OSC Staff Notice 51-720

Issuer Guide for Companies Operating in Emerging Markets

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BACKGROUND

EMERGING MARKET ISSUER REVIEW

In response to public questions and concerns involving Canadian public companies with significant business operations in emerging markets[1] (referred to in this guidance as "emerging market issuers"), the OSC announced on July 5, 2011 the commencement of a regulatory review (EMIR Review or the Review) of selected emerging market issuers. We engaged in this review in recognition of our increasingly globalized marketplace and the need to protect Ontario investors and the integrity of our markets. 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 their auditors and underwriters and the exchanges on which the issuers had listed. Our findings and recommendations were published in OSC Staff Notice 51-719 *Emerging Markets Issuer Review* dated March 20, 2012 (the EMIR Report).

As indicated in the EMIR Report, we selected 24 issuers to be subject to the EMIR Review, which represented more than 50% of the 46 emerging market issuers for which Ontario is the principal regulator. The issuers selected included all non-resource emerging market issuers (14) and approximately one-third of the resource issuers operating in emerging markets (10). Staff conducted in-depth reviews of the public disclosure record of the selected emerging market issuers and examined information concerning the function of each selected emerging market issuer's board and audit committee.

Our review identified the following main areas of concerns related to emerging market issuers:

- Corporate Governance Practices
  It appeared to us that the level of engagement by boards and audit committees in their oversight of management and sense of responsibility for the stewardship of an emerging market issuer with public investors was in certain cases deficient. We were also

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[1] As indicated in OSC Staff Notice 51-719 *Emerging Markets Issuer Review*, while the term 'emerging market" has different meanings in different contexts, 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.

concerned with the extent of knowledge of boards and audit committees of the cultural and business practices of the jurisdictions in which the issuer operated.

- Corporate Structures
  We were concerned that the complexity of certain corporate structures did not appear to be either clear or necessary to support the emerging market issuer's underlying business model and that the quality of controls in place to manage the risks arising from the complexity of the structure was a concern.

- Related Party Transactions
  We were particularly concerned with the extent and frequency of related party transactions and the quality of the management and board processes in place to identify and approve these transactions. Our disclosure reviews also revealed deficiencies in the completeness and appropriate clarity of these related party disclosures.

- Risk Management and Internal Controls
  Many risks were not appropriately identified, understood or managed by the board. We also found that risk disclosures by the issuers were not specific or relevant as they should have been to be informative to investors.

Our review identified material disclosure deficiencies in 15 of the 24 emerging market issuers reviewed. After this review, the disclosure deficiencies identified were corrected through restatements and refilings or prospective enhancements. Several issuers were referred to Enforcement for further investigation of additional issues.

OUTCOMES OF THE EMIR REVIEW

The OSC has identified several changes required to address the concerns outlined in the review. These include:

OSC

We have adapted our continuous disclosure review issuer selection process to incorporate the key risk factors identified in the EMIR Review. The prospectus review process has also been enhanced to address both the risks and concerns that arise in emerging market issuers. We continue to look to improving the OSC oversight regime.

Issuers

We do recognize that board members of emerging market issuers may face a steeper learning curve to understand the emerging market issuer's business and operating environment. The time zone, language, location of key books and records and cultural differences may make communication especially complicated in these situations. Nevertheless, all board members of Canadian reporting issuers, regardless of where they are located and where the business operations are located, are required to adhere to Canadian regulatory requirements.

We believe specific guidance that highlights areas of risk that require particular focus and clearly articulates OSC staff's expectations regarding regulatory compliance will assist directors and management of emerging market issuers in meeting the level of standards that are expected in Ontario capital markets. This Guide has been prepared to provide such guidance, and is one of the steps the OSC is taking to address the principal concerns identified in the EMIR Report.

Other regulatory partners

Underwriters:

The OSC will work with the Investment Industry Regulatory Organization of Canada as it reviews underwriting due diligence standards with a view of promoting industry best practices and standards in this area.

Auditors:

The OSC is working closely with the Canadian Public Accountability Board (CPAB) on issues of common interest, including the opportunity to share information permitted by legislation. We have held discussions with the audit community, CPAB and international securities regulators to address concerns about the use, access and reliance on foreign component auditors' work products. The OSC will examine the need for changes in order to respond to other audit related concerns identified.

Exchanges:

Toronto Stock Exchange and TSX Venture Exchange are currently finalizing additional guidance to address risks associated with listing emerging market issuers. This includes clarification of the expectations of issuers and the advisory community. The Exchanges expect to publish the new requirements for comment in November.

PURPOSE OF THIS GUIDE

We believe directors and management of all market issuers will benefit from specific guidance that help them meet the regulatory and investor expectations in Ontario's capital markets. We are publishing this Guide to provide assistance to emerging market issuers and their directors and management on their governance and disclosure practices in light of the unique challenges they face.

Specifically, this Guide:

1. highlights to emerging market issuers and their directors and management potential areas of risk or red flags that may warrant further scrutiny;
2. sets out questions that directors and management of emerging market issuers should consider when deciding how to address risks of doing business in emerging markets; and
3. outlines our expectations regarding compliance with existing disclosure requirements.

This Guide is intended to help clarify the existing continuous disclosure requirements under securities legislation for emerging market issuers other than investment funds who are reporting issuers in Ontario. It should not be considered legal advice and is not intended to create new legal obligations or modify existing ones.

While this Guide is primarily directed at emerging market issuers and their directors and management, other issuers will find the discussion useful. We also anticipate that investors in emerging market issuers will find this Guide useful to help them understand and assess the operational, strategic and compliance performance of the companies in which they have either invested or are planning to invest.

EIGHT AREAS TO CONSIDER FOR COMPANIES OPERATING IN EMERGING MARKETS

We have identified eight areas for consideration. In each of the areas we have highlighted matters to consider and disclosure tips to assist companies and their boards in assessing risks and complying with securities laws.

The eight areas are as follows:

1. Business and operating environment
2. Language and cultural differences
3. Corporate structure
4. Related parties
5. Risk management and disclosure
6. Internal controls
7. Use of and reliance on experts
8. Oversight of the external auditor

This is not an exhaustive list, and these issues may be considered along with the other matters the board and management determine to be appropriate.

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, as these are the foundation from which the executives will make decisions and carry out their responsibilities. Canadian directors on the boards of Canadian public companies are generally expected to have a thorough understanding of the Canadian marketplace and its legal and political framework from their experience doing business in this market. On the other hand, Canadian directors of an emerging market issuer may, with respect to the company's foreign operations, have limited knowledge and experience regarding its operating environment. They must therefore be cognizant of the need to exercise additional diligence to close any knowledge gap that might exist.

Canadian reporting issuers, their management and board are reminded that they are required to adhere to Canadian regulatory requirements regardless of the location of the company's operations.

Regardless of the location of a company's operations, Canadian reporting issuers, their management and board are reminded that they are required to adhere to Canadian regulatory requirements. It is the responsibility of the company to ensure that its directors and management have the appropriate orientation and training on Canadian capital markets' requirements. Foreign directors and management of an emerging market issuer who are unfamiliar with Canadian regulatory requirements should also address any knowledge gap, including seeking assistance from Canadian directors and advisors, who may be in the best position to provide guidance.

Matters to Consider

Boards of companies operating in emerging markets should enhance their knowledge of the business and operating environment of an emerging market by addressing the following questions:

- What role does the foreign government and regulatory authorities have in the foreign operations?
- Have restrictions or conditions been imposed, or can they be imposed, by the foreign government and regulatory authorities on the company's ability to operate in the foreign jurisdiction?
- Who in the company manages the relationship with the foreign government and regulatory authorities?

- What is the legal environment of the foreign jurisdiction? How does the legal system operate and how may it impact the company?
- What regulatory requirements is the company or its business or operations subject to in the foreign jurisdiction?
- Does the board have access to relevant expertise to ascertain the political, legal and cultural realities of the jurisdiction where the company's principal business operations are located, and the impact they may have on the company's business or operations?
- What are the banking customs in the foreign jurisdiction? How do they differ from Canadian customs?
- Are there any restrictions on the company's ability to transfer and/or verify the existence of funds in bank accounts located in foreign countries?
- What are the impacts of local laws and customs on ownership and rights to property?
- Who are the major suppliers and customers? How did the company establish relationship with them? Are these entities, or their executive officers or directors, related to the company or its officers?
- How frequently do Canadian board members and management visit operations in the foreign jurisdiction?
- Where are the company's books and records located and are there any access restrictions?
- Will an investor's ability to exercise and enforce statutory rights and remedies under Canadian securities law be impacted by the fact that all or substantially all of the issuer's assets are primarily located in a foreign jurisdiction?

Section 19 of the Ontario Securities Act requires reporting issuers to keep appropriate books and records. Boards are also reminded that they should have effective access as needed to these books and records, and should consider what mechanisms are in place to ensure this happens.

Disclosure Requirements

Securities legislation requires a company to describe its business and operations.
For example, a company's annual information form (AIF) must include, among other things, disclosure about the company's principal markets, competitive conditions, economic dependence on significant contracts, and dependence on foreign operations[2]. A company's management's discussion and analysis (MD&A) is also required to discuss events or uncertainties that are

[2] Item 5 of Form 51-102 F2 *Annual Information Form.*

reasonably likely to have an effect on the company's business, and industry and economic factors affecting the company's business[3]. For companies operating in emerging markets, the disclosure should highlight the challenges and risks of operating in these markets. Meaningful disclosure for investors can only be provided when management and the board thoroughly understand the intricacies of the company's business.

Disclosure Tips

A company's disclosure should:

The disclosure should allow an investor to understand the business model of the company and its unique characteristics.

- sufficiently highlight those operating conditions that are applicable to the company as a result of operating in an emerging market
- capture issues, risks and characteristics unique to operating in the emerging market
- provide both a factual description and an analysis of these issues, risks and characteristics, and how they affect operations
- use understandable language and either refrain from including, or provide explanations for, industry jargon

2. Language and Cultural Differences

Given that the environment in which emerging market issuers operate may be significantly different from that in Canadian markets, it is important that the board of an emerging market issuer includes members that have appropriate experience in the emerging market in addition to members with only Canadian or North American business expertise. This will assist the board in identifying the specific risks associated with the company or with the foreign jurisdiction in which the company operates, so that the board's governance and oversight responsibilities can be properly discharged.

One such challenge relates to language and/or culture of the emerging market being different from that of North America. Boards should devise appropriate policies such as the use of an independent translator to overcome these language and cultural barriers. They should also be

[3] Item 1 of Form 51-102 F1 *Management's Discussion and Analysis.*

mindful of placing full reliance on local management, or local board members who are not independent of the company, and should develop mechanisms to obtain independent input from other sources. In addition, companies should consider the inclusion on the board of independent board members with an understanding of carrying on business operations in the emerging market. Boards should also arrange for site visits to the foreign business operations to mitigate the geographic distance between the board and the local operations.

Matters to Consider

The board should consider the following questions when evaluating the language and cultural differences that may impact the issuer:

- Does the composition of the board provide the appropriate level of knowledge and expertise in the language and cultural practices of the emerging market?
- Is any board member fluent in the foreign language or does the board have access to an independent translator to overcome any language differences?
- How frequently should the board members visit the operations in the emerging market and meet with local management?
- Has the board engaged with local management to understand the manner in which business is conducted in the foreign jurisdiction?
- Have the books and records, including key documents such as material contracts or bank documents, been prepared in English or French or appropriately translated?
- Does the board have access to resources, beyond local management or local directors who are not independent, that can help overcome language and cultural issues?

3. Corporate Structure

Emerging market issuers may face challenges associated with designing an appropriate structure that takes into consideration the political, legal and cultural realities of emerging markets. In some cases, the legal or regulatory system may present impediments to foreign ownership or control and may result in the need for complex structures to enable the company to do business in that market.

While there may be important reasons for their establishment, complex structures may be difficult to understand and may present additional challenges for the board to effectively direct the decision making of the company. Boards should consider the risks that may flow from complex structures, such as obscuring the misappropriation of assets or other fraudulent activities, or conveying a false impression of financial performance or condition through distorted financial statements.

Boards should assess whether a simpler corporate structure could facilitate the conduct of the company's business and align with its operating environment.

Although complex corporate structures may take various forms, two types of structures are commonly used by companies operating in emerging markets: (i) those that have multiple layers of entities and numerous subsidiaries which are incorporated in various jurisdictions; and (ii) those that encompass “special purpose entities”[4].

(i) Structures with multiple layers and numerous subsidiaries

Any structure that separates the board from its operating subsidiaries may present challenges for the board in effectively directing the decision making of the company. For example, key operating decisions may be made at lower levels of the corporate hierarchy without being communicated to the board for its consideration. The existence of numerous subsidiaries incorporated in various foreign jurisdictions may also make it more difficult for a board to fully understand the risks associated with each of the entities and the particular risks associated with their jurisdiction of incorporation.

(ii) Control through a special purpose entity (SPE)

Some emerging market issuers may use one or more SPEs to provide an investor with a controlling interest in an entity that is not based on a majority of voting rights. Although the relationship may be similar to one established by majority voting rights, control will be established through a series of structural and contractual arrangements with the entity. For example, through an SPE structure, the foreign operating entities of an emerging market issuer may transfer their economic returns through multiple entities (which often include an offshore entity), and ultimately to the Canadian holding company. The foreign operating entities’ operations would be included in the Canadian holding company’s financial statements on a consolidated basis in the same way as the operations of a Canadian company with a majority voting right. This structure is often used to gain access to sectors of emerging market economies where foreign investment is restricted or

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[4] Emerging market issuers have customarily used the phrase *variable interest entities* to refer to the unique structure described herein. This phrase was used under Canadian generally accepted accounting principles – Part V, but not under International Financial Reporting Standards, which, instead, specify the accounting treatment for *special purpose entities*, a concept similar to, but broader than, *variable interest entities*. Readers should note that the discussions herein with respect to *special purpose entities* are on the implications and risks resulting from the use of such structures in general, and may include those structures usually termed *variable interest entities*.

prohibited. Where an SPE is used for this purpose, there is a risk that a company could nonetheless be deemed by the government of the relevant foreign jurisdiction not to be in compliance with the foreign investment restrictions of that jurisdiction, and the foreign government may consequently force the structure to be unwound. In addition, there are legal risks that need to be assessed related to enforceability of the contracts used to establish the SPE. The use of an SPE may therefore make it difficult to assess whether a Canadian reporting entity has effective continuing control and ownership over the foreign operating entities and their assets.

Matters to Consider

In assessing the risks of an emerging market issuer's corporate structure, its board should ask the following questions:

- Has the need for a complex structure been carefully assessed by management, including whether the company's objectives could be achieved through a simpler structure?
- Is the company's corporate structure consistent with its business model and the political, legal and cultural realities of the jurisdiction where its principal business operations are located?
- Where the company uses a structure that involves one or more SPEs, does it have effective control and ownership over the foreign operating entities and is the SPE structure compliant with relevant foreign investment restrictions?
- Does the board have the means to monitor legal and regulatory developments in the foreign jurisdiction relative to SPE structures?
- Does the corporate structure limit or inhibit the ability of the board to oversee and monitor management of the foreign operations?
- How does the board ensure that information from the local jurisdiction is communicated to the board in a timely manner?
- Can the Canadian parent company effectively change the board and management of the foreign operating entities?
- Have the risks associated with the company's corporate structure been identified and evaluated? Does management have appropriate controls in place to address those risks?

Disclosure Requirements

We expect a company's disclosure to contain a clear and understandable description of its corporate structure, together with an explanation of how that structure facilitates the company's business and aligns with the parameters of its operating environment. The disclosure should also describe the risks associated with the structure and how those risks are managed. Where a company files an AIF, we expect that companies with complex structures will address in their disclosure the matters described above in the course of discussing their inter-corporate relationships. (See additional guidance related to risk disclosure in section 5 of this Guide.)

The following example[5] illustrates disclosure that would be considered boilerplate with a comparison to enhanced disclosure that provides more useful information for investors. Issuers should consider including a diagram depicting the corporate structure with the narrative disclosure to facilitate readers' understanding.

Example of boilerplate disclosure:

Company A is incorporated in Country 1. Company A holds a 99% interest in Company B which is incorporated in Country 2. Company B, in turn, holds a 100% interest in each of Company C which is incorporated in Country 3 and Company D which is incorporated in Country 4.

Example of entity-specific disclosure:

Company A is incorporated in Country 1. Company A holds a 99% interest in Company B which is incorporated in Country 2. Company B, in turn, holds a 100% interest in each of Company C which is incorporated in Country 3 and Company D which is incorporated in Country 4.

Country 1 has experienced political and economic stability for many years and its legal system is based on the British common law system. Its banking system and standards for professional services are comparable to those in North America, at lower operating costs. In addition, Country 1 has a tax treaty with each of Countries 2, 3 and 4 that exempts payments from those countries from local tax.

Company B was the holding company of each of Company C and Company D at the time of the acquisition of those companies by Company A. The Company's manufacturing operations are conducted by Companies C and D which are incorporated in Countries 3 and Country 4, respectively. This structure is necessary for the Company's operations in these countries, as it allows the Company to comply with the laws of each of these countries and is conducive to maintaining positive relationships with local entities and government officials upon whom the Company's operations are substantively reliant. Operating through Companies C and D which are located in the same jurisdictions as its manufacturing operations also enables the Company to maintain more effective controls over those operations and financial reporting.

There are however risks associated with operating in Countries 3 and 4. These include….

[5] Examples in this Guide are provided for illustrative purposes only, and may have been simplified for ease of illustration.

Disclosure Tips

A company's disclosure should:

- provide a description of the company's corporate structure, including a diagram of the structure where helpful
- 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
- describe the risks associated with the corporate structure and how the board monitors and addresses those risks

4. Related Parties

Transactions with other companies in the same group (i.e., the company's parent company and fellow subsidiaries) or with parties linked to its shareholders, directors or management, or other related party transactions (RPTs)[6], may represent a heightened risk for emerging market issuers. This is due to differences in local business practices, cultural norms, and legal requirements compared to North American standards. Investors must be able to understand how RPTs impact a company's operations and financial results.

RPTs may provide the company with benefits or better terms than those that are available from arms' length parties. Conversely, it is also possible that RPTs may benefit the related party while providing little or no benefit for the company. Non-related investors may also be harmed by an inappropriate transfer of corporate assets to related parties. Such transfers may occur on a one-off basis or could involve a series of continuous transfers via smaller operational expenditures that are cumulatively material. Transactions of this nature are often detrimental to the company and undermine the credibility of our capital markets.

In some cases, companies may be owned or controlled by a small group of individuals or a family. In family controlled companies, senior management and the board are often dominated by family members. The interests of a company's controlling shareholders may not fully align with those of its minority shareholders. In these circumstances, there is a heightened risk, which the

[6] Please refer to paragraph 9 of IAS 24 *Related Party Disclosures* or section 1.1 of MI 61-101 for more precise definitions of a related party.

board should manage, that the company may be operated in a manner that disproportionately advances the interests of its controlling shareholders at the expense of its minority shareholders.

Effective identification and monitoring of RPTs by management and the board is necessary to prevent potential abuse and protect investors. This requires appropriate policies, procedures and scrutiny for the identification, evaluation and approval of RPTs. In addition, boards should ensure that the company complies with requirements under generally accepted accounting principles and Form 51-102 F1 *Management's Discussion and Analysis* for the disclosure of RPTs (see further discussion below).

The board should ensure that policies and procedures are in place to identify and independently evaluate and approve related party transactions.

Issuers are further reminded that certain RPTs are subject to Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions* (MI 61-101), which requires, among other things, a formal valuation and minority shareholder approval of the transaction. Companies are also required in these circumstances to disclose the review and approval process adopted by the board of directors and the special committee, if any, as well as the material factors on which the directors relied in assessing the fairness of the transaction.[7]

Matters to Consider

In assessing the risks of RPTs, the board should consider the following questions:

- Has management implemented effective policies and procedures to identify related parties and any transactions with such parties, evaluate the merits of such transactions, and require that the transactions be reported to the board and be subject to prior board approval?
- Are directors and senior management required to obtain board approval or the approval of independent or disinterested directors before entering into transactions in which they have an interest?

[7] Issuers are also reminded to consider requirements under stock exchange rules, which require valuation and/or shareholder approval for certain related party transactions.

- Are RPTs evaluated by disinterested directors (i.e., as opposed to evaluation by directors who may be definitionally "independent" for purposes of securities regulation but would not be considered disinterested by a reasonable person)?
- Is the transaction subject to the minority shareholder approval and formal valuation requirements under MI 61-101?
- Are transactions that fall outside the normal course of business scrutinized to determine whether related parties have a direct or indirect interest in those transactions?
- Could the same or similar benefits derived by a company through an RPT be obtained at a lower cost or with less risk on an arm's length basis (including, for example, public tender)?
- What would the impact be on the company in the event the related party no longer supplied certain goods or its services?
- What is the track record of the related party in supplying the goods or services?
- Does the related party have the requisite skills, experience and/or financial capability to supply the good or service?
- Are balances due from related parties collectible?
- Are there tax risks that arise from RPTs?
- Can the business effectively continue to operate without the approval or participation of the related party or significant shareholder?

Disclosure Requirements

Comprehensive disclosure of related party transactions is essential for investors to understand and evaluate those transactions.

Comprehensive disclosure is essential for investors to understand and evaluate RPTs. Minimum disclosure requirements for RPTs are prescribed in both accounting standards and securities regulation. For example, International Financial Reporting Standards require that a company's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties[8].

The disclosure in a company's MD&A should contribute to an investor's understanding of an RPT's business purpose and economic substance, and not merely repeat the disclosure included

[8] Paragraph 1 IAS 24 *Related Party Disclosure*

in its financial statements[9]. It should be comprehensive in nature, encompassing both quantitative and qualitative information necessary to achieve that understanding. In fulfilling this objective, a company is required to disclose at least the following information:

- 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
- any ongoing contractual or other commitments resulting from the transaction

We expect issuers to consider the materiality of RPTs. In making this determination we encourage all issuers to review and apply the discussion relating to the "Interest of Management and Others in Material Transactions" in Item 13 of Form 51-102 F2 *Annual Information Form*. The instructions for this item direct that the materiality of an interest is to be determined on the basis of the significance of the information to investors in light of all the circumstances of the particular case. The importance of an interest to the person that holds that interest, the relationship of the parties to the transaction with each other, and the amount involved are among the factors to be considered in determining the significance of the information to security holders. In other words, qualitative, in addition to quantitative, factors have to be considered.

Example of boilerplate disclosure:

On September 24, 2011, the Company entered into an exploration contract in the amount of $5,800,000 with XYZ Exploration Ltd., a company controlled by the brother of an officer and director of the company. The contract was to conduct exploration on the ABC property. On December 12, 2011, the Company made a deposit of $3,900,000 under the contract.

Example of entity-specific disclosure:

On September 24, 2011, the Company entered into an exploration contract in the amount of $5,800,000 with XYZ Exploration Ltd., a company controlled by the brother of John X who is an officer, director and controlling shareholder of the company. The contract was to conduct sufficient exploration and drilling on the ABC property in order to determine an initial resource estimate. On December 12, 2011, the Company made a deposit of $3,900,000 under the contract.

The contract was put out for public tender and three bids were submitted. XYZ Exploration Ltd. was selected to undertake the exploration program as its bid was the lowest of the three bids that

[9] Item 1.9 of Form 51-102F1 *Management's Discussion & Analysis*

were received, and it was well qualified to undertake the exploration work, having conducted significant exploration in the area of the ABC property over the last several years.

In [name of country], it is customary for an exploration contractor to provide both a fixed price bid and a flexible price bid. Under a fixed price bid, a contractor undertakes to conduct a given project at the fixed price. Under a flexible price bid, a contractor undertakes to conduct a given project at an estimated price, which may ultimately be more or less than the actual cost of a given project. The actual cost of the project is the one that is ultimately charged to a company. The Company's board, which is required to pre-approve all related party transactions proposed to be entered into by the Company, determined that it was beneficial to accept a fixed price bid in order to avoid any unexpected costs. John X recused himself from the board's discussion of the contract as well as from the vote to approve the transaction.

Disclosure Tips

A company's disclosure should:

- not merely repeat the disclosure included in its financial statements
- specifically identify the related parties and their relationship with the company
- include both quantitative and qualitative information that is necessary for an investor to understand the business purpose and economic substance of RPTs
- discuss the nature, role, impact, benefits and risks of RPTs in conducting business in the jurisdiction where the applicable business or operations are located
- discuss how the company's structure impacts on its use of RPTs in conducting its business
- describe the company's processes and procedures for identifying, evaluating and approving RPTs

5. Risk Management and Disclosure

National Policy 58-201 *Corporate Governance Guidelines* states that the board should adopt a written mandate in which it explicitly acknowledges responsibility for, among other things, the identification of principal risks of the company's business and oversight of the implementation of appropriate systems to manage these risks[10]. The board oversees management, which is responsible for identifying and quantifying a company's exposure to risks and for adopting suitable risk management systems to address such risks.

[10] Part 3.4(c) of National Policy 58-201 *Corporate Governance Guidelines.*

Boards of companies whose principal operations are located in an emerging market should be particularly sensitive to the risks associated with operations in those markets, especially those that may result in serious disruption to, or significant adverse impact on, business operations. Board members should ensure that they have a sufficient understanding of the legal, regulatory, political and cultural risks impacting the company and evaluate these risks in the context of the particular emerging market, rather than through a North American lens. Risk analysis and mitigation techniques that may be appropriate in the Canadian or North American business context may be less effective in emerging markets. It is important that boards obtain an understanding of how the risks of operating in emerging markets impact the corporate structure, operations and material assets of the company.

Boards should obtain a clear understanding of any risks associated with operations in a particular emerging market and how they impact operations. Boards should consider that risk analysis and mitigation techniques that may be appropriate in the North American business context may be less effective in emerging markets.

Examples of some specific risks of operating in emerging markets may include risks related to:

- political factors, including political instability and arbitrary or sudden changes to laws
- the legal and regulatory framework in the foreign jurisdiction which may increase the likelihood that laws will not be enforced and judgments will not be upheld
- the movement and conversion of currency out of the foreign jurisdiction, which could hinder the payment of dividends or other distributions to Canadian investors
- corruption, bribery (including possible prosecution under the federal *Corruption of Foreign Public Officials Act* [11]), civil unrest and economic uncertainty, which may negatively impact and disrupt business operations
- factors that may affect the company's title to its assets
- potential expropriation or nationalization of assets
- access to assets

[11] Boards should be aware of the *Corruption of Foreign Public Officials Act* (Canada). Under this legislation, the federal government has jurisdiction over the bribery of foreign public officials and may prosecute an individual or a corporation for this offence and may also seize the property and proceeds obtained or derived from bribing a foreign official. The OSC has the authority to share certain information on potential criminal matters, including possible violations under the *Corruption of Foreign Public Officials Act*, with the police.

Matters to Consider

In assessing the quality of the risk management processes, the board should consider the following questions:

- Does the board have a full understanding of the risks facing the company and how those relate to the overall risk appetite of the company?
- Is there a strategy in place to ensure that significant risks related to operations in the emerging market are identified and managed by the board and management?
- Does the board regularly engage with management to review and update the risk identification and management strategy?
- Does the board ask probing questions and seek confirmations that decisions made by management are consistent with board-approved strategies and the company's overall risk appetite?
- Does the board obtain confirmation from management that risk exposures are in compliance with established limits?
- Do board members take appropriate steps to stay informed of key developments that could increase the company's risk exposure in the emerging market?
- Has the board established contacts in the foreign jurisdiction that may assist the board in staying abreast of developments that could impact the company's risk exposure and does the board regularly engage with these contacts?
- Does the board have a clear understanding of the internal controls and processes in place to respond to risk?
- Does the board review how disruptions to business operations caused by political, legal and cultural factors in the emerging market were dealt with by management?

Disclosure Requirements

A company's disclosures about the risks it faces are an important element of investor protection. Boards should ensure that investors are provided with sufficient information about the risks associated with operating in a particular emerging market.

Companies required to file an AIF under securities law must disclose the risks that would most likely influence an investor's decision to purchase securities of the company[12]. All companies are required to disclose in their MD&A those risks that have affected their financial statements and those that are reasonably likely to affect them in the future[13]. Further, all issuers must disclose risk factors in their prospectus filings[14].

Boards should ensure that disclosures relating to risks of operating in emerging markets are entity-specific.

Example of boilerplate disclosure:

The company is exposed to significant political risk resulting from operations in developing countries. These risks may have a significant impact on the ability of the Company to carry on business operations.

Example of entity-specific disclosure:

<u>Risk Factors</u>
The company is exposed to significant political risk resulting from operations in developing countries. In particular, operations in Country ABC may be severely impacted by the changing political landscape experienced in recent years as a result of the economic crisis which began two years ago. Significant changes to laws may be imposed by the Country ABC government and responses to similar changes in the past have resulted in civil unrest in Country ABC. The government of Country ABC has implemented restrictions on imports and exports of goods and services and has imposed restrictions on the conversion of Country ABC's currency.

Each of these factors may have a significant impact on the ability of the Company to carry on business operations in Country ABC. Currently, all of our widgets are only sold within Country ABC and any import of supplies in our production of widgets must be approved by Country ABC Import Agency. The Company currently has all required import permits and is in good standing with Country ABC Import Agency. Further, the Company has not experienced any labour stoppages as a result of the economic crisis and civil unrest that has recently occurred in Country ABC.

<u>Risk Management Strategies</u>
To manage the political risks of operating in Country ABC, processes are in place to actively monitor and analyze the political landscape in Country ABC. On a monthly basis, executives meet to discuss and analyze the political developments in Country ABC. The Company's

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[12] Item 5.2 of Form 51-102F2 *Annual Information Form*
[13] Part 1 of Form 51-102F1 *Management's Discussion & Analysis*
[14] Item 1.10 of Form 41-101F1 *Information Required in a Prospectus* and Item 17 of Form 44-101F1 *Short Form Prospectus*

strategic, operational and investment plans are adjusted accordingly where required. The Board of Directors has an oversight role in ensuring the Company's strategy takes into account shifts in political factors.

Disclosure Tips

A company's disclosure should:

- identify the company's specific risks of operating in an emerging market
- where the issuer or its operating entities are domiciled in a foreign jurisdiction, explain the risks and other implications on investors' ability to exercise statutory rights and remedies under Canadian securities law
- provide sufficient details for investors to understand the nature of the risks and what the risks mean to the company (i.e. how such risks could be detrimental to the company's business operations in the foreign market)
- indicate the board's responsibility for oversight and management of risks and any board and management-level committee to which responsibility for oversight and management of risks has been delegated
- describe the process used by the board to oversee the risk management process
- 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
- be updated in each filing to reflect any new identified risks and the company's current risk management strategy

6. Internal Controls

Effective internal controls (including internal control over financial reporting and disclosure controls and procedures) help reduce the risks of inaccurate financial reporting. A breakdown of the integrity of financial reporting may stem from a lack of or a circumvention of internal controls. It is therefore important for board members to consider the guidance in National Policy 58-201 *Corporate Governance Guidelines* in which it is recommended that boards adopt a written mandate explicitly acknowledging responsibility for the stewardship of the company, including responsibility for the company's internal control and management information systems[15].

[15] Section 3.4(f) of National Policy 58-201 *Corporate Governance Guidelines*.

The unique risks of operating in an emerging market magnifies the importance of strong internal controls. For example, it is particularly challenging for a board whose members principally reside in Canada to appropriately oversee a company whose operations are located in a foreign jurisdiction. The time zone, language, and cultural differences can make communication especially complicated and may hinder the accuracy and timeliness of financial reporting that properly reflects the business decisions made in the local jurisdiction. Appropriate internal controls can provide checks and balances on the local operations to reduce the risks of inaccurate financial reporting and ensure that appropriate information is reported on a timely basis.

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. The audit committee, and the board more generally, should also oversee the timely remediation of weaknesses and, in the interim, the mitigation of the related risks. In our view, this responsibility is inherent in the audit committee's obligation under NI 52-110 *Audit Committees* (NI 52-110) to review the company's financial statements, MD&A and annual profit or loss press releases before they are publicly disclosed[16].When the effectiveness of internal controls is in doubt or ongoing material weaknesses are present, audit committee members should exercise a higher degree of scepticism in their review of the company's filings.

Matters to Consider

At board and audit committee meetings, discussions with management should be interactive and probing. Moreover, remediation plans should be put in place to address internal control deficiencies. Board members should hold management accountable if the remediation of internal control deficiencies and weakness has not progressed according to plan.

Questions regarding internal controls that the audit committee should ask management include:

- What has management done to determine if the company has the proper internal controls in place to address each of the identified risks, in particular the risks associated with operating in an emerging market?

[16] Section 2.3 (5) of NI 52-110 *Audit Committees*

- What are the deficiencies and weaknesses in internal controls that have been identified? How material are these deficiencies or weaknesses?
- What potential risks flow from the identified deficiencies and weaknesses?
- What are the ways that such deficiencies and weaknesses can be remediated?

Companies that continue to have material weaknesses in internal controls in successive years may have heightened risks that need to be actively managed and controlled.

- Does management have a plan and timeframe for the remediation? Does the plan include immediate/ interim steps to manage the risks that have been identified? Is the timeframe proposed by management reasonable?
- What is the status of on-going remediation plans?
- Are there any interim measures that should be adopted before the remediation is complete?
- What are the auditor's views on the company's internal controls?

Disclosure Requirements

Certifying officers of a non-venture issuer are required to certify that they have established and evaluated, on an annual basis, the effectiveness of the issuer's internal controls. If material weaknesses in internal controls are identified, this fact must be disclosed in the issuer's MD&A pursuant to NI 52-109 *Certification of Disclosure in Issuer's Annual and Interim Filings*[17]*.* It is also advisable for venture issuers to disclose known material weaknesses in internal controls in their MD&As, if the material weaknesses give rise to a risk factor for the company.

The disclosure should be entity specific, and contain the information expected by regulators as discussed in the guidance in Companion Policy 52-109CP[18]. Transparency is particularly important to investors when a company has identified material weaknesses in its internal controls over financial reporting (ICFR), and sufficient information should be provided to investors to allow them to assess the nature and implications of those weaknesses.

Example of boilerplate disclosure: (Note)

Based on an evaluation of the Company's internal controls over financial reporting, the Company concluded that material weaknesses exist in the internal controls over the Company's process for

[17] Section 3.2 of NI 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*
[18] Sections 9.6 and 9.7 of 52-109 CP, in particular

recognizing sales and receivables. The material weaknesses were due to inadequate accounting systems and the lack of segregation of duties in this process. The Company will endeavour to remediate these material weaknesses in the near future.

Example of entity-specific disclosure: (Note)

Based on an evaluation of the Company's internal controls over financial reporting (ICFR), the Company concluded that there are material weaknesses relating to both the design and operating effectiveness of ICFR over the Company's process for recognizing sales and receivables.

Material weaknesses of ICFR over sales and receivables include the following:

- The use of manual spreadsheets to record sales transactions, and the lack of end-user computing controls to prevent unauthorized access to the spreadsheets.
- The lack of controls over management override with respect to the recording of sales transactions.
- The lack of segregation of duties in the authorization, recording and reconciliation of sales transactions.
- The lack of appropriate documentation for certain sales transactions that took place in the current fiscal year.

Due to these material weaknesses, there are risks related to whether the recorded sales transactions occurred and whether the recorded accounts receivable existed, and whether they were recorded at the appropriate amounts. Therefore, management concluded that the ICFR over the Company's process for recognizing sales and receivables is ineffective.

To mitigate these risks, management directed financial personnel other than those involved in the sales and receivables process to verify 100% of the Company's sales transactions in the year, and obtained appropriate independent verification for those sales transactions that lacked documentation. In addition, the audit committee of the Company independently reviewed the validity of individual sales transactions on a sample basis, and conducted interviews with the financial personnel involved to ascertain the process relied upon for recording and verification of sales transactions.

The Company is currently seeking to replace the manual spreadsheets with appropriate accounting applications, and to build in the proper controls to prevent or overcome management overrides and the lack of segregation of duties. A third-party provider has been engaged to assist in this process, and the Company expects to remediate these material weaknesses before the end of the second quarter in fiscal 2013.

Note: For simplicity, these examples have focused only on internal control over financial reporting, and have not included disclosure related to disclosure controls and procedures.

Disclosure Tips

The disclosure should be specific and should include sufficient details to allow a reader to understand:

- Each of the internal processes or functions that contain a material weakness
- The nature of each of the material weaknesses
- The implications of each of those material weaknesses on financial reporting, as well as on the company's internal controls over financial reporting
- Details of any mitigating factors that help to reduce the risks stemming from the material weaknesses
- Details of any remediation plan that management is carrying out to remediate the material weaknesses
- The timeline and status of the remediation plan

7. Use of and Reliance on Experts

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.

Companies need to bear in mind the risks associated with the use of and reliance on experts in emerging markets. Emerging market issuers should evaluate experts' credentials and specialized knowledge to asses whether they are similar to what would be expected in a Canadian context. When an expert is retained to assist in matters that are material to the company and could expose it to significant liability or result in a disruption of its business operations, boards should evaluate the level of diligence exercised by the expert in carrying out the task.

Companies operating in emerging markets may hire industry professionals or experts with specialized knowledge to assist with complex matters arising in the foreign jurisdiction. Some examples of when companies may consider retaining experts in emerging market operations include:

- Tax professionals may be retained to assist with the intricacies of taxation laws for entities operating in emerging markets. Taxation laws developed in emerging markets may have specific rules for companies that are considered to be foreign-owned by the applicable local tax regulatory authority.
- Legal professionals may be retained for their expertise on various matters including the interpretation and application of laws in the emerging markets.

- Valuation professionals may be retained to provide certified valuation opinions on proposed acquisitions/sales within the foreign jurisdiction.

Industry professionals in the emerging market may not be subject to equivalent rules of professional conduct and standards of care as they would be in the Canadian market. Boards will therefore need to assess the quality of the advice provided and their ability to rely on the advice.

Matters to Consider

When using and relying on experts, the board should consider the following:

- Has the company considered the significance of the expert's work on the company's operations and the potential impact on the company of an error or inaccuracy in the expert's work?
- What are the expert's credentials? Have background checks on the expert been conducted, including whether the expert is in good standing with its relevant industry organization in the foreign jurisdiction?
- Does the board have systems in place to identify whether the expert is independent of the company, its management, directors, officers, significant shareholders, and other related parties?
- Has the company considered differences between local customs and practices in the emerging market compared to Canada, and the adequacy of the rules of professional conduct developed by the professional organization of the expert in the emerging market?
- Has the company evaluated the level of due diligence exercised by the expert? Was the expert's opinion fully substantiated by accurate facts and thorough analysis?
- Is a corroborating opinion (provided by Canadian experts, for example) necessary or desirable?

Disclosure Requirements

In certain circumstances, companies required to file an AIF under securities law must disclose the names of experts who have prepared or certified a report, valuation, statement of opinion referred to in a continuous disclosure filing and (subject to specified exceptions) must also disclose all of an expert's interests in the company[19]. As part of their oversight role, boards should ensure that

[19] Item 16 of Form 51-102F2 *Annual Information Form*

disclosure of experts' interests is adequate and provides sufficient detail for investors.

Example of boilerplate disclosure:

The company has relied on the work of XYZ Valuations Inc. To the Company's knowledge, the employees and partners of XYZ Valuations Inc. beneficially own, directly or indirectly, less than 1% of the company's securities.

Example of entity-specific disclosure:

The company has relied on the work of XYZ Valuations Inc. to provide an independent valuation of the market value of Property A in Country ABC as referred to in our December 31, 2011 financial statements and related Management's Discussion and Analysis filed under NI 51-102.

XYZ Valuations Inc.'s independent valuation was prepared by Country ABC Valuation Standards governed by the Valuation Institute of Country ABC. XYZ Valuation Inc. is in good standing with the Valuation Institute of Country ABC.

As of the current date and to the company's knowledge, the registered or beneficial interests, direct or indirect, in any of the company's securities or other property of the company held by, received by, and to be received by the- "designated professionals" (as defined in NI 51-102) including the partners, employees or consultants of XYZ Valuations Inc., represent less than 1% of any class of shares issued by the company or of any of the company's associates or affiliates.

Disclosure Tips

A company's disclosure should:

- 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;
- 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

The external auditor is an important gatekeeper that investors rely on to ensure that a company's financial statements are fairly presented. As stated in NI 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[20]. In order for the audit committee to discharge its responsibilities, it must determine if the company's external auditors have the appropriate expertise and experience to carry out the audit, and that the audit committee effectively oversees the external auditor's work.

Matters to Consider

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 when it recommends that the board of directors retain a particular external auditor. Similar considerations should apply where a company's domestic auditor delegates a portion of the audit to a foreign "component" auditor[21]. Additional questions for the audit committee to consider when selecting an auditor of an emerging market issuer include:

- Does the auditor have a presence or affiliation in the jurisdiction in which the company's overseas operations are located?
- Do any members of the audit team have the language, skills relevant to, and cultural knowledge of, the local jurisdiction?
- Does the auditor have sufficient experience in the accounting and tax rules of the foreign jurisdiction?
- Does the auditor understand the risks and challenges facing the emerging market issuer, and does it have sufficient appropriate audit procedures to address them?
- What are the responsibilities of the domestic auditor versus the component auditor?
- How does the domestic audit team oversee the component audit team?
- How can the audit committee ensure that it has sufficient access, directly or indirectly, to the component audit team to discharge its external auditor oversight responsibility?

Overseeing the external auditor's work

In order for an emerging market issuer's audit committee to discharge its responsibility in reviewing financial statements as required under NI 52-110, the audit committee should 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 fulfilled its responsibility to obtain

[20] Section 2.3 (3) of NI 52-110 *Audit Committees*

[21] i.e., an auditor who performs work on financial information related to a component of the group audit. A component auditor may or may not belong to the same firm as the domestic auditor.

sufficient appropriate audit evidence in these areas of risk. This would include an understanding of how component auditors are used and the extent of audit evidence provided by the component auditor used by the domestic auditor to support its opinion.

The audit committee should maintain continuous communication with the auditor throughout the year and foster an environment for open and frank exchange of information.

In staff's view, it would be beneficial for the audit committee 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 audit planning and completion stages. The committee should pay particular attention to any signs of delays in the audit schedule or unusual management intervention in the audit process. We also believe it would be beneficial for the audit committee to hold "in-camera" sessions (meetings without the presence of management) with the auditor. The auditor can be a significant source of information, and a frequent and open dialogue with the auditor helps the audit committee to tap into that information.

Disclosure Tips

When there is a change of auditor, a company needs to disclose (among other things) any "reportable event", i.e., a disagreement, a consultation, or an unresolved issue, with the former auditor, to comply with securities rules[22]. When an auditor resigns, we expect directors to further 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 and risks about the company.

[22] Section 4.11 of NI 51-102 *Continuous Disclosure Obligation*

CONCLUSION

All reporting issuers, including emerging market issuers, their management and boards, are expected to discharge their responsibilities in a way that promotes the protection of Ontario investors and confidence in our markets. Boards, in particular, are expected to adopt appropriate corporate governance practices to facilitate the proper oversight of management. Faced with the unique challenges of operating in an emerging market, boards of emerging market issuers have to take extra measures to ensure investors' interests are protected.

This Guide is one of the steps that OSC staff are taking to help directors and management of emerging market issuers to more effectively discharge their responsibilities. We expect emerging market issuers to carefully consider the guidance provided in this Guide in evaluating and improving their corporate governance practices.

Questions

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