

## OSC Staff's latest views have implications for capital markets transactions – Highlights from the 2016-2017 Annual Report of the Corporate Finance Branch

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The Corporate Finance Branch of the Ontario Securities Commission (OSC) released its latest Annual Report on September 21, 2017. A link to the report is provided <a href="https://example.com/here-en-link-number-en-li

1. OSC comments on forward-looking management targets and other forward-looking information in prospectuses and continuous disclosure documents - The OSC has gone on the public record with its views on the inclusion of longer-term forward-looking information in prospectuses and continuous disclosure documents. Staff's views are presumably aimed at the recent practice of including three- or five-year financial and operating targets in IPO prospectuses, a practice which started during the wave of IPOs in 2015 and continues today, particularly for issuers in retail and consumer-focused industries. While not prohibiting this practice, Staff reiterate the views they have expressed in their comment letters on IPO prospectuses containing forward-looking target disclosure. Notably, the OSC says it believes the time period for which a financial outlook can be reasonably estimated will, in many cases, not go beyond the end of the issuer's next fiscal year. Does this mean that three- or five-year financial and operating targets in an IPO prospectus will be rejected? We don't believe so. However, Staff say they may ask issuers to limit forward-looking disclosure to a shorter period (such as one or two years) if targets for longer periods are not sufficiently supported by reasonable qualitative and quantitative assumptions. We believe Staff have a preference for numerous and detailed assumptions underpinning growth targets, which we note is at odds with how these targets are disclosed in the U.S. market. According to Staff, an issuer projecting aggressive growth targets without the benefit of historical experience should be able to show (i) a reasonable basis for those targets, including key drivers referring to specific plans and objectives that support the projected growth, and (ii) why management believes the targets are reasonable. The OSC reminds issuers of their obligations to update disclosure of targets when events or circumstances are reasonably likely to cause actual



- results to differ materially from previously disclosed targets and to include a comparison of actual results to previously disclosed targets. In practice, we believe this means updating progress against targets on an annual basis in the issuer's MD&A.
- 2. A warning on non-GAAP financial measures The OSC has used its strongest language yet in terms of signalling an intention to take regulatory action against issuers over non-GAAP financial measures if Staff consider that an issuer has disclosed information in a manner that they consider misleading or otherwise contrary to the public interest. Among other considerations, the OSC has flagged its concern over the prominence placed on non-GAAP financial measures and provided examples of Staff's expectations for non-GAAP measures for issuers in certain industries. For example, the OSC has called out REITs for their disclosure of the sustainability of distributions, as well as for the prominence of funds from operations (FFO) and adjusted funds from operations (AFFO) measures, and the "unclear adjustments" being made in deriving these non-GAAP financial measures. Staff have also reiterated that non-GAAP financial measures should not describe adjustments as non-recurring, infrequent or unusual, when a similar loss or gain is reasonably likely to occur within the next two years or occurred during the prior two years. These comments are not new, but the signalling of the OSC's intention to take regulatory action against issuers is a clear warning to issuers and their advisors.
- 3. IPOs may require three years of financial statements and MD&A for acquired businesses - We remind issuers and their advisors of Staff's views that the three-year financial statement and MD&A requirements for a long-form prospectus apply not only to the issuer but to any predecessor businesses of the issuer or businesses acquired by the issuer at any time during the last three financial years or in the current financial year, including acquisitions that have not closed. As we have seen on past transactions, Staff take the view that the significant acquisition rules essentially do not apply on an IPO. This can be a major headache for acquisitive issuers such as technology companies, real estate issuers and any business with a strategy of making strategic or "tuck-in" acquisitions, since it means that an issuer has to have access to and be prepared to provide a full three years' worth of audited financial statements and MD&A for potentially all recent and non-de minimis acquisitions. In our experience, exemptive relief is only available where an acquired business is small enough in size, or the acquisition occurred sufficiently long ago (two or three years ago), such that the business has been included in the issuer's audited financial statements for a sufficient length of time. It is not clear if other securities commissions in Canada take the same view as Staff, but all issuers considering an IPO should carefully consider the financial disclosure requirements applicable to acquired businesses early in the IPO process.
- 4. OSC suggests that issuers may need to provide additional financial and other disclosure on offerings used to fund transformative acquisitions To our knowledge, Staff have made their first clear public statement that issuers should consider whether the standard disclosure for significant acquisitions is adequate in situations where an issuer is raising proceeds to fund an acquisition that makes up a material portion of its business, or that is larger than the issuer's existing business. We believe the OSC is clearly taking aim



at "transformative" acquisitions by issuers that are funded in whole or in part through the proceeds of a prospectus offering, including a bought deal. These acquisitions have taken place in many different industries in the past few years. The OSC hints that an issuer may need more than the prescribed business acquisition report (BAR) disclosure in these cases, but provides limited details on what this should entail, saying that reporting issuers with an existing annual information form (AIF) should consider if the AIF needs to be supplemented with additional disclosure in the prospectus in light of the acquisition, and whether inclusion of additional financial statements (presumably beyond the standard two financial years and most recent comparative interim periods) is necessary. We believe this development is potentially very significant, as issuers and their advisors must now consider whether to have pre-filing discussions with Staff that could lead to more than two years of annual financial statements for the target business and potentially additional disclosure of the target business and the impact of the acquisition on the issuer's own business. It is possible that the OSC may be aiming its guidance at the inconsistency between the prospectus disclosure requirements for significant acquisitions, and the more onerous disclosure requirements for an information circular that can apply in the context of a significant acquisition where a shareholder meeting is required.

- 5. Issuers are reminded to comply with audit committee requirements on IPOs We have recently seen examples of issuers on an IPO taking advantage of available exemptions in the audit committee rules that allow an audit committee to have less than a full complement of independent directors at the time of the final prospectus on the IPO. In particular, an issuer is technically allowed to have one out of three independent directors on the audit committee at the time of the final prospectus, but must have two out of three independent directors within 90 days of the receipt for the final prospectus, and three out of three independent directors within one year of the receipt for the final prospectus, assuming an audit committee size of three members. These exemptions are sometimes used when issuers are unable to recruit a full complement of independent directors in time to execute on a market window for the IPO. The OSC notes that, where an issuer files an IPO prospectus, it must have an audit committee in place that meets the composition requirements prescribed by National Instrument 52-110 - Audit Committees (the Instrument) no later than the date of the receipt for the final prospectus. It is unclear to us why the OSC has provided this guidance given that it also refers to the exemptions set out in the Instrument, which would include the exemptions referred to above that permit an issuer to meet the requirements for independent directors on an audit committee within the prescribed time periods. We assume issuers will continue to be able to take advantage of available exemptions in the Instrument in appropriate circumstances.
- 6. Mining issuers need to be extremely cautious with technical disclosure, including with respect to preliminary economic assessments (PEAs) The OSC notes again that it continues to see non-compliant disclosure of PEAs in technical reports which incorporate the economic analyses, production schedules and cash flow models based on inferred mineral resources with economic studies based on mineral reserves. Staff indicate they



will monitor this area closely. In our view, it is critical that mining issuers and their advisors not launch a bought deal under a short form or shelf prospectus without being comfortable that the issuer has complied with the guidance for PEA disclosure and that the issuer otherwise has no material issues with its technical disclosure. Failure to do so may create serious risk of a failed offering due to the fact that it is difficult to fix materially deficient technical disclosure mid-deal.