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Current Developments: Canadian Securities and Auditing Matters

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Canadian Securities and Auditing Matters

This edition provides a summary of newly effective and forthcoming regulatory and auditing matters in Canada from July 1, 2017 to September 30, 2017.

Canadian Securities: New guidance

Disclosure Reviews

In July 2017, the Canadian Securities Administrators (CSA) announced in Staff Notice (SN) 51-351 *Continuous Disclosure Review Program Activities for the fiscal year ended March 31, 2017* that it will announce the results of its continuous disclosure review program on a biennial basis instead of annually. The CSA noted that the disclosure considerations published in the prior year are still very relevant and encouraged reporting issuers to continue to apply the guidance in CSA Staff Notice 51-346 *Continuous Disclosure Review Program Activities for the fiscal year ended March 31, 2016*.

In September 2017, the Ontario Securities Commission (OSC) released SN 51-728 *Corporate Finance Branch 2016-2017 Annual Report*. Compliance outcomes for full continuous disclosure reviews are noted below (issuers can appear in more than one category):

Outcome	2017	2016
Prospective	72%	57%
Refilings	16%	22%
Education and awareness	2%	15%
Enforcement Referral / Default List	5%	0%
No action	5%	6%

The results of issuer oriented reviews tend to be less comparable depending on the focus from year to year.

The staff notice highlighted the following matters in Part B: Compliance of the Annual Report with respect to Management's Discussion and Analysis (MD&A):

- change in accounting policies including initial adoption – the need to provide increasingly detailed qualitative and quantitative disclosures about the expected impacts of new standards as the effective date approaches (e.g. IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers*, and IFRS 16 *Leases*);
- results of operations – the need to provide increased depth of analysis beyond the percentage change or amount of the various factors that affect revenues and expenses;
- risks and uncertainties – the need for specificity about the material risks and its potential impact and the need to update risk disclosures when circumstances change; and
- liquidity and capital resources – the need to discuss material cash requirements / working capital needs, how these will be met, and how they relate to future business plans and milestones.

Other matters highlighted included non-GAAP measures, forward-looking information, social media disclosures (see SN 51-348), mining disclosures related to preliminary economic assessments, investment entities disclosures (see SN 51-349), the adoption by venture issuers of new quarterly highlights and executive compensation disclosures, disclosures of cyber security risks and incidents (see SN 51-347) and disclosure about women in boards and in executive officer positions (see SN 58-308).

With respect to prospectuses, some of the matters the staff highlighted in the notice include:

- disclosure improvements needed with respect to the description of the business and regulatory environment, risk factors related to the business and/or offering, MD&A disclosure in a long form prospectus, and the use of proceeds;
- inappropriately concluding that an acquisition is an asset acquisition when under securities law it is a business acquisition;
- the need for issuers to consider whether additional disclosure beyond the prescribed forms is needed for a prospectus to have full, true and plain disclosure when an issuer is raising proceeds for a significant acquisition that will make up a material portion of its business;
- the need for three years of history of the primary business in an initial public offering (IPO) (two years for IPO venture issuer);
- the need for an IPO issuer to have an appropriate audit committee in place no later than the receipt of the final prospectus; and
- the need to file material contracts (other than those in the ordinary course of business) on which the business is substantially dependent on SEDAR.

Other topics addressed in the Annual Report in Part B: Compliance included Special Purpose Acquisition Reports, the Exempt Market, Exemptive Relief Applications, Insider Reporting and Designated Rating Organizations.

Part C: Responsive Regulation addresses Exempt Distribution Reporting, Proposed Foreign Issuer Resale Exemption, Distribution of Securities Outside of Ontario, Syndicated Mortgages, Climate Change Related Disclosure and Reducing Regulatory Burden for Non-Investment Fund Reporting Issuers.

Cryptocurrency Offerings

In August 2017, the CSA released SN 46-307 *Cryptocurrency Offerings* to provide guidance regarding what obligations may arise under securities laws when completing offerings such as initial coin offerings (ICO), initial token offerings (ITO) and sales of securities of cryptocurrency investment funds. The staff observed of the ICO/ITO offerings reviewed to date, in many instances they have concluded that the coins/tokens offered constitute securities for the purposes of securities laws because they represent investment contracts. Staff also observed that many of the products may also be derivatives and subject to derivative laws adopted by the CSA, including trade reporting rules.

The staff notice:

- responds to requests from financial technology (fintech) businesses for guidance on the applicability of securities laws to cryptocurrency offerings and what staff will consider in assessing if an ICO/ITO is a distribution of securities;
- discusses what steps fintech businesses can take if they are raising capital through ICOs/ITOs, so that they comply with securities laws;
- highlights issues that fintech businesses looking to establish cryptocurrency investment funds should be prepared to discuss with staff;
- discusses how the use of cryptocurrency exchanges may impact staff's review of ICOs/ITOs and cryptocurrency investment funds; and
- explains how the CSA Regulatory Sandbox can help fintech businesses with cryptocurrency offerings comply with securities laws through a flexible process which allows firms to register and/or obtain exemptive relief from securities law requirements under a faster and more flexible process than through standard application, in order to test their products, services and applications throughout the Canadian market on a time-limited basis.

Adoption of T+2 Settlement Cycle

In September 2017, the *Amendments to National Instrument 24-101 Institutional Trading Matching and Settlement* came into force shortening the settlement cycle for equity and long-term debt market trades from three days to two days to align with changes made in the United States.

Also in August 2017, the CSA announced *Amendments to National Instrument 81-102 Investment Funds* and a consequential amendment to *National Instrument 81-104 Commodity Pools* and provided guidance to address conventional mutual funds which were not covered in the NI 24-101 amendments. These amendments were drafted to allow adoption at the same time as the NI 24-101 amendments although they are not expected to come into force until November 14, 2017.

Protection of Minority Security Holders in Special Transactions

In July 2017, a Multilateral Instrument (MI) *SN 61-302 Staff Review and Commentary on Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions* was issued by Ontario, Quebec, Alberta, Manitoba and New Brunswick.

The SN outlines the transaction review approach of these regulators and shares their views with respect to:

- the role of boards of directors and/or special committees of independent directors in negotiating, reviewing and approving or recommending material conflict of interest transactions; and
- disclosure obligations that enable security holders to make informed decisions to vote or tender in favour of proposed material conflict of interest transactions.

Material conflict of interest transaction refers to insider bids, issuer bids, business combinations and related party transactions defined in MI 61-101 that give rise to substantive concerns as to the protection of minority security holders (being security holders that are not an interested party in the transaction).

Amendments to Registration Requirements

In July 2017, the CSA released Amendments to National Instrument 31-103 Registration Requirements, Exemptions and On-Going Registrant Obligations and Related Instruments.

The amendments were grouped by the regulator into four buckets:

- custody amendments,
- exempt market dealer (EMD) amendments,
- client relationship model amendments; and
- house-keeping amendments.

The custody amendments enhance custody requirements applicable to registered firms that are not members of the Investment Industry Regulatory Organization of Canada (IIROC) or the Mutual Fund Dealers Association of Canada (MFDA) (collectively, Non-SRO Firms). IIROC member firms and MFDA member firms will comply with the custodial regimes of IIROC or MFDA. The custody amendments address potential intermediary risks when Non-SRO Firms are involved in the custody of client assets, enhance the protection of client assets, and codify existing custodial best practices of Non-SRO Firms.

The exempt market dealer amendments clarify the activities that may be conducted under the EMD category of registration in respect of trades in prospectus qualified securities.

The client relationship model amendments make permanent certain temporary relief granted to IIROC and MFDA members to client reporting requirements on the condition that they comply with IIROC and MFDA requirements.

The amendments, other than the custody amendments, will come into force on December 4, 2017 assuming the necessary ministerial approvals are obtained. The custody amendments come into force June 4, 2018.

Annual Summary Report for Dealers, Advisers and Investment Fund Managers

In July 2017, the OSC released SN 33-748 *Annual Summary Report for Dealers, Advisers and Investment Fund Managers*.

The notice covers the following matters:

- outreach to registrants;
- registration of firms and individuals;
- information for dealers, advisers and investment fund managers;
- acting on registrant misconduct;
- key policy initiatives impacting registrants; and
- additional resources.

Applications for Registration

In July 2017, the CSA issued SN 33-320 *The Requirement for True and Complete Applications for Registration* to alert stakeholders to the serious problem of false or misleading applications for registration, to caution them about the potential consequences of submitting such applications, and to provide guidance regarding the completion of the application form.

An applicant's suitability for registration is determined with reference to three criteria: integrity, proficiency and solvency. If the application contains false or misleading information then it is a red flag that the applicant may be lacking in integrity. False or misleading statements made during the application process may also constitute a provincial or criminal offence. The notice emphasizes that carelessness or misunderstandings are not satisfactory explanations for non-disclosure then provides examples of typical areas where incorrect interpretations have been made by applicants.

Canadian Securities: Proposed guidance

Designated Rating Organizations

In July 2017, the CSA released *Proposed Amendments to National Instrument 25-101 Designated Rating Organizations* and proposed amendments to other securities rules that refer to designated rating organizations (DROs). The proposed amendments relate to DROs and credit ratings of DROs.

The CSA is proposing to amend NI 25-101 to reflect new requirements for credit rating organizations in the European Union (EU) that must be included by June 1, 2018 in order for (a) the EU to continue to recognize the Canadian regulatory regime as "equivalent" for regulatory purposes in the EU and (b) credit ratings of a Canadian office of a DRO to continue to be used for regulatory purposes in the EU. The amendments will also reflect new provisions in the March 2015 version of the IOSCO Code of Conduct Fundamentals for Credit Agencies (the IOSCO Code) of the International Organization of Securities Commissions (IOSCO).

Amendments are also proposed to recognize the credit ratings of the Kroll Bond Rating Agency, Inc. which has filed an application for designation as a DRO. The CSA intends to recognize their credit ratings but only in certain circumstances for issuers of asset-backed securities.

Comments were due by October 4, 2017.

Auditing Matters

Auditor Reporting Model

More insight and transparency

The International Auditing and Assurance Standards Board (IAASB), has issued new requirements on auditor reporting.

Without changing the scope of an independent audit, these requirements open the door for the auditor to give users more insight into the audit and improve transparency.

In April 2017, the Auditing and Assurance Standards Board (AASB) in Canada approved the new and revised auditor reporting standards as Canadian Auditing Standards (CASs) effective for periods ending on or after December 15, 2018.

Highlights of the new auditors' report in Canada include re-ordering the contents of the auditors' report (opinion first), expanded descriptions of responsibilities, disclosure of engagement partner's name (listed entities) and description of key audit matters (KAMs) (applicable only when required by law or regulation or when the auditor is engaged to do so).

U.S. developments

In June 2017, subject to SEC approval, the Public Company Accounting Oversight Board (PCAOB) adopted their enhanced auditor reporting standards which includes, among other requirements, discussion of critical audit matters (CAMs) (similar to KAMs) and tenure of the auditor.

Highlights and effective dates of the new U.S. standards are:

- New auditors' report format, tenure and other information: audits for fiscal years ending on or after December 15, 2017;
- Communication of CAMs for audits of large accelerated filers: audits for fiscal years ending on or after June 30, 2019; and
- Communication of CAMs for audits of all other companies: audits for fiscal years ending on or after December 15, 2020.

Impact to Foreign Private Issuers in Canada

Auditors of foreign private issuers (FPIs) are trying to address whether they can still issue a "combined" report (which most FPIs in Canada issue today) that meets both the CAS and PCAOB standards for 2017 year-end engagements and 2018 year-end engagements, when the revised CAS reporting standards are effective.

Determining the feasibility of a "combined" report is currently under review by the AASB. At this time, the major accounting firms in Canada have tentatively concluded that a combined report is possible and we believe the AASB will also conclude the same shortly. However, even if the firms and the AASB conclude that a combined report is possible, the matter of having a combined report will require the approval of the SEC and PCAOB, which may take until the fall of 2017. At this time, it is uncertain whether the SEC and PCAOB will approve a combined report. If the SEC and PCAOB determine that a combined report is not possible, auditors of FPIs may need to consider whether issuing only a report under PCAOB standards is appropriate for their needs or whether they will need to issue two reports; one referring to the CASs and one referring to the standards of the PCAOB.

The way forward in Canada

The AASB, working alongside the regulatory bodies, continue to deliberate how the disclosure of KAMs will be required to listed entities in Canada given the recent developments in the U.S.

Auditing Accounting Estimates and Related Disclosures

The IAASB has issued an exposure draft on ISA 540 (Revised). Significant changes in how auditors evaluate accounting estimates and related disclosures have been proposed.

This proposed standard:

- enhances requirements for risk assessment procedures to include specific factors related to accounting estimates, namely complexity, judgment, and estimation uncertainty;
- sets a more detailed expectation for the auditor's response to identified risks related to accounting estimates, including augmenting the auditors' application of professional skepticism; and
- is scalable regardless of the size or sector of the business or audit firm.

Numerous stakeholders have submitted comment letters in regards to the exposure draft to the IAASB expressing concerns over how to operationalize this new standard.