

MSC NOTICE 2003-29

NOTICE AND REQUEST FOR COMMENTS

PROPOSED MULTILATERAL INSTRUMENT 52-108 AUDITOR OVERSIGHT

We, the securities regulatory authorities in each jurisdiction other than British Columbia (the Participating Jurisdictions), seek public comment on proposed Multilateral Instrument 52-108 *Auditor Oversight* (the Proposed Instrument). We invite comment on the Proposed Instrument generally. In addition, we have raised a number of questions for your specific consideration.

Introduction

The Proposed Instrument is an initiative of certain members of the Canadian Securities Administrators (CSA). The Proposed Instrument is expected to be adopted as a rule in each of Alberta, Manitoba, Newfoundland and Labrador, Nova Scotia, Ontario, Québec, and the Northwest Territories, as a Commission regulation in Saskatchewan, as a policy in New Brunswick, Prince Edward Island, and the Yukon Territory, and as a code in Nunavut. The British Columbia Securities Commission has not yet determined whether it will adopt the Proposed Instrument.

The purpose of the Proposed Instrument is to contribute to public confidence in the integrity of financial reporting of reporting issuers by promoting high quality, independent auditing. The Proposed Instrument will require reporting issuers to engage auditors that:

- participate in an independent oversight program established by the Canadian Public Accountability Board (CPAB) for public accounting firms that audit the financial statements of public companies (the CPAB Oversight Program), and
- are participants in good standing with the CPAB.

In addition, the Proposed Instrument will require, other than in Alberta and Manitoba, public accounting firms that audit reporting issuers to:

- participate in the CPAB Oversight Program,
- be participants in good standing with the CPAB, and
- provide notice to their audit clients and securities regulators of any sanctions or restrictions imposed by the CPAB.

Background

The U.S. capital market recently suffered an erosion of investors' confidence as a result of several large corporate failures involving accounting irregularities. Following these corporate failures, the U.S. government enacted the *Sarbanes Oxley Act of 2002* (the "SOX Act") in July 2002. The SOX Act introduced numerous accounting, disclosure and corporate governance reforms aimed at restoring public confidence in the U.S. capital markets. One of these reforms was the creation of the Public Company Accounting Oversight Board (PCAOB) to oversee the auditing of public companies that are subject to U.S. securities laws. The PCAOB is mandated, among other things, to establish a registration system for public accounting firms that prepare audit reports for issuers and to conduct inspections of registered public accounting firms. Under

the SOX Act, it will be unlawful for any public accounting firm that is not registered with the PCAOB to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to an issuer subject to U.S. securities laws.

Although the corporate scandals that triggered the threat to market confidence took place in the United States, they have revealed the vulnerability of our markets and the need to strengthen existing requirements in our jurisdictions. In response, several initiatives have been introduced to address the issue of investor confidence and to maintain the reputation of our capital markets internationally, including the creation of the CPAB that will oversee the work done by auditors of public companies in Canada.

The CPAB

In July 2002, federal and provincial financial and securities regulators, as well as Canada's chartered accountants announced the creation of the CPAB. The CPAB represents a new independent public oversight system for accountants and accounting firms that audit reporting issuers. It is incorporated as a corporation without share capital under the *Canada Corporations Act*. A copy of its By-laws are attached to this Notice in Appendix A.

The mandate of the CPAB is to promote high quality external audits of reporting issuers. It will be responsible for developing and implementing an oversight program that includes regular and rigorous inspections of the auditors of Canada's public companies.

The Council of Governors

Structurally, the CPAB has a Council of Governors that appoints the Chair and members of the Board. The Council also has the power to remove the Chair and members of the Board.

The five-member Council of Governors is made up of the:

- Chair of the CSA (currently the Chair of the Alberta Securities Commission)
- Chairs of the Ontario Securities Commission and the Commission des valeurs mobilières du Québec
- Superintendent of Financial Institutions Canada
- President and CEO of The Canadian Institute of Chartered Accountants (CICA)

The Council selects its own Chair from among the four non-CICA Governors. Each Governor is entitled to one vote and decisions are made by majority vote.

The Council will periodically review the effectiveness of the new system and take appropriate action, as necessary, to improve its effectiveness.

The Board of Directors

The Board has 11 voting members. Seven members, including the Chair, are from outside the accounting profession. Of the remaining four members, initially three will be the CEOs of the provincial Institutes of Chartered Accountants in Alberta and Ontario and the CEO of the Ordre des comptables agréés du Québec. Board members are appointed for a term of up to 3 years and will be eligible for reappointment, provided that the total tenure does not exceed 6 years. Should a vacancy arise, the Council of Governors will appoint a replacement.

Mandate and Responsibilities

The CPAB will enter into contractual agreements with firms auditing reporting issuers that will permit the CPAB to take actions necessary to carry out its responsibilities.

As part of the CPAB Oversight Program, the CPAB will, among other things:

- Promote, publicly and proactively, high quality external audits of reporting issuers;
- Establish and maintain participation requirements for public accounting firms that audit reporting issuers;
- Conduct inspections of public accounting firms that audit reporting issuers to ensure compliance with professional standards and participation requirements;
- Receive and evaluate reports and recommendations resulting from the inspection process, including, if appropriate, reports from provincial accounting organizations on results of inspections of public accounting firms that audit reporting issuers that are not inspected directly by the CPAB;
- Impose, where appropriate, sanctions and restrictions on public accounting firms that audit reporting issuers and, where necessary require remedial action;
- Maintain a register of public accounting firms that audit reporting issuers;
- Refer matters, as appropriate, to provincial accounting organizations for discipline purposes;
- Refer matters, as appropriate, to securities regulators;
- Provide comments and recommendations on accounting standards, assurance standards and governance practices to relevant standards-setting and oversight bodies; and
- Provide recommendations to securities regulatory authorities.

The Board will report to the public at least annually on the results of its activities. The form and content of this report will be determined by the Board taking into account the need to provide a high degree of transparency.

Funding

The CPAB will establish a fee schedule that is designed to recover its start-up costs and its ongoing operating costs from participating public accounting firms. Annual operating costs have yet to be determined fully but are estimated to be in the range of \$3 to \$5 million. The structure and amount of the fees to be levied will be determined by the CPAB taking into account the need to ensure an equitable distribution of costs that reflects the extent to which a participating audit firm is involved in auditing reporting issuers. Elements that could be the subject of separate fees include: (i) start-up cost recovery fees, (ii) initial registration fees, (iii) annual participation fees, and (iv) inspection fees.

Registration with the CPAB

Any firm seeking to participate in the CPAB Oversight Program must demonstrate its suitability in its application. The Board will prescribe the form and content of the application. In connection with its review of a public accounting firm's application, the CPAB may examine the books and records of the applicant and make copies in order to ascertain and verify the information contained in the application. Once a public accounting firm's application is approved, it will have to enter into a participation agreement agreeing to abide by all of the

provisions of the by-laws and rules and regulations of the CPAB pertaining to the Program. The Board will prescribe the time period within which a public accounting firm will have to enter into a participation agreement with the CPAB.

The CPAB will develop and maintain a publicly accessible register of participating public accounting firms that are in good standing.

The Inspection Program

The CPAB will hire full-time staff, including practice inspectors led by a full-time CEO. The Board of Directors is currently in the process of recruiting the CEO.

It is currently contemplated that CPAB's practice inspectors will inspect the majority of the largest accounting firms that audit reporting issuers to determine whether the firms are complying with professional standards, Rules of Professional Conduct, relevant regulatory requirements and the contractual requirements of the CPAB. In order to maximize efficiency and minimize duplication, it is possible that the CPAB will work with staff of provincial accounting organizations to inspect some public accounting firms that audit a small number of reporting issuers.

The exact scope, nature and frequency of inspections of participating firms will be determined by the CPAB. However, it is expected that the frequency of inspections will be greater for those firms that audit a large number of reporting issuers. The extent of each inspection may include:

- a review of the results of the firm's internal inspection program;
- follow-up on any matters reported in a previous inspection;
- a review of the implementation of any new CPAB requirement; and
- a review of any significant changes in the firm's policies such as changes in the firm's audit methodology.

Each inspection is expected to result in preparation of a report to the Board addressing matters such as:

- the adequacy of the firm's quality control policies and procedures for the public company audit practice;
- comments on compliance with the system of quality control for the public company audit practice and with the requirements of the CPAB; and
- deficiencies relating to the application of generally accepted auditing standards, including compliance with independence standards.

Summary and Discussion of the Proposed Instrument

The Proposed Instrument has five parts.

Part 1

Part 1 contains definitions of terms and phrases used in the Proposed Instrument that are not defined or interpreted under a national definitions instrument in force in a Participating Jurisdiction. National Instrument 14-101 *Definitions* defines commonly used terms and phrases and should be read together with the Proposed Instrument.

Part 1 also stipulates that the sections of the Proposed Instrument that impose requirements directly on auditors do not apply in Alberta and Manitoba. We have carved these jurisdictions out of these sections because they do not have rule-making authority to prescribe requirements respecting qualifications of auditors.

Part 2

Part 2 of the Proposed Instrument will require, in effect, every public accounting firm that audits an issuer that is a reporting issuer in any of the Participating Jurisdictions to participate in the CPAB Oversight Program.

a. Requirement to participate in the CPAB Oversight Program

Section 2.1 imposes a requirement, other than in Alberta and Manitoba, on any public accounting firm that chooses to audit financial statements of a reporting issuer to enter into a participation agreement with the CPAB. It should be emphasized that this requirement is being imposed directly on the auditor of a reporting issuer.

In addition to the requirement imposed on auditors, section 2.3 imposes a requirement on all reporting issuers in the Participating Jurisdictions to file auditor's reports issued by auditors that are participating in the CPAB Oversight Program.

The timing as to when a public accounting firm must enter into a participation agreement will be determined and announced by the Board of Directors of the CPAB. In accordance with its By-laws the CPAB may, until December 31, 2005, restrict the number of public accounting firms that are eligible to participate in the CPAB Oversight Program.

The necessity to participate in the CPAB Oversight Program, either by virtue of section 2.1 or section 2.3, only applies to an accounting firm that issues an auditor's report with respect to the financial statements of a reporting issuer. It does not apply to an accounting firm that participates or assists in the preparation or issuance of an auditor's report. This contrasts with the requirement under the SOX Act that any public accounting firm that participates in the preparation or issuance of an auditor's report to any issuer must register with the PCAOB. We have limited the scope of the Proposed Instrument to audit firms that issue the auditor's reports because we believe there will be relatively few situations in which a public accounting firm participates in the preparation or issuance of an auditor's report with respect to a reporting issuer and is not otherwise required to register with the CPAB. In addition, we note that Canadian generally accepted auditing standards require an auditor that is engaged to express an opinion on financial statements containing financial information audited by another auditor to carry out sufficient procedures to support the opinion given. Unlike in the U.S., the primary auditor assumes sole responsibility for the opinion expressed and may not refer to the work of another auditor except to explain the reason for a reservation of opinion.

We note that if proposed National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers* (NI 71-102) is implemented in the Participating Jurisdictions, certain foreign issuers that are reporting issuers will not be required to comply with section 2.3. Specifically, a foreign issuer that is defined as a "SEC foreign issuer" or as a "designated foreign issuer" in NI 71-102 will be deemed to comply with section 2.3 provided it complies with the regulations in its home jurisdiction respecting audit reports and financial statements. However, section 2.1 will require the issuer's auditors to enter into a participation agreement with the CPAB. We believe it is important that public accounting firms based outside

Canada that audit foreign issuers reporting in the Participating Jurisdictions be subject to oversight by the CPAB. The CPAB will maintain flexibility on how it exercises that oversight, however, and it may choose to consider entering into arrangements with independent oversight bodies in the home jurisdiction of the auditor to share information about the results of inspections of the auditor carried out by that oversight body.

Request for Comments

Do you agree that public accounting firms in foreign jurisdictions should be required to participate in the CPAB Oversight Program? If not, what other alternatives should be considered? For example, should a public accounting firm based outside Canada that is subject to oversight by a comparable body in a foreign jurisdiction, such as the PCAOB, be treated differently?

b. Requirement to be in good standing

Sections 2.2 and 2.3 of the Proposed Instrument have the effect of requiring a participating audit firm to be in good standing at the time it issues an auditor's report relating to the financial statements of an issuer that is reporting in one of the Participating Jurisdictions.

For the accounting firm to be considered "in good standing", its participation agreement with the CPAB must not have been suspended or terminated at the time the auditor's report is issued. In addition, if the participating audit firm is subject to CPAB imposed sanctions or restrictions at the time it issues the auditor's report, it must be in compliance with those sanctions or restrictions. Further, if the accounting firm had been subject to CPAB imposed sanctions or restrictions that expired prior to the time it issues the auditor's report, it must have complied with those sanctions or restrictions to satisfy the good standing requirement.

Part 3

Part 3 does not apply in Alberta or Manitoba.

Section 3.1 requires public accounting firms that are subject to sanctions imposed by the CPAB to give written notice to their reporting issuer audit clients. This means that each audit client that is a reporting issuer in any one of the Participating Jurisdictions, other than Alberta or Manitoba, will have to be provided notice. In addition, the auditor will also have to provide notice to the regulator in each Participating Jurisdiction, other than Alberta and Manitoba, where a client is a reporting issuer.

The notice must provide details of the sanctions and be delivered within five business days. In addition, notice will have to be provided to potential reporting issuer clients if the public accounting firm is proposing to undertake an audit of their financial statements.

If, in the course of carrying out an inspection of a participating audit firm, the CPAB identifies defects with the firm's quality control systems, the board of directors of the CPAB may impose restrictions on the participating audit firm in order to address these deficiencies. In such cases, section 3.3 requires a public accounting firm that is subject to restrictions to give written notice to the regulator in each Participating Jurisdiction, other than Alberta or Manitoba, where a client is a reporting issuer. The public accounting firm, however, will not have to provide notice to its audit clients except when it fails to address the defects in its quality control systems to the satisfaction of the CPAB within the agreed time period.

Section 3.4 recognizes that there are benefits to providing the CPAB and a public accounting firm with the opportunity to address issues respecting a firm's quality control system without having to disclose that it is subject to restrictions. We believe that, by requiring disclosure only in situations where a public accounting firm fails to address the underlying deficiencies in its quality control systems within a reasonable period of time, it will act as an incentive to address deficiencies. Restrictions that will be imposed by the CPAB while the accounting firm addresses the underlying deficiencies will ensure that any auditor's report the firm may issue meets acceptable standards. A similar benefit is reflected in paragraph 2 of subsection 104(g) of the SOX Act that provides that the PCAOB does not have to publicly disclose findings of defects in the quality control systems of a public accounting firm except where those defects are not addressed by the firm within 12 months.

Request for Comments

Do you think that five business days is an appropriate length of time for a public accounting firm to provide notice to its audit clients? Do you agree that an audit firm should only be required to provide notice to its audit clients when it fails to address defects within the time period prescribed by the CPAB? Are there other more effective means of having information about sanctions or restrictions communicated? For example, should the CPAB disclose to the public on a timely basis any sanctions or restrictions it imposes on a public accounting firm?

Part 4

Part 4 provides for exemptive relief from the requirements of the Proposed Instrument.

Part 5

Part 5 sets out the effective date of the Proposed Instrument.

Authority for Proposed Instrument - Ontario

In those jurisdictions in which the Proposed Instrument are to be adopted or made as a rule or regulation, the securities legislation in each of those jurisdictions provides the securities regulatory authority with rule-making or regulation-making authority regarding the subject matter of the Proposed Instrument.

The following provisions of the *Securities Act* (Ontario) provides the Ontario Securities Commission (OSC) with authority to adopt the Proposed Instrument:

Paragraph 143(1)25(iv) authorizes the OSC to make rules prescribing requirements in respect of financial accounting, reporting and auditing, including standards of independence and other qualifications for auditors.

Paragraph 143(1)39(iii) authorizes the OSC to make rules prescribing format, preparation, form, content, execution, certification, dissemination and other use, filing and review of all documents required under or governed by Ontario securities law.

Alternatives Considered

No alternatives were considered.

Unpublished Materials

In proposing the Proposed Instrument, we did not rely upon any significant unpublished study, report, decision or other written materials.

Anticipated Costs and Benefits

The anticipated costs and benefits of implementing the Proposed Instrument are discussed in the paper entitled *Investor Confidence Initiatives: A Cost Benefit Analysis*, which has been published together with this Notice and is incorporated by reference into this Notice.

Related Instruments

The Proposed Instrument is related to the following instruments: (i) proposed National Instrument 51-102 *Continuous Disclosure Obligations*, which requires auditor's reports to be filed with financial statements; (ii) proposed National Instrument 52-107 *Acceptable Accounting Principles, Auditing Standards and Reporting Currency*, which will introduce certain requirements respecting auditor's reports and acceptable auditors; and (iii) proposed National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*, which will exempt certain foreign issuers that are reporting issuers from requirements respecting annual financial statements and auditor's reports filed in Canada.

In Ontario, the Proposed Instrument is related to section 78 of the *Securities Act* (Ontario)(the Act) and section 2 of the Regulation made under the Act (Regulation 1015).

Comments

Interested parties are invited to make written submissions on the Proposed Instrument. Submissions received by September 25, 2003 will be considered. **Due to timing concerns, comments received after the deadline will not be considered.**

Submissions should be sent, in duplicate, to the securities regulatory authorities listed below in care of the OSC and CVMQ:

Ontario Securities Commission
Commission des valeurs mobilières du Québec
Alberta Securities Commission
The Manitoba Securities Commission
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Securities Commission of Newfoundland and Labrador
Nova Scotia Securities Commission
Saskatchewan Financial Services Commission
Office of the Attorney General, Prince Edward Island
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut

c/o John Stevenson, Secretary
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A diskette containing the submissions (in Windows format, preferably Word) should also be submitted.

Comment letters submitted in response to requests for comments are placed on the public file in certain jurisdictions and form part of the public record, unless confidentiality is requested. Comment letters will be circulated amongst the securities regulatory authorities, whether or not confidentiality is requested. Although comment letters requesting confidentiality will not be placed in the public file, freedom of information legislation in certain jurisdictions may require securities regulatory authorities in those jurisdictions to make comment letters available. Persons submitting comment letters should therefore be aware that the press and members of the public may be able to obtain access to any comment letters. Questions may be referred to the following people:

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Proposed Instrument

The text of the Proposed Instrument follows.

Dated: June 27, 2003