

NOVEMBER 2012

- 1 *OSC Staff Notice 51-720 – Issuer Guide for Companies Operating in Emerging Markets*
- 2 Contact Us

OSC Staff Notice 51-720 – Issuer Guide for Companies Operating in Emerging Markets

By Corrine M. Fiesel

On November 9, 2012 the Ontario Securities Commission published *Staff Notice 51-720 – Issuer Guide for Companies Operating in Emerging Markets* (the “**Guide**”). The Guide is based upon a prior review by the OSC of the adequacy of disclosure and regulatory compliance by 24 issuers, representing more than 50% of the 46 emerging market issuers for which Ontario is the principal regulator, which resulted in the publication of *Staff Notice 51-719 – Emerging Markets Issuer Review* dated March 20, 2012 (the “**Review**”). The Review focused on issuers with the following characteristics:

- mind and management are largely outside of Canada; and
- the principal active operations are outside of Canada, in regions such as Asia, Africa, South America and Eastern Europe.

The Review identified four main areas of concern with respect to these emerging market issuers (“**EMIs**”):

- **Corporate Governance Practices** – The OSC found deficiencies in the level of engagement by boards and audit committees in the oversight of management, and in the extent of knowledge of these bodies of the cultural and business practices of the jurisdictions in which the EMIs operated.
- **Corporate Structures** – The OSC found in many cases that the complexity of certain corporate structures that were put in place was neither clear nor necessary to support the underlying business model of the EMIs and that the quality of controls in place to

manage the risks arising from such complex structures was lacking.

- **Related Party Transactions** – The OSC became concerned with the extent and frequency of related party transactions amongst these EMIs and the quality of the management and board processes put in place to identify and approve these transactions, as well as the lack of clarity in the disclosure made about the transactions.
- **Risk Management and Internal Controls** – Many risks were not appropriately identified, understood or managed by the boards of these EMIs and risk disclosures were often incomplete and lacked clarity.

The OSC recognizes in the Guide the unique challenges that boards and management of EMIs face in truly understanding an EMI's business and operating environment; time zones, language, location of key books and records and cultural differences, for example, may make communication particularly complicated for such issuers. However, recognizing that all Canadian reporting issuers, regardless of where they are located or their operating environment, must comply with Canadian regulatory requirements, the Guide attempts to provide assistance to EMIs and their directors and management in meeting the level of standards expected in Canadian capital markets.

The Guide identifies eight areas for the directors and officers of EMIs to consider and offers disclosure tips and examples designed to assist such companies and their boards in assessing risks and complying with Canadian securities laws. However, while these eight areas are considered by the OSC to be especially relevant to EMIs, the Guide seems intended to encourage directors and management of all issuers to review the discussion and issues raised in the context of their businesses as they review generally the potential areas of risk they face.

The eight identified areas, and some of the OSC's commentary relevant to each, are as follows:

1. Business and Operating Environment

A company's board and management must have a thorough understanding of the political, cultural, legal and business environments of the company. Canadian directors of EMIs may have limited knowledge and experience regarding the operating environment of the company and must therefore be aware of the need to exercise additional diligence to close any knowledge gaps that may exist. An EMI's disclosure should sufficiently highlight those operating conditions that are applicable to the company as a result of operating in an emerging market, which means capturing the issues, risks and characteristics unique to operating in the market, and providing both a factual description and analysis of these risks and issues and how they affect operations.

2. Language and Cultural Differences

It is important that the board of an EMI include members that have appropriate experience in the emerging market in order to properly identify risks associated with the foreign jurisdiction. However, heavy reliance upon board members local to the emerging market jurisdictions to deal with language and cultural differences can raise issues of independence. Boards should devise appropriate policies to deal with these risks such as the use of independent translators, and the appointment of independent directors with an understanding of the emerging market environment, as well as develop mechanisms to obtain input from outside sources when needed.

3. Corporate Structure

While there may be important regulatory reasons in emerging market environments to establish complex corporate structures – such as impediments to foreign ownership or control – boards should consider the risks that may flow from such complexities, such as obscuring the misappropriation of assets or other fraudulent activities, or conveying a false impression of

financial performance or condition. An EMI's disclosure should provide a clear description of the corporate structure, including a diagram, explain how that structure facilitates (or hinders) the conduct of the company's business, explain how that structure is necessary or desirable given the company's operating environment, and describe the risks associated with the structure and how the board specifically monitors and addresses those risks.

4. Related Parties

While related party transactions should be of concern to all issuers, the OSC points out in the Guide that they can present a heightened risk to EMIs due to differences in cultural norms and business practices. An EMI, for example, may be owned or controlled by a small group of individuals or a family, with management and the board dominated by these same individuals. Circumstances in which the majority shareholders' interests are favoured over those of the minority in an EMI's ongoing operations may not be seen to be outside of the norm by non-independent management. The Guide recommends that an EMI's disclosure should specifically identify the related parties and their relationship with the company or its principals, include both quantitative and qualitative information that is necessary for an investor to understand the business purposes and economic substance of the related party transactions, discuss the nature, role, impact, benefits and risks of related party transactions in conducting business in the emerging market environment, indicate how the company's structure may impact its use of related party transactions, and describe the company's processes and procedures for identifying, evaluating and approving related party transactions.

5. Risk Management and Disclosure

Boards of EMIs should not only be knowledgeable of the risks associated with their markets but should view these risks and the appropriate options for mitigating the risks outside of a North

American cultural framework. A sufficient understanding of the legal, regulatory, political and cultural risks impacting the company and appropriate risk analysis and knowledge of mitigation techniques are required. An EMI's disclosure should not only identify the specific risks applicable to the company but provide sufficient details for investors to understand the nature of the risks and what the risks mean to the company's operations, indicate the board's responsibility for oversight and management of risks, and describe the methods used by the board to oversee the risk management process.

6. Internal Controls

Communication breakdowns between EMI board members that reside in Canada and local management can readily occur due to the differences in time zones, language and culture. Strong internal controls can provide checks and balances on the local operations to reduce the risks of financial and other reporting. The audit committee of the board, in particular, should actively oversee the monitoring of any identified weaknesses in internal controls, as well as the risks they create for the company. An EMI's disclosure should describe each of the internal processes or functions that contain a material weakness and the implications of these weaknesses, along with mitigating factors and detailed remediation steps taken by management.

7. Use of and Reliance on Experts

EMIs may hire industry professionals or experts with specialized knowledge to assist with complex matters arising in foreign jurisdictions. Such professionals may not be subject to equivalent rules of professional conduct or standards of care in the local jurisdiction to those that would apply in Canadian markets, and boards therefore need to carefully assess the quality of the advice provided and their ability to rely on such advice.

8. Oversight of the External Auditor

EMI boards should take into consideration factors relating to an external auditor's competence, experience and qualifications in the foreign jurisdiction. Canadian auditors may not have the language skills, cultural knowledge or experience with the accounting and tax rules of foreign jurisdictions, and likewise domestic auditors may not have the understanding of the requirements of North American capital markets.

Communication between domestic and foreign auditor offices may be complicated by these factors. In the OSC's view, it would be beneficial for audit committees of EMIs to maintain frequent informal communications with the audit engagement team and to obtain information regarding the audit on a real-time basis, in addition to formally meeting with the auditor at the planning and completion states. Particular attention should be paid to any signs of delay in the schedule or unusual management intervention in the process.

All reporting issuers in Canada, regardless of location in the world, are expected to comply with Canadian reporting and regulatory requirements. Given the unique challenges that boards and management of EMIs face in operating in emerging market environments, the OSC recommends that extra measures be taken to ensure that the interests of the investing public are protected. The Toronto Stock Exchange and TSX Venture Exchange are currently finalizing additional guidance to address risks associated with listing EMIs. This will include clarification of the expectations of issuers and the advisory community. The exchanges expect to publish these new requirements some time later this month.

Contact Us

This article contains a summary only of some of the main points in the Review and Guide. For further information or assistance in developing a governance and disclosure plan for an EMI or determining how the Guide may apply to your

business, contact:

Bill Gilliland: bill.gilliland@fmc-law.com; (403) 268-6826 or

Corrine Fiesel: corrine.fiesel@fmc-law.com; (403) 268-6349.

For further information, please contact a member of our [National Securities | Corporate Finance Group](#).