Current Developments: Canadian Securities and Auditing Matters

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Canadian Securities and Auditing Matters

This edition provides a summary of newly effective and forthcoming regulatory and auditing matters in Canada from April 1, 2018 to June 30, 2018.

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Distribution Disclosures and Non-GAAP Financial Measures in the Real Estate Industry

In April 2018, the Canadian Securities Administrators (CSA) issued Staff Notice (SN) 52-329 *Distribution Disclosures and Non-GAAP Financial Measures in the Real Estate Industry* which summarizes findings and provides guidance from their review of real estate investment trusts (REITs) and real estate operating companies (REOCs).

In total, the distribution disclosures for 47 REITs and REOCs were reviewed. As a result of the review 72% received comment letters, 6% were required to restate MD&A and 62% agreed to enhanced disclosure prospectively.

The CSA commented that REITs and REOCs generally provided adequate disclosure about their distributions, other than "excess distributions". Only 68% of issuers met the requirement to quantify the amount of the excess distribution relative to cash flows from operating activities. The majority of issuers failed to disclose a description of the sources of cash used to fund the "excess distribution" or their description was boilerplate.

There were a number of issues related to non-GAAP financial measures including the following:

- a lack of transparency and lack of disclosure about the adjustments made in arriving at non-GAAP financial measures such as adjusted funds from operations (AFFO);
- a lack of clarity in how management used each individual non-GAAP financial measure;
- a failure to clearly identify the most directly comparable GAAP measure; and
- non-GAAP financial information being presented more prominently than the GAAP information.

The notice highlighted in particular issues with how maintenance capital expenditures are determined, which is frequently used as an adjustment to reconcile between the non-GAAP financial measure and GAAP measure. The notice indicates that for issuers using a maintenance capital expenditures reserve, the management, discussion and analysis (MD&A) should provide additional disclosure, including:

- the method by which management determined the reserve;
- why the method was chosen in determining the reserve and why that method was appropriate;
- how the reserve amount compares to actual maintenance capital expenditures in the period and historically; and
- an explanation of why management's estimate is more relevant than the actual.

The notice highlighted that 69% of issuers making a working capital adjustment in determining non-GAAP financial measures used the same dollar amount as the change in non-cash working capital reported in the statement of cash flows. The CSA has challenged why the entire amount is not indicative of sustainable cash flows.

Additionally, the notice highlighted that certain issuers that use joint ventures to own and operate real estate assets were presenting a full set of non-GAAP financial statements in the MD&A, unwinding the equity accounting in the GAAP financial statements to present the pro-rata financial statements. Where the discussion in the MD&A was pervasively based on non-GAAP metrics at pro-rata interest, without a GAAP discussion presented with equal or greater prominence, the issuer was asked to restate the MD&A. These issuers were also requested to add clarifying disclosure to indicate that the issuer does not independently control the unconsolidated joint

ventures, and that the presentation of pro-rata assets, liabilities, revenue and expenses may not accurately depict the legal and economic implications of the issuer's interest in the joint venture.

The notice also reminded issuers to consider how a non-GAAP measure is used when determining what to reconcile the measure to and that issuers should avoid using multiple non-GAAP financial measures for the same purpose.

Climate Change-related Disclosure Project

In April 2018, the CSA issued SN 51-354 *Report on Climate Change-related Disclosure Project* which summarized the findings of a project to review the disclosure by reporting issuers of risks and financial impacts associated with climate change. The objectives of the project were:

- to assess whether current securities legislation in Canada and guidance are sufficient for issuers to determine what climate change-related disclosures they should provide;
- to better understand what climate change-related information investors need to make informed voting and investment decisions; and
- to see whether or not issuers are providing appropriate disclosures in this regard.

In connection with the project, the CSA conducted:

- research in respect of the current or proposed climate change-related regulatory disclosure requirements in selected jurisdictions outside of Canada as well as disclosure standards contained in certain voluntary frameworks related to climate change;
- a targeted review of current public disclosure practices of 78 issuers from the S&P/TSX Composite Index;
- a voluntary and anonymous on-line survey designed to solicit feedback from a wide-range of TSX-listed issuers; and
- focused consultations with issuers, users and other stakeholders.

The disclosure review did not result in any re-filings, restatements or other corrective actions being requested; however, the CSA did observe variations in disclosure practices and room for improvement. 56% of issuers reviewed provided specific climate change-related disclosure in their MD&A and/or annual information forum (AIF), with 22% providing boiler plate disclosure and 22% no disclosure at all. When no disclosure was provided, the principal reason given was that such disclosures were not material from a Canadian securities law perspective.

As a result of the project, the CSA announced its anticipated future work to include the following:

- developing guidance and educational initiatives with respect to business risks and opportunities and potential financial impacts of climate change;
- considering new disclosure requirements regarding corporate governance in relation to business risks, including climate change-related risks, and risk oversight and management; and
- monitoring the quality of issuers' disclosure and the evolution of best disclosure practices in this area, to assess whether further work needs to be done to ensure that Canadian issuers' disclosures continues to develop and improve; and
- monitoring developments in reporting frameworks, evolving disclosure practices and investors' need for additional types of climate change-related disclosure to make investment and voting decisions, including whether disclosure requirements in relation to certain greenhouse gas emissions are warranted in the future.

Reducing Regulatory Burden for Investment Fund Issuers

In May 2018, the CSA issued SN 81-329 *Reducing Regulatory Burden for Investment Fund Issuers* which provided an update on the status of its project to rationalize investment fund disclosures. The CSA intends to propose rule amendments by March 2019 to:

- remove redundant information in select disclosure documents;
- use web-based technology to provide certain information about investment funds;
- codify exemptive relief that is routinely granted; and
- minimize the filing of documents that may contain duplicative information, such as Personal Information Forms.

Proposals that required additional analysis will be implemented in the medium to long-term. These proposals will review the need for, and usefulness and efficiency of, certain:

- financial continuous disclosure obligations;
- prescribed notices and reporting requirements; and
- methods used to communicate with investors.

Offerings of Tokens

In June 2018, the CSA issued SN 46-308 *Securities Law Implications for Offering of Tokens* to provide guidance with respect to (i) when an offering of tokens may or may not involve an offering of securities; and (ii) offerings of tokens that are structured in multiple steps.

An offering of tokens may involve the distribution of securities because:

- the offering involves the distribution of an investment contract; and/or
- the offering and/or the tokens issued are securities under one or more of the other enumerated branches of the definition of security or may be a security that is not covered by the non-exclusive list of enumerated categories of securities.

In determining whether an investment contract exists, consideration should be given to whether the offering involves (1) an investment of money (2) in a common enterprise (3) with the expectation of profit (4) to come significantly from the efforts of others.

The CSA indicated that they have received submissions that a proposed offering of tokens does not involve securities because the tokens will be used in software, on an online platform or application, or to purchase goods and services. They indicated that they have found that most such offerings do involve the distribution of a security because there is an investment contract. The SN provides illustrative examples of tokens being issued and the analysis that may be performed.

The CSA notes that whether the tokens are reasonably expected or marketed to trade on one or more crypto asset trading platforms, including decentralized or "peer-to-peer" trading platforms, or to otherwise be freely tradeable in a secondary market may be suggestive that there is an investment contract. The CSA also noted that with the offerings of tokens they have seen that have involved securities, the public transferability of the tokens has not been restricted, potentially placing persons trading the tokens offside resale restrictions in securities laws.

The CSA has noted that some offerings of tokens have occurred in two steps. In the first step the purchaser agrees to contribute money in exchange for a right to receive tokens at a future date. In the first step, there is generally a distribution of security, specifically the right to a future token. In the second step, the token is delivered.

The CSA noted in several instances issuers have taken the position that the token itself is not a security. However, the CSA notes:

- the delivery of the token at the second step may be the delivery of a security because the token may have a security-like attribute, such as a profit sharing interest;
- the distribution of the security is subject to the prospectus requirements. The CSA reminds issuers that many capital raising prospectus exemptions under NI 45-106 *Prospectus Exemptions* are subject to resale restrictions under NI 45-102 *Resale of Securities*;
- a person or company that is in the business of trading in securities is subject to the dealer registration requirement under securities laws;
- if the distribution of the security at the first step is made without complying with securities law requirements, the issuer will remain in default of securities law requirements, even though subsequent steps may have occurred; and
- they will have concerns where a multiple step transaction is used in an attempt to avoid securities legislation.

Staff of the CSA note that they are conducting active surveillance of coin and token offerings. The notice encourages businesses with proposed offerings of tokens to consult with qualified securities legal counsel and members of the CSA.

Embedded Commissions for Mutual Fund Sales

In June 2018, the CSA issued SN 81-330 *Status Report on Consultation on Embedded Commissions and Next Steps*. In January 2017, the CSA had issued a consultation paper regarding the practice of investment fund managers remunerating dealers and their representatives for mutual fund sales through commissions, including sales and trailing commissions (embedded commissions) and whether such practice should be discontinued.

The notice outlines the policy changes expected as a result of the consultation, including:

- implementing enhanced conflict of interest mitigation rules and guidance for dealers and representatives requiring that all existing and reasonably foreseeable conflicts of interest, including conflicts arising from the payment of embedded commissions, either be addressed in the best interests of clients or avoided (see Proposed Amendments to NI 31-103 *Registration Requirements* article);
- prohibiting all forms of the deferred sales charge option, including low-load options and their associated upfront commissions in respect of the purchase of securities of a prospectus qualified mutual fund; and
- prohibiting the payment of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who do not make a suitability determination in connection with the distribution of prospectus qualified mutual fund securities.

The CSA anticipates publishing a notice and request for comment, including transition measures, on the proposed changes in September 2018.

Designated Rating Agency

In June 2018, the approved amendments to various rules to recognize the Kroll Bond Rating Agency as a designated rating agency came into force, but only for the purposes of the alternative eligibility criteria in section 2.6 of NI 44-101 *Short Form Prospectus Distribution* and section 2.6 of NI 44-102 *Shelf Distribution* for issuers of asset-backed securities.

There are four other designated rating agencies in Canada: S&P Global Ratings Canada, Moody's Canada Inc., Fitch Ratings, Inc. and DBRS Limited

Canadian Securities: Proposed guidance

NI 31-103 Registration Requirements

In June 2018, the CSA issued proposed amendments to National Instrument (NI) 31-103 *Registration Requirements, Exemptions and Ongoing Registration Obligations and related guidance*. Comments are due on or before October 19, 2018. The amendments seek to:

- address conflicts of interest in the best interest of the client;
- put the client's interest first when making a suitability determination; and
- do more to clarify for clients what they should expect from their registrants.

This is done by amending provisions in the rule relating to know your client (KYC), know your product (KYP), suitability, conflicts of interest and relationship disclosure information (RDI). In addition, the CSA is proposing changes to requirements and guidance concerning the training of representatives and maintenance of policies, procedures, controls and documentation to support the important role of registrants' internal compliance systems. Key changes are noted below:

***KYC Changes**:* Registrants would be required to gather sufficient information about the client to support an enhanced suitability determination obligation, and update KYC information at specified intervals.

***KYP Changes**:* This a new section in the rule; currently guidance only exists in the companion policy. It will impose requirements at both the registered firm and registered individual levels.

***Suitability Changes**:* Unsuitable recommendations generate the majority of complaints and as such the amendments in this area are extensive. The proposal includes as a core requirement that registrants must put their clients' interests first when making a suitability determination. Enhanced suitability obligations would also include: explicitly requiring registrants to consider certain factors, including costs and their impact, in making suitability determinations; moving away from trade-based suitability to an overall portfolio-level suitability analysis; and prescribing triggering events that will require a registrant to reassess suitability.

***Conflicts of Interest Changes**:* The proposal requires that conflicts be addressed in the best interest of the client. Other reforms include: specifying that all conflicts of interest must be addressed, not only those that are material; expressly applying conflicts of interest obligations to registered individuals, as well as their sponsoring firms; adding guidance relating to particular conflicts of interest, such as conflicts arising from sales and incentive practices and compensation arrangements, including the acceptance of compensation from third parties (such as embedded commissions) and the use of proprietary products; restricting certain referral arrangements; and expanding recordkeeping, particularly as it concerns sales practices, compensation arrangements and other incentive practices.

***RDI Changes**:* The proposal will require adequate disclosure about a registrant's use of proprietary products, limitations on the products and services the registrant will make available to a client and the impact these restrictions may have on investment returns.

Auditing Matters

Auditor Reporting Model

What's new and effective for 2018?

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

Highlights of the new auditors' report in Canada include:

- re-ordering the contents of the auditors' report (opinion first);
- expanded descriptions of responsibilities of management, those charged with governance and the auditors;
- separate section on "Material Uncertainty Related to Going Concern", if applicable;
- separate section on "Other Information" (e.g. MD&A); and
- disclosure of engagement partner's name (listed entities).

Key audit matter reporting

Currently, the reporting of key audit matters (KAM) in the auditors' report is only applicable when required by law or regulation or when the auditor is engaged to do so. Given the U.S. developments, it is expected that KAM reporting will be required for certain listed entities in Canada starting 2020.

U.S. developments

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

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

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

Impact to Foreign Private Issuers in Canada

At this time, it is unlikely the SEC and PCAOB will approve a combined report (which many foreign private issuers (FPIs) in Canada issue today) for 2018. If the SEC and PCAOB determine that a combined report is not possible, auditors of FPIs may need to consider whether issuing only a report under PCAOB standards is appropriate for their needs or whether they will need to issue two reports; one referring to the CASs and one referring to the standards of the PCAOB.

Auditing Accounting Estimates and Related Disclosures

The International Auditing and Assurance Standards Board (IAASB) approved the final text of ISA 540 (Revised) in June 2018.

This standard:

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

The IAASB is in progress of determining the effective date of this standard.