British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Nova Scotia Securities Commission

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April 12, 2005

Dear Sirs/Mesdames:

Proposed Repeal and Replacement of National Instrument 44-101 Short Form Prospectus Distributions

I am enclosing our response to the proposed changes to this instrument. We believe the significant enhancements made in 2004 to the continuous disclosure requirements provide an appropriate foundation for expanding access to the short form distribution system. We are pleased to see the CSA moving forward with integrating the enhanced continuous disclosure requirements into the short form prospectus contents, but see considerable room for improvement in the proposed approach to integrating the Business Acquisition Report requirements.

We strongly support the elimination of auditor's comfort letters on unaudited financial statements, but would like to see the CSA's recognition of the enhanced professional standards for an auditor's association with an offering document in CICA Handbook Section 7110 extended to eliminate requirements for a compilation report on pro forma financial statements. We also would like to see

section 4.4 of proposed NI 44-101 amended to accept the inclusion in the short form prospectus of the form of auditor's consent in CICA Handbook Section 7110 as satisfying the consent requirements that would otherwise apply under section 4.4.

We strongly object to including Canadian auditors within the scope of Item 15 "Interests of Experts" of Form 44-101 and Item 16 of Form 51-102F2 "Annual Information Form". Recent developments to establish oversight of auditors by the Canadian Public Accountability Board under NI 52-108 and by the audit committees of reporting issuers under NI 52-110, coupled with professional standards in CICA Section 5751 "Communications with Those Having Oversight Responsibility for the Financial Reporting Process" requiring an auditor to communicate at least annually to the audit committee on matters relating to auditor independence, more than adequately address the disclosure objectives of Items 15 and 16 of the short form prospectus and AIF forms, respectively, as they would otherwise apply to the auditors of the reporting issuer.

We would welcome any opportunity to discuss our responses with you in greater detail.

Yours very truly

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I. Response to Specific Questions

Proposed Qualification Criteria - Alternative A or Alternative B?

1. The changes reflected in Alternative A of Part 2 of Proposed NI 44-101 are necessary to update and harmonize Current NI 44-101 with the CD Rules and other regulatory developments. Alternative B, however, represents a significant broadening of access to the short form prospectus system. Do you believe this broadening of access is appropriate? What are your views on the proposed qualification criteria set out as Alternative B?

Response: We support broadening the access to the short form prospectus system. However, we are concerned about one major area in which the financial reporting needs to be enhanced for those issuers who qualify for and choose to access the short form prospectus system. There presently are no regulatory requirements for a reporting issuer to file restated annual financial statements for "Type A" subsequent events such as retroactive changes in accounting principles and discontinued operations. Absent any action on the part of Canadian securities administrators, these restatements will happen for the most part only when an issuer must obtain the auditor's consent in connection with a short form prospectus filing. The professional standards in CICA Handbook paragraph 7110.52 state: "When a Type A subsequent event requires restatement and/or additional disclosure in the audited financial statements…the auditor would not consent to the use of the auditor's report in the prospectus until the appropriate changes are made". In the context of a short form prospectus CICA Handbook paragraph 7110.57 states: "…it may not be possible to describe the required restatement adequately in the short form prospectus or in another document incorporated by reference. Accordingly it will be necessary for the entity to restate the financial statements". In similar circumstances SEC requirements do not permit financial statements requiring restatement to be included or incorporated by reference in a registration statement.[1] We believe similar requirements should be formally recognized in the Instructions to Form 44-101F1. We recognize this would create an inconsistency between the primary and secondary market financial disclosure requirements; however, the rapid pace of accounting change as world accounting standards continue

[1] Part I of Appendix C to the SEC Training Manual indicates audited restated financial statements "…must be furnished if a registrant is required to include its financial statements in a filing made under the Securities Act or Exchange Act that will be made effective subsequent to an event requiring retroactive restatement under GAAP." Requirements for restated financial statements are also embedded in certain SEC forms. For example, SEC Form F-3, Part I, Item 5(b)(ii) contains a requirement to include restated financial statements in the prospectus where an error or a change in accounting principles requires a material retroactive restatement.

to converge would place too great a burden on reporting issuers if they had to file restated annual financial statements after every retroactive accounting change.

From the inception of NI 44-101 until the implementation of NI 51-102 last year, an issuer accessing the short form distribution system was subject to an accelerated annual financial statement filing deadline. As it stands, Alternative B permits a venture issuer to access the short form distribution system without accelerating the financial statement filing deadlines. We believe a venture issuer that chooses to access the short form distribution system should be subject to a requirement to file its annual financial statements, annual MD&A and AIF within 90 days of its financial year end.

We also have some specific concerns about continuous distributions under the existing shelf prospectus procedures that could cause considerable uncertainty for the auditors of the issuers should the number of these distributions significantly increase as a result of broadened access to the short form distribution system. These concerns are addressed in our separate response to the proposed revisions to NI 44-102.

Other Aspects of the Proposed Rule

2. Is the requirement to deliver an undertaking of the issuer to file the periodic and timely disclosure of applicable credit supporters under paragraph 4.3(b)2 of Proposed NI 44-101 an appropriate response to our concern about the lack of adequate credit supporter disclosure in the secondary market? If not, why not? Please also suggest alternatives to this requirement.

We believe it is appropriate because in many cases, such as an issue of medium term notes of the Canadian subsidiary, the investor essentially is investing in unsecured debt of the guarantor.

3. Is each of the exemptions in Item 13 of Proposed Form 1 appropriate? If not, why not? Are there any other exemptions we should include? If so, why? Is each of the conditions to the exemptions in Item 13 of Proposed Form 1 necessary to ensure that investors have all the information they need to make informed investment decisions? If not, why not? Are there any other conditions we should include? If so, why?

From a financial information perspective, we don't believe the exemptions in Item 13 are appropriate. We already have national instruments designed to facilitate the direct offering of securities in Canada by foreign issuers – NI 71-102 and NI 52-107. In addition, certain U.S. issuers may benefit from the exemptions provided in NI 71-101. We are not convinced that comparable exemptions are warranted when the foreign parent company chooses to access our capital markets through a wholly-owned Canadian subsidiary. If the Canadian subsidiary has little or no operations, the investor in notes payable guaranteed by a foreign parent company essentially holds unsecured debt of the foreign parent. In contrast, if the Canadian subsidiary is a substantive operating entity,

the guarantee may be little more than a “sweetener” and the prospects of having to take recourse against the foreign guarantor may be extremely remote. We believe the investor should be provided with GAAP financial statements of the Canadian subsidiary to enable them to judge whether it is a conduit (i.e., an entity with no or minimal operations), a substantive operating entity with substantial borrowing capacity on its own merit, or something in between. The summary financial information described in Item 13 is too sparse to allow any meaningful financial analysis of the issuer’s financial position and results of operations. As an accommodation to a foreign parent company, the CSA should consider providing an option for the Canadian subsidiary to prepare its financial statements in accordance with accounting principles the foreign parent company would be eligible to use under NI 52-107.

We also have concerns for the form and content of the auditor’s report on the proposed summary financial information. We assume an auditor’s report will be required but this is not clear. The “summary financial information” cannot be properly described as “financial statements” and thus would not be subject to the general audit requirement for financial statements included in a prospectus. Since Item 13 obviously was drafted with a close eye on Rule 3-10 of Regulation S-X, we looked at the corresponding U.S. requirements and found that this information generally is required to be included in a note to the audited annual financial statements filed with the SEC, in which case the information in the note is covered by the auditor’s report. When consolidating information is presented outside of the basic financial statements, the U.S. auditor reports on it in accordance with paragraph 19 of AU 551 “Reporting on Information in Auditor-Submitted Documents”. This report provides an opinion that the information “…is fairly stated in all material respects in relation to the basic financial statements taken as a whole”. The SEC rules require the consolidating financial information to be presented in sufficient detail to allow investors to determine the assets, results of operations and cash flows of each of the consolidating groups. Given the substantial difference in the nature and extent of the consolidating financial information typically included in SEC filings and the proposed summary financial information, we are uncertain whether a U.S. auditor of a U.S. credit supporter would be able to opine that the summary financial information is “fairly stated”. In the case of a Canadian credit supporter we point out that (i) there are no Canadian professional standards for preparing consolidating information and (ii) the type of opinion expressed in paragraph 19 of AU 551 is not covered under Canadian GAAS.

It is our understanding that neither Rule 3-10 nor AU 551 requires an audit of the underlying financial statements of the subsidiary entities of the credit supporter. In contrast, instruction 1(c) to Item 13 requires the summary financial information of the subsidiary entities to be derived from financial statements of the subsidiary that are audited for the same periods that the parent company’s financial statements have been audited. This audit requirement alone is certain to render the exemptions useless to most multinational issuers.

4. Does Item 15 of Proposed Form 1 accomplish its objective, which is to ensure disclosure of any ownership interests that would be perceived as creating a potential conflict of interest on the part of an expert? If not, what changes should be made to the parameters?

Response: Including the auditors of the issuer within the scope of this Item is contradictory to the objective. The auditors of a reporting issuer are subject to:

- rigorous standards under the Rules of Professional Conduct of the various provincial institutes/ordre that prohibit the holding of any financial interests that could be seen as impairing their professional judgment or objectivity;
- the direct oversight of the Canadian Public Accountability Board ("CPAB") under NI 52-108;
- the direct oversight of the audit committee of the reporting issuer under NI 52-110; and
- the professional standards in CICA Handbook Section 5751 "Communications with Those Having Oversight Responsibility for the Financial Reporting Process", which require written communication to the audit committee, at least annually, on matters relating to the auditors' independence.

No other group of professionals typically involved with a prospectus filing is subject to such intensive independence requirements and regulatory oversight. The Canadian securities regulatory authorities have had significant input into the development of all of the foregoing requirements and we believe that auditors subject to the oversight of CPAB (or a comparable authority in the case of a foreign auditor) should be exempt from the scope of the disclosure requirements for interests of experts. If the CSA believes it is desirable for an auditor to confirm independence every time a reporting issuer files a prospectus, then they should work with the Auditing and Assurance Standards Board of the CICA to effect appropriate amendments to the professional standards in Section 5751 and/or Section 7110.

We assume that conforming changes will be made to Item 16 of Form 51-102F2.

General

5. Do you believe that issuers, investors or other market participants would benefit from the elimination of preliminary prospectuses and prospectus review? What are the principal benefits of such a system? Are there any potential drawbacks? Are you concerned about a lack of regulatory review in the context of a prospectus offering? Are you concerned that expediting the prospectus filing would put undue pressure on the due diligence process?

Response: We will not attempt to answer each of the questions posed above.

We believe the preliminary prospectus is a very important document in the marketing of a prospective distribution of securities. As a document filed on SEDAR it also contains information relevant to the secondary market trading of the securities of an existing reporting issuer. We support enhancing the stature of the preliminary prospectus by eliminating items that tend to give it the appearance of a "draft" document, such as the "red herring", the use of bullets, the inclusion of incomplete financial statements of entities that have yet to be constituted and the provisions for unsigned auditors' reports. The final prospectus as we know it today would become an amended prospectus reflecting matters such as the terms of the underwriting agreement, changes arising from the prospectus review process, updated financial statement disclosure, etc.

We believe the emphasis on harmonized continuous disclosure reviews as described in CSA Notice 51-312 warrants a reduction in, but not elimination of, the regulatory review of prospectus filings. We support a substantial broadening of the access to the short form distribution system, but would be concerned if the securities regulatory authorities concurrently eliminated prospectus reviews. The North American capital markets are in the process implementing substantial new and revised processes to rebuild investor confidence. In addition, time pressures are already tight for performing due diligence in short form prospectus offerings. A substantial increase in the number of eligible issuers could strain the limited human resources of the underwriters, legal counsel and auditors. Securities regulators should not let down their guard at this juncture. After a transition period of a couple of years we foresee the standard level of the regulatory review of prospectuses evolving into a targeted review of specific areas of interest arising from market developments, economic circumstances or new/changed requirements under Canadian securities legislation.

Qualification Criteria

6. If we eliminate the preliminary prospectus and prospectus review as contemplated above, do you think we should impose more onerous restrictions on this offering system, given the lack of regulatory review at the time of the offering? Such restrictions could include additional qualification criteria and restrictions, such as the following:

- *a one year seasoning requirement to ensure eligible issuers have filed required CD for a minimum period and to allow for regulators to review such CD;*
- *a prohibition from offering securities if the regulator has identified significant unresolved issues relating to the issuer's CD; and*
- *a restriction on types of eligible securities to disallow securities which may not be supported by the issuer's CD.*

Do you think these are appropriate?

Response: We believe some restrictions would be absolutely necessary and appropriate. We do not believe a "blanket" prohibition from offering securities is justified where there significant unresolved issues relating to the issuer's CD. This is best addressed as it is today with the standard caution in

the regulator's CD letters noting the possible impact unresolved issues may have on a future prospectus filing. The facts and circumstances need to be assessed on a case-by-case basis, taking into consideration the nature and complexity of the issues. Obviously, if a possible misrepresentation is involved, the issuer and its professional advisers will want to work diligently towards a timely resolution.

II. Comments on Other Specific Matters

1. Form 44-101F1 Item 6 - Earnings Coverage Ratios

We note and support the changes "…to clarify the requirements and the transition year expectations where there has been a change in year end". However, in our view there is a greater need to provide clarification that will ensure uniform interpretation and calculation of the earnings coverage ratios. In surveying practice in this area we have identified two significantly different methods of calculating earnings coverage ratios. One method is the "all interest" method, whereby all interest expense is added back to pre-tax earnings for purposes of the numerator, and all interest requirements are included in the denominator. The second method is the "long-term debt interest" method, whereby only the interest on long-term debt is added back to pre-tax earnings for purposes of the numerator, and only the interest requirements on long-term debt are included in the denominator.

We believe the different interpretations of the existing guidance are due to inconsistencies in the wording of the instructions to Item 6. Instructions (2), (3), (6) and (7) make no reference to "long-term" debt or interest thereon, whereas Instruction (4) and the new Instruction (5) clearly refer to or contemplate only the inclusion of long-term debt or interest thereon.

The existence of two widely-used methods makes it impossible to base comparisons based solely on the calculated coverage ratios. A simple example can illustrate the potentially significant differences.

> Issuer A has $200 million of current bank indebtedness bearing interest at 6% and $50 million of long-term debt bearing interest at 8%. A summary of its earnings is as follows:
>
> | | |
> |---|---|
> | Earnings before interest and taxes | $44 |
> | Interest on bank indebtedness | (20) |
> | Interest on long-term debt | (4) |
> | Earnings before income taxes | 20 |
> | Income taxes | (8) |
> | Net earnings | 12 |
>
> Earnings coverage – "all interest" = 44/24 = **1.8 times**.
>
> Earnings coverage – "long-term debt interest" = 24/4 = **6.0 times**.

Based on published materials we have seen, an issuer's capacity to meet its interest obligations is best indicated by including all interest requirements in the earnings coverage calculation. When NI 44-101 was implemented the CSA expressly rejected the "prior deduction method" because investors might falsely interpret the higher ratio as indicating less risk. The 6.0 times coverage calculated in the above example similarly provides an undue degree of "comfort" as to the ability of the Issuer A to meet its interest requirements.

The clear affirmation of the "all interest" method in the revised Form 44-101F1 would eliminate the need for new Instruction (5) because the ability of an issuer to meet its interest requirements is not impacted by the classification of debt as current or non-current. We encourage the CSA to consult with financial analysts to confirm the superiority of the all interest calculation and to obtain and provide further guidance on dealing with computational matters such as seasonal borrowings, equity method investments, and non-controlling interests.

2. Form 44-101 Item 11 - Documents Incorporated by Reference

Integration of Business Acquisition Reports in the Short Form Distribution System

The proposed approach to integrating a Business Acquisition Report ("BAR") filed under NI 51-102 into the short form prospectus diminishes the historical importance placed on pro forma financial statement in Canadian prospectuses and falls significantly short of the comparable SEC requirements. We believe an issuer should be required to include updated pro forma financial statements in subsequently filed short form prospectuses and that the pro forma financial statements should reflect all significant acquisitions made during the current and immediately preceding financial years.

In the U.S. an SEC registrant must update the pro forma financial information in a subsequently filed registration statement even if the financial statements of the acquired business do not require updating. **[8.029 of DPP Guide]** This is comparable to the existing Canadian requirements.

> For example, assume Issuer A files a BAR on July 5, 20X4 containing pro forma income statements for the year ended December 31, 20X3 and the three months ended March 31, 20X4. Under the existing Canadian and SEC rules a prospectus filed on December 15, 20X4 requires an updated pro forma income statement for the nine months ended September 30, 20X4. This statement should be deemed to supersede the pro forma income statement for the three months ended March 31, 20X4 included in the BAR. Also, the pro forma balance sheet as at March 31, 20X4 included in the BAR should be deemed to be superseded by the unaudited balance sheet as at September 30, 20X4 which presents the actual accounting effects of the acquisition.

> Further, a prospectus filed on April 10, 20X5 should require an updated pro forma income statement for the year ended December 31, 20X4. This updated pro forma statement should supersede all previous pro forma financial statements related to that acquisition included in previously filed documents incorporated by reference in the short form prospectus.

The impact of the lack of updated pro forma financial information is compounded in circumstances where multiple significant acquisitions have occurred in the current and immediately preceding financial years. Pro forma financial statements under SEC rules reflect the effects of all of the significant acquisitions in this period on a combined basis (with note disclosure of the individual transactions) or on a disaggregated basis. **[8.019]** Under the proposed revisions to NI 44-101 financial analysts and other interested parties will be left to compile their own updated pro forma income statements when considering the financial information included or incorporated by reference in a short form prospectus. Among other things, this will require a guess as to the "stub period" operating results of the acquired businesses between the date of the most recent financial statements of the business in the BAR and the acquisition date.

A practical drawback to the approach in the proposed Instrument is that any interim pro forma financial statements in a BAR is likely to contain a column derived from the issuer's interim financial statements that may not have been reviewed by the issuer's auditors at the time the BAR was filed. The professional standards in CICA Handbook Section 7110 would require the auditors to review the underlying interim financial statements for this period in addition to reviewing any more recently filed interim financial statements of the issuer included or incorporated by reference in the prospectus. Updating pro forma financial statements for purposes of the prospectus would provide better information and would be supported by the financial statements of the issuer included or incorporated by reference in the prospectus.

We acknowledge our recommendation would create an inconsistency between the continuous disclosure system and the prospectus system. One way of mitigating this inconsistency would be to amend the pro forma financial statements requirements in NI 51-102 to require them to reflect, in addition to the acquisition that is the subject of the BAR, all significant acquisitions made during the periods covered by the audited and unaudited pro forma income statements of the issuer included in the BAR, to the extent not already reflected in the underlying historical statements.

Compilation Reports on Pro Forma Financial Statements

Last fall the AICPA International Practices Task Force discussed whether Canadian compilation reports should be permitted to be included in SEC filings. SEC Staff indicated they would follow up with appropriate Canadian regulators, but we are unaware of the outcome of any further discussions. Revisions to Canadian securities legislation to eliminate the requirement for a compilation report on

pro forma financial statements are long overdue. While appropriate assurance standards exist for an auditors' examination of pro forma financial statements, even under the high standards of the U.S. capital markets the perceived benefits of obtaining auditors' reports on pro forma financial statements consistently have not warranted the costs of such assurance.

By proposing to eliminate the auditors' comfort letter on unaudited financial statements, the CSA displays its willingness to rely on the professional standards in CICA Handbook Section 7110 applicable to the unaudited financial statements included in a prospectus. We strongly encourage the CSA to eliminate the requirements for any report (compilation or otherwise) on pro forma financial statements for the same reasons.

3. 44-101CP Subsections 1.8(7) and 2.6(4) – Successor Issuer

The example using a portion of the business that was "spun-off" is helpful. Consider expanding it to cover a "reverse spin-off" where, in accordance with the substance of the transaction, the entity legally spun-off should be considered to be the successor issuer (for more information on reverse spin-offs see EITF 02-11).