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June 30, 2005

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Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Nova Scotia Securities Commission
Office of the Attorney General, Prince Edward Island
Superintendent of Securities, Government of Newfoundland and Labrador
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice,
Government of Northwest Territories
Registrar of Securities, Legal Registries Division,
Department of Justice, Government of Nunavut

c/o John Stevenson
Secretary
Ontario Securities Commission
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c/o Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
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Montréal, Québec H4Z 1G3

Dear Sirs/Mesdames:

Re: Proposed Multilateral Instrument 52-111—Reporting on Internal Control over Financial Reporting

This is our firm's response to the request for comment on proposed Multilateral Instrument 52-111, *Reporting on Internal Control over Financial Reporting* (the **"Internal Control Rule"**), Companion Policy 52-111CP (the **"Companion Policy"**), and the proposed amendments to Multilateral Instrument 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings* (the **"Certification Rule"** and, together with the Internal Control Rule and Companion Policy, the **"Proposals"**) published on February 4, 2005 by the securities regulatory authorities of Alberta, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland and Labrador, Yukon, Northwest Territories and Nunavut.

PART A - GENERAL OPPOSITION TO THE PROPOSALS

U.S. Experience

Much has been written about the *Sarbanes-Oxley Act of 2002* ("S-Ox") and the experiences of U.S. public companies. It is generally observed that S-Ox was adopted by Congress in haste, and this has led to questions about whether some of the provisions of S-Ox were sufficiently considered by Congress. It is almost certainly the case that section 404 is one of those provisions.

Surveys have shown that although many U.S. public companies have seen value in the S-Ox section 404 process, most would agree that the costs have outstripped the benefits. Recently, the U.S. Securities and Exchange Commission and the Public Company Accounting Oversight Board have attempted to relax or modify the effects of section 404 (within the narrow authority given them in section 404) through guidance to assist public companies and their auditors. In addition, the Committee of Sponsoring Organizations of the Treadway Commission is now developing guidance that will help smaller businesses implement the COSO control framework and evaluate their internal controls.

The hope is that these initiatives will reduce the cost of compliance and achieve a balance between the costs and benefits of the exercise for these businesses.

Canada Should Achieve a Better Balance Between Costs and Benefits

We are, however, unconvinced at this stage that the guidance by the SEC, PCAOB and COSO will achieve the kind of balance—especially for smaller companies—that is sought. This concern, and the concern that section 404 may have been ill-considered by Congress, leaves us unsure whether section 404 was appropriate for the world's largest capital markets. Given that uncertainty, we are even less convinced that the Internal Control Rule is appropriate for Canada's much smaller capital market and much smaller public companies. Of course, like others, we are also concerned that compliance with the Internal Control Rule by Canadian public companies will be as onerous and costly as was compliance with section 404 of S-Ox, especially in the first year.

In light of our concerns, we do not think that the Canadian securities regulators should proceed with the Proposals in their current form.

While it is important for investors to have as much confidence in the Canadian capital markets as in the U.S. capital markets, Canada should not feel bound to follow the U.S. approach of detailed internal control reviews and external audits. There is precedent for Canada and the U.S. taking different approaches to regulation. For example, in the area of bank regulation, the U.S. follows a very "hands on" approach, with extensive and detailed checklists, while the Office of the Superintendent of Financial Institutions follows a risk management approach with far fewer specific rules. Many would say that Canada has a superior regulatory regime, and Canadian financial institutions have not suffered in the eyes of investors or depositors by reason of this difference.

Adopt a Risk-Based Rule Coupled With Negative Assurance From the Auditor

For the most part, the S-Ox section 404 reviews have been conducted from the bottom-up, with detailed testing of every control whether material or not. Given that the major financial reporting frauds of the last several years have been committed top-down, it seems advisable to focus more on the entity-level controls (such as the "tone-at-the-top") and on significant controls that address the real risks to the particular business, backed up by a management report and CEO and CFO certifications of the design of internal control over financial reporting.

In addition, auditor attestation should not be required because external auditor involvement has contributed significantly to the cost-benefit mismatch. Audit firms legitimately fear second-guessing by the securities regulators and auditing oversight bodies and therefore have been unwilling to apply the professional judgment that they have traditionally brought to bear in financial statement audits, leading to overkill in the internal control auditing process. The external auditor's role could be restricted to providing negative assurance on management's report on internal control, much the same as the auditor now reviews Managements' Discussion and Analysis.

These two suggestions are essentially alternatives one and four noted by the Canadian securities regulators in the Request for Comments. We believe that the approach outlined above would reduce costs to acceptable levels yet still provide a reasonably high level of comfort to investors.

PART B - SPECIFIC COMMENTS ON THE PROPOSALS

We have the following specific comments on the Proposals, should the Canadian securities regulators decide to proceed with the Proposals in their current form. The fact that we have included specific comments on the Proposals should not be interpreted as an endorsement of the Proposals.

Exemption for Venture Issuers

Given that compliance costs are disproportionately higher for smaller issuers than for larger issuers, the Internal Control Rule, as proposed, does not apply to venture issuers. The Certification Rule does, however, apply to venture issuers. Therefore, CEOs and CFOs of these

issuers will be required to acknowledge responsibility for internal control over financial reporting and certify that they have designed such controls. In order to support these certifications, CEOs and CFOs will be required to review and document the internal controls, although detailed testing will not necessarily be required and auditor attestation will not be mandated.

On balance, we believe that it is appropriate to exempt venture issuers from the Internal Control Rule, although this view is not shared by all of us.

Timing of Implementation

Since the publication of the Proposals, the SEC has delayed by one year the application of S-Ox section 404 to smaller U.S. companies and foreign private issuers. These companies now have until their first year ended on or after July 15, 2006 to comply with section 404 of S-Ox.

We recommend that the Canadian securities regulators delay the compliance date for the Internal Control Rule, at each stage of the phase-in, by one year. We suggest that the largest reporting issuers should have until the first year ended on or after June 30, 2007 to comply and the smallest issuers would have to comply on the first year ended on or after June 30, 2010. A delay would enable those issuers that are cross-listed on a U.S. stock exchange or otherwise have securities registered with the SEC to "go first", with other large issuers complying the following year, thus alleviating the pressures on accounting firms and consultants whose manpower would otherwise be spread very thin. We believe that these pressures are serious enough, in terms of extra costs and reduced efficiency, that a one-year delay is warranted even if issuers themselves were otherwise capable of complying with the proposed deadlines. Also, without a delay in the Canadian timetable, cross-border issuers with a June 30 year end would be required to comply with the Internal Control Rule a year before they are required to comply with section 404 of S-Ox.

Adopt SEC, PCAOB and COSO Guidance

If the Canadian securities regulators do adopt the U.S. regime fully, the guidance recently provided by the SEC and the PCAOB (and forthcoming from COSO) should be incorporated, perhaps in the Companion Policy. The guidance by COSO may prove to be appropriate for Canadian companies, which for the most part are smaller than U.S. public companies.

Internal Control Rule

Management's Conclusion About Effectiveness

The rules made by the SEC under section 404 of S-Ox explicitly state that management cannot conclude that internal control over financial reporting is effective if there are any material weaknesses. Although the CICA's proposed internal control auditing standard prohibits the auditor from concluding that internal control over financial reporting is effective if there are any material weaknesses, the Internal Control Rule and Companion Policy lack a similar statement with respect to management's assessment.

It would be helpful if the Internal Control Rule or Companion Policy could contain a clear statement as to when management cannot conclude that internal control is effective.

Audit Committee Approval of Internal Control Report

The Internal Control Rule requires the board of directors to approve management's internal control report. We question whether it should not also be a requirement that the audit committee review the internal control report and make a recommendation to the board as to whether or not the board should approve the report.

Relationship Between Internal Control over Financial Reporting and Disclosure Controls

As noted in various literature, there is overlap between the concepts of internal control over financial reporting and disclosure controls and procedures. We have noted from a small sample of U.S. public disclosure that companies appear to be reaching the conclusion that their disclosure controls are necessarily ineffective if the company has a material weakness in internal control. In our view, this conclusion is misguided. While some material weaknesses in internal control will impugn the effectiveness of disclosure controls, we believe that this will not necessarily be the case.

It would be useful for the Canadian securities regulators to clarify that a company is not required to conclude that its disclosure controls are ineffective solely because it has identified a material weakness in its internal control. If the two concepts are completely linked, companies would have to disclose material weaknesses in internal control that are discovered prior to the Internal Control Rule applying to the company, since the annual MD&A must now include the CEO's and CFO's evaluation of disclosure controls. It would also be useful to have guidance on whether a material change report is required if a material weakness in internal control is detected.

Interaction with the Short Form Prospectus Rule

Management's internal control report and the internal control audit report contemplated by MI52-111 will not be incorporated by reference into a short form prospectus under either the current National Instrument 44-101, *Short Form Prospectus Distributions*, or the proposed replacement NI44-101. We wonder whether these reports should be specifically incorporated by reference into a short form prospectus. Whether or not the short form prospectus is amended to incorporate management's internal control report by reference, it would be helpful if the Canadian securities regulators could provide guidance on the extent to which material weaknesses in internal control will have to be disclosed in a short form prospectus (or, indeed, any prospectus) in order to meet the "full, true and plain disclosure" requirement as companies will discover material weaknesses prior to the filing of their first internal control report.

Certification Rule

Form of Certification for Asset-Backed Issuers

Issuers of asset-backed securities are subject to the Certification Rule (although many of these issuers seek exemptive relief from the requirements of the Certification Rule), yet exempt from the Internal Control Rule. These issuers are required to file the full annual certification in the form of Form 52-109F1; however, we question whether this is appropriate. It may be more appropriate for these issuers to file the same form of annual certification as is to be filed by venture issuers, which are also exempt from the Internal Control Rule. (This may, however, be a moot point as we understand that the Canadian securities regulators are currently reviewing the continuous disclosure requirements of asset-backed issuers.)

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We appreciate the opportunity to comment on the Proposals and would be pleased to discuss any aspect of this submission.

Yours truly,

"Robert H. Karp"

Torys LLP

RHK/jlf

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