to ensure that they have a sufficient understanding of the legal, regulatory, political, and cultural risks. These risks should be evaluated in the context of the particular emerging market. Boards should recognize that certain risk analysis and mitigation techniques that may be appropriate in the North American context may be less effective in emerging markets.

Boards should ensure that sufficient information about the risks associated with operating in an emerging market is disclosed to investors and that such disclosure is entity-specific. The disclosure should also:

- where the issuer or its operating entities are domiciled in a foreign jurisdiction, explain the risks to investors' ability to exercise statutory rights and remedies under Canadian securities law;
- describe the process used by the board to oversee the risk management process; and
- where appropriate, describe the company's risk management strategy and the systems that management has in place to manage and mitigate the risks of operating in emerging markets.

6. Internal Controls

It is challenging for board members who reside in Canada to oversee a company whose operations are located in an emerging market. The time, language, and cultural differences can make communication difficult and may affect the accuracy and timeliness of financial reporting. The unique risks of operating in an emerging market magnify the importance of strong internal controls.

The audit committee of the board should actively oversee the monitoring of any identified weaknesses in internal controls, as well as the risks they create for the company. The audit committee and the board should also oversee the timely remediation of weaknesses and, in the interim, the mitigation of the related risks. When the effectiveness of internal controls is in doubt or ongoing material weaknesses are present, the audit committee should exercise a higher degree of skepticism when reviewing a company's filings.

The disclosure should be entity-specific and contain information expected by regulators as discussed in Companion Policy 52-109CP. Transparency is important when a company identifies material weaknesses in internal controls over financial reporting (ICFR). The disclosure should allow its readers to understand:

- each of the internal processes or functions that contain a material weakness and its nature;
- the implications of each material weakness on financial reporting and on the company's ICFR; and
- details of any mitigating factors and remediation plan.

7. Use of and Reliance on Experts

Companies operating in emerging markets may hire experts, such as tax or legal professionals, to assist with complex matters arising in the foreign jurisdiction. However, boards should keep in mind that industry professionals in emerging markets may not be subject to the same rules of professional conduct as they would be in Canada. Therefore, credentials and specialized knowledge of experts in emerging markets should be evaluated to see if they are similar to what would be expected in Canada. In addition, boards should evaluate the level of diligence exercised by experts.

In certain circumstances, companies required to file an AIF under securities law must disclose the names of experts and all of an expert's interests in the company. Boards should ensure disclosure of experts' interests is adequate and provides sufficient detail for investors. The disclosure should also:

- identify all experts, both in Canada and in the company's foreign operations, who have been named in or referred to in a continuous disclosure filing;
- identify the report prepared by or certified by the expert and make reference to the continuous disclosure document that contains the report; and
- quantify all registered or beneficial interests held by, received by, or to be received by the expert in any securities or other property of the company.

8. Oversight of the External Auditor

Pursuant to National Instrument 52-110, a company's audit committee is directly responsible for overseeing the work of the external auditor, including the resolution of any disagreements between management and the external auditor regarding financial reporting. The audit committee is required to determine if the company's external auditors have the appropriate expertise and experience to carry out the audit.

The audit committee of an emerging market issuer should take into consideration factors relating to the auditor's competence, experience, and qualifications in the foreign market. The committee should also enquire about and evaluate the external auditor's approach in auditing the areas that present risks specific to the company, and understand how the auditor obtained sufficient audit evidence in these areas of risk. In addition to formal meetings, the committee should maintain informal and continuous communication with the auditor. "In-camera" sessions (meetings without the presence of management) with the auditor are also beneficial. Furthermore, the committee must pay particular attention to any signs of delay in the audit schedule or unusual management intervention in the audit process.

When an auditor resigns, directors are expected to consider whether the reasons for the auditor's resignation should also be disclosed even if they do not represent a reportable event, so that investors have full access to pertinent information about the company.

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1 The Guide provides a list of matters that a company should consider in order to evaluate each of the eight identified areas of risks.

2 As indicated in OSC Staff Notice 51-719, OSC staff focused on issuers with the following characteristics when conducting the review of selected emerging market issuers:
- issuers whose mind and management are largely outside of Canada; and
- issuers whose principal active operations are outside of Canada, in regions such as Asia, Africa, South America and Eastern Europe.

3 Form 51-102F1, *Management's Discussion and Analysis*.

4 Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transaction*.

Model Behaviour: Rules for Derivatives Product Determination, Trade Repositories

Shahen A. Mirakian and
Ryan Walker, student-at-law,
McMillan LLP, Toronto

On December 6, 2012, the Canadian Securities Administrators OTC Derivatives Committee (the "CSA Committee") published CSA Staff Consultation Paper 91-301, *Model Provincial Rules–Derivatives: Product Determination and Trade Repositories and Derivatives Data Reporting*. The consultation paper delineates the scope of the contracts and instruments that must be reported to trade repositories (the "Scope Rule") and sets out requirements for the designation and operation of trade repositories and the mandatory reporting of derivatives trade data (the "TR Rule").

The TR Rule is based on the recommendations relating to derivatives trade repositories and reporting set out in *CSA Consultation Paper 91-402 – Derivatives: Trade Repositories* ("CSA Paper 91-402").[1] The Scope Rule was initiated as a result of comments by interested parties indicating a need for a uniform definition of "derivative" for regulatory purposes. These are the first two model rules in a series that will implement Canada's G-20 commitments in respect of OTC derivatives regulation.

These new requirements have been published as model rules, rather than as National Instruments, since legal frameworks for derivatives regulation differ across Canadian jurisdictions. The model rules were drafted based on the Ontario *Securities Act* (the "OSA")[2] and other jurisdictions will be required to make changes to fit their respective regimes.

The model rules have been published for comment, following which the CSA Committee will recommend appropriate revisions, Local regulators will publish their own versions for comment prior to implementation. The goal of the CSA Committee is that each jurisdiction implement the substance, if not the exact text, of the rules.

THE SCOPE RULE

The OSA broadly defines a "derivative" as "an option, swap, futures contract, forward contract or other financial or commodity contract or instrument whose market price, value, delivery obligations, payment obligations or settlement obligations are derived from, referenced to or based on an underlying interest (including a value, price, rate, variable, index, event, probability or thing)".[3] The definition excludes commodity futures contracts and options,[4] contracts ordered by the Ontario Securities Commission (the "OSC") not to be derivatives, and contracts or instruments prescribed not to be derivatives by regulation.[5] Other provinces are seeking to include definitions of "derivative" in their securities acts.[6]

Recognizing that it may not be appropriate for every instrument caught by the OSA definition to be governed by rules requiring counterparties to report derivative trades to trade repositories (e.g., because an instrument may be caught by both the rules governing "derivatives" and those governing "securities"), the CSA Committee has, through the Scope Rule, prescribed the following not to be derivatives for the purposes of the TR Rule:

- contracts or instruments regulated by federal or provincial gaming control legislation;
- insurance or annuity contracts issued by licensed insurers;
- spot FX contracts, where physical delivery of the currency must be made or taken within two days, the contract or instrument cannot be rolled over, and cash settlement is not permitted;
- contracts or instruments that are evidence of bank or credit union deposits; and
- contracts or instruments for spot or deferred delivery of a "physical commodity", other than cash or currency, where physical delivery of the commodity must be made or taken and cash settlement is not permitted.[7]

The CSA Committee indicates that "financial commodities such as currencies, interest rates, securities and indexes" would not be considered physical commodities.

The CSA Committee further lists contracts or instruments that, since they are not "derivatives" under the OSA, would not be captured by the TR Rule. They include:

- consumer contracts or instruments to purchase products or services at a fixed, capped or collared price;
- guarantees and performance bonds;
- contracts or instruments representing lending arrangements relating to building an inventory of assets in anticipation of securitizing such assets; and
- commercial contracts or instruments containing mechanisms indexing purchase price or payment terms for inflation (e.g., by reference to an interest rate).

Under the Scope Rule, contracts or instruments that fit the OSA definition of "derivative", but are also "securities" under the OSA solely because they are "investment contracts" or "options", are prescribed not to be securities for the purposes of the Scope Rule, and are thus subject to the TR Rule.

All other contracts or instruments falling under both the OSA definitions of "derivative" and "security" are prescribed not to be derivatives, and thus not subject to the TR Rule. Structured notes, asset-backed securities, exchange-traded notes, capital trust units, exchangeable securities, income trust units, securities of investment funds and warrants are examples of such instruments. They would remain subject to prospectus and continuous disclosure rules and dealer and adviser registration requirements, as applicable.

The Scope Rule also excludes from the ambit of the TR Rule contracts or instruments used by issuers or their affiliates (i) solely to compensate employees or service providers; or (ii) as financing instruments, where the underlying interest is stock of the issuer or affiliate. Examples of compensatory interests covered by these exclusions include stock options, restricted share units, deferred share units and phantom stock units. A financing instrument must have been issued to raise capital in order for it to be excluded under this provision.

Although the Scope Rule would initially apply only to the TR Rule, the CSA Committee expects that with appropriate alterations, it will eventually apply to existing derivatives provisions and future rules.

THE TR RULE

The TR Rule sets out: (i) the general requirements that must be met by a trade repository to be "designated" by a local authority, as well as operational requirements for such repositories; and (ii) the requirement on counterparties to report derivatives transactions to designated trade repositories ("DTRs"). The CSA Committee has put forth the TR Rule in an effort to enhance transparency and promote the public interest in the derivatives market, and to provide data that will both permit regulators to accurately assess risk and guide them in formulating policies.

1. Trade repository designation and operational requirements

The OSA permits the OSC to designate a person or company who proposes to carry on business as a trade repository in Ontario.[8] The TR Rule requires that prospective DTRs be designated by the regulator.

In order to become a DTR an applicant must provide information sufficient to demonstrate that: (i) designation would be in the public interest; (ii) it is, or will be, in compliance with securities law; and (iii) it has appropriate written rules, policies and procedures.

The CSA Committee anticipates that local regulators will consider numerous factors in considering whether an applicant has demonstrated that designation would be in the public interest, including: (i) whether the DTR has sufficient financial and operational resources; (ii) whether its rules and procedures foster fairness and efficiency in the capital markets and improve transparency in the derivative markets and; (iii) whether it has appropriate policies and systems in place to ensure derivatives data are kept secure and confidential.

Additional applicant requirements are derived from the propositions in the April 2012 *Principles for financial market infrastructures* report of the Bank for International Settlements and the International Organization of Securities Commissions (the "PFMI Report").[9] DTRs may be expected to "observe or broadly observe" all relevant principles in the PFMI Report, even though the TR Rule does not expressly address some of them.

Foreign trade repositories

Although the TR Rule requires all trade repositories to be designated in order for counterparties to use them, the CSA Committee recommends that regulators grant exemptions to foreign trade repositories if they are in compliance with "equivalent" regulatory and oversight regimes in their home jurisdictions.

2. Derivatives data reporting

The OSA provides the OSC with the ability to regulate "the listing or trading of publicly traded securities or the trading of derivatives, including rules…requiring the reporting of trades and quotations".[10] In addition, an amendment to the OSA, passed by the legislature but not yet in force, will allow the OSC to prescribe "requirements relating to derivatives", including "record keeping, reporting and transparency requirements".[11] The TR Rule requires that "derivatives data" for each transaction be reported to a DTR or, if there is no appropriate DTR, to the local securities regulator.

Transactions involving "entering into, assigning, selling or otherwise acquiring or disposing of a derivative" or the novation of a derivative must be reported. "Derivative" is defined in the Scope Rule. This is largely similar to the proposals in CSA Paper 91-402.

Reporting counterparties

The TR Rule states that where one counterparty is a derivatives dealer and the other is not, the dealer bears the reporting obligation. In all other situations, both counterparties are responsible for ensuring that the necessary information has been reported to a DTR, unless the two agree in writing that only one of them will be the reporting counterparty. The CSA Committee recommends this in order to avoid "duplicative reporting".

Regardless, if the counterparty that is required or selected to report to a DTR is not a "local counterparty" (e.g., not a reporting issuer or registrant of the local jurisdiction, or did not negotiate or execute any part of the transaction in the local jurisdiction), and it fails to fulfill the reporting obligation, the local counterparty must report all relevant data. A reporting counterparty may delegate the reporting function, but it retains the ultimate responsibility for ensuring such reporting obligation is fulfilled.

Data to be reported

The reporting counterparty is required to report "derivatives data" to a DTR. Derivatives data consist of creation, life-cycle and valuation data.

Creation data, which must be reported upon the execution of a trade, include, among other things, basic operational information (including whether the transaction was cleared and whether a broker was used), the material terms of the transaction, and the identity of the counterparties.

Life-cycle data consist of changes to creation data and must be reported when such changes arise.

Valuation data consist of the current value of the trade as well as the date and type of valuation. For cleared transactions, valuation data must be reported at the end of every business day. For non-cleared transactions, valuation data must be reported at the end of every business day if the transaction involves a derivatives dealer, and not later than 30 days after a calendar quarter for reporting counterparties that are not derivatives dealers.

Local counterparties are also required to maintain records of derivatives data for the lifetime of the derivative and for seven years thereafter.

When to report

A reporting counterparty is required to make a report in real time, unless it is not "technologically practicable" to do so, in which case the report must be made as soon as technologically practicable and not later than the end of the business day after the event.

Unique identifiers

The TR Rule requires that reporting counterparties include three "identifiers" with their reports. The "legal entity identifier" ("LEI") identifies the counterparties using the standards set out in the Global Legal Entity Identifier System (the "System").[12] If the System is not available to a counterparty at the time it must make a report, the DTR must assign it a substitute LEI until the counterparty is assigned an LEI pursuant to the System.

Additionally, the "unique transaction identifier", delineates individual trades and is assigned by the DTR. Finally, the "unique product identifier", is assigned to each transaction based upon its "taxonomy" and need not be provided if international or industry standards for such identifiers are not available at the time the reporting obligation arises.

Pre-existing derivatives

Data on derivatives contracts outstanding on the date the rule comes into force must be reported to a DTR not later than 365 days thereafter. However, pre-existing derivatives that expire or terminate within that period need not be reported.

Access to data

The TR Rule requires DTRs to provide local regulators with "direct, continuous and timely electronic access" to data, as well as to fulfill *ad hoc* data requests. DTRs are also required to provide transaction counterparties with access to all relevant derivatives data.

The public's access to derivatives data is restricted under the TR Rule. DTRs must periodically provide aggregate transactional data to the public. They must also provide the principal economic terms of each reported transaction to the public no later than one day after receiving them if the reporting counterparty is a derivatives dealer or two days thereafter in all other cases. DTRs may not disclose the identities of counterparties to the public.

The time delays on public disclosure apply to all transactions, regardless of their size, and there would appear to be no explicit provision for publication delays specifically on particularly large "block trades", as proposed in CSA Paper 91-402.

Exemptions

While local regulators are given room for discretion in granting exemptions to the TR Rule, the rule specifically provides that a local counterparty need not report physical commodity transactions that would otherwise be subject to a reporting obligation if the party has less than $500,000 "notional value" under all outstanding derivatives contracts. If the other counterparty's total derivatives notional value is above the threshold, it must report the required data. This exemption applies to the requirement to report data to trade repositories but not to other aspects of the TR Rule, such as the requirement to maintain derivatives data.

EFFECTS OF THESE PROPOSALS

The rules described above represent a serious and tangible step toward bringing derivatives markets into the daylight. The requirements set out in these rules are meant to implement regulatory oversight in the derivatives markets while not placing undue burden on market participants. Accordingly, the CSA Committee has signaled flexibility, particularly by encouraging local regulators to grant exemptions for foreign-based trade repositories facing an equivalent regime at home. Only time will tell whether the rules have brought regulators closer to their goal without frustrating the market in the process.

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1 See Canadian Securities Administrators, *CSA Consultation Paper 91-402 – Derivatives: Trade Repositories* (23 June 2011). See also McMillan LLP Derivatives Law Bulletin "Reporting for Duty: Canadian Regulators Publish Framework for OTC Derivatives Trade Reporting and Repositories" (June, 2011).

2 R.S.O. 1990, c. S.5.

3 OSA, s. 1.

4 In Ontario, this exclusion is supposed to exempt exchange-traded derivatives from the Scope Rule (and, consequently, the Trade Repositories Rule). However, it is not clear if, or how, listed options which are not "commodity futures options" would be excluded from the Scope Rule.

5 OSA, s 1.

6 By the CSA Committee's admission, the proper implementation of the Scope Rule in a jurisdiction will require that jurisdiction to adopt a definition of "derivative" that is "substantially similar" to those already used.

7 Contracts or instruments where cash settlement was used in the event of a legitimate default or force majeure event preventing physical delivery do qualify for this exclusion.

8 OSA at s. 21.2.2(1).Other jurisdictions will be required to take steps to include a similar provision in their securities or derivatives legislation.

9 Bank for International Settlements and International Organization of Securities Commissions, *Principles for financial market infrastructures* (April 2012).

10 OSA, s. 143(1), para 11(ii). Other jurisdictions' securities legislation will be required to include such powers. As noted above, the OSC may also designate trade repositories in Ontario – see OSA, s. 21.2.2(1).

11 OSA, s. 143(1), para 35(ii) (not in force).

12 As noted by the CSA Committee, the System is being created and implemented under the supervision of the Financial Stability Board. Endorsed by the G-20, it is anticipated that the System will become operational in March 2013.