

Corporate governance reform in Canada

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ABSTRACT

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Canada has been slower than the USA in developing corporate governance reform responses to recent financial

collapses and management scandals. Canada's regulatory structure consists of provincial and territorial securities regulators, rather than a national body. The Ontario Securities Commission has been active in proposing corporate governance reform initiatives. The Ontario Securities Commission recently introduced new reform measures, focusing on the formation of effective and independent audit committees, the role of the CEO and CFO in ensuring the accuracy and quality of reported financial information and the part that external auditors play in the audit process. The Ontario Securities Commission has also recently proposed new measures that will confirm as best practice certain governance standards and guidelines and require issuers to disclose those governance practices they have adopted.

Financial collapses and management scandals have been catalysts for a host of aggressive and widely reported reform initiatives by US lawmakers, regulators, law enforcement and stock exchanges.

The US legislative approach to reform has been to enact legislation, such as the Sarbanes-Oxley Act (SOX) in 2002. The New York Stock Exchange (NYSE) and the NASDAQ Stock Market have made significant changes to their respective corporate governance listing standards, which are aimed at helping restore investor confidence by empowering and ensuring the independence of directors and strengthening corporate governance policies. Corporate governance reform in Canada has been somewhat slower in the making.

CANADIAN TIES TO US MARKETS

Many public companies are interlisted on Canadian and US stock exchanges. Given the different approaches to corporate governance, this produced a situation where, potentially, interlisted companies would be called upon to observe a higher standard than those with a purely domestic listing. This dichotomy, as well as Canada's own recent corporate embarrassments, have prompted some Canadian regulators and stock exchanges to act more aggressively in imposing improved corporate governance standards. While there was initially considerable reluctance to follow the US lead, recent initiatives have suggested a more formal approach to corporate governance in order to secure confidence in the Canadian markets and provide consistency between these two closely related markets.

Canadian issuers have enjoyed easier access to US capital markets since the implementation of the multijurisdictional disclosure system (MJDS) in 1991. The MJDS, which is a collection of rules, forms and schedules adopted by Canadian securities regulators and the Securities and Exchange Commission (SEC) in the USA, allows qualifying Canadian issuers to bypass the SEC's lengthy and expensive disclosure document regulations, if they comply with the regulations of a Canadian security regulator (with similar treatment provided to US issuers by Canadian regulators), although they must still comply with the requirements of SOX if listed on a US exchange or are otherwise considered a 'foreign private issuer' under SOX. The similarity of filing standards in Canada and the USA has allowed many Canadian issuers to use the MJDS to access a larger pool of capital in the USA when the Canadian pool cannot satisfy its needs. Recent indications, however, are that such access may be significantly reduced by the SEC's proposed amendments to the MJDS.

CANADIAN REGULATORY STRUCTURE

In Canada, there is no single, national securities regulator like the SEC. Instead, Canada's ten provinces and three territories are responsible for securities regulation within their own territory. Securities regulators from each province and territory have worked together to form the Canadian Securities Administrators (CSA), a body without specific regulatory power. The CSA is primarily responsible for coordinating and harmonising regulation of Canadian capital markets. Through its 'mutual reliance' system, the CSA has attempted to increase market efficiency by reducing the number of regulatory agencies that an issuer reporting in more than one Canadian jurisdiction must deal with.

CANADIAN CORPORATE GOVERNANCE IN TRANSITION?

The Ontario Securities Commission (OSC) has been a leader in proposing governance reform since the introduction of SOX. In the autumn of 2002, David Brown, the chair of the OSC, issued an open letter to market participants in Canada outlining the OSC's approach to addressing corporate governance issues. The letter called for a balanced approach that would provide protection to investors without unduly compromising the efficiency of Canadian capital markets. While there is broad support in Canada for reforms to restore public confidence in governance and disclosure practices, there is apprehension at the industry and regulatory levels about placing undue cost and pressure on Canadian public companies and capital markets, especially mid- and small-cap issuers.

In a testimony given before a Canadian senate committee in the autumn of 2002, the chair of the OSC advocated mandatory corporate governance rules rather than guidelines. However, he also stressed that Canada's 'unique circumstances' justified the development of a 'made-in-Canada solution'

rather than rules along the lines of those recently adopted or proposed in the USA. 'We have to make sure that we don't try to impose rules that make sense for large corporations but don't make sense for small corporations.'

Starting long before SOX, the Toronto Stock Exchange (TSX) was actively involved in efforts to improve the corporate governance standards and practices of its listed companies. The TSX has favoured a voluntary 'guidelines' approach rather than the 'rules' approach taken in the USA, although its recent proposed amendments were designed to bring the guidelines into line with international developments. Such proposals have not been and likely will not be implemented, as the TSX has indicated that it will defer to provincial securities regulators to set the corporate governance enforcement standards of its listed companies. In this regard, on 16th January, 2004, the OSC published for comment a proposed policy and multilateral instrument on corporate governance guidelines and disclosure requirements, respectively. The TSX intends to revoke its guidelines and related disclosure requirements when these proposals become effective.

The guidelines approach has been characterised by some observers as too weak to address properly the serious corporate governance concerns highlighted by recent scandals. However, others have argued that the differences between the Canadian and US capital markets and corporate environments mean that a guidelines approach is preferable in Canada. They point out that a greater proportion of Canadian public companies, including 'large-cap' companies, are closely held or managed by the company's founders or their descendants. Canada's capital markets are also populated by a greater proportion of 'small-cap' issuers that may lack the resources to attract directors who could meet strict rules relating to financial experience and expertise.

The OSC has recently implemented, effective 30th March, 2004, rules that are designed to assist in improving the quality of financial disclosure in Canada. A review of these new rules will help prepare public issuers, their boards of directors, public accounting firms and those who advise all of them of these new requirements and guidelines that will shape and influence the structure and operations of Canadian companies. This will be followed by a brief review of the OSC's proposed corporate governance guidelines and disclosure requirements.

NEW OSC REFORMS

On 26th March, 2004, the OSC published new measures that it believes will be essential for improving investor confidence in Canadian capital markets. The OSC has focused specifically on the formation of effective and independent audit committees, the role of the chief executive officer (CEO) and chief financial officer (CFO) in ensuring the accuracy and quality of reported information and the part that external auditors play in the audit process. These new measures, took effect on 30th March, 2004, and are embodied in *National Instrument 52-108 — Auditor Oversight* (NI 52-108), *Multilateral Instrument 52-109 — Certification of Disclosure in Issuers' Annual and Interim Filings* (MI 52-109) and *Multilateral Instrument 52-110 — Audit Committees* (MI 52-110) (collectively referred to as the 'New Instruments').

The New Instruments were part of an initiative by the members of the CSA in all of the Canadian provinces except for British Columbia (except for NI 52-108, which, despite initial resistance, has now taken effect in British Columbia), and are aimed at improving the quality of financial disclosure by issuers and thereby promoting investor confidence in the integrity of Canadian capital markets. The British Columbia Securities Commission has generally favoured a different, 'non SOX-like'

approach to corporate governance reform aimed at reducing existing rules, such as the complex disclosure rules.

The CSA determined that due to the integration between Canadian and US capital markets, similar financial reporting and corporate governance requirements needed to be introduced domestically. While the requirements in the New Instruments correspond closely with those enacted in SOX, they are in some cases less onerous than the US requirements, and have been adjusted to conform with distinct features of securities regulation in Canada.

Audit committees (MI 52-110)

Pursuant to the New Instruments reporting issuers are required to establish and maintain an effective and independent audit committee. The requirement under MI 52-110 essentially mirrors the audit committee requirements currently being implemented in the USA. A reporting issuer *must* have an audit committee, and *must* require its external auditor to report directly to the audit committee in order to eliminate the potential conflict of interest that arises where management oversees the audit.

In addition to overseeing the work of the external auditor, the audit committee is responsible for recommending to the board of directors the nomination and compensation of the external auditor, pre-approving all non-audit services to be provided by the auditor, reviewing financial disclosures before they are released to the public and establishing 'whistle-blower' procedures with respect to complaints regarding the issuer's accounting, controls and auditing matters.

All audit committee members *must* be directors of the issuer and the committee *must* consist of at least three members. Furthermore, all of the audit committee members *must* be (or become in certain circumstances) 'financially literate', which involves being able to read and understand the financial statements of the issuer and the

accounting principles applicable to that issuer.

Unless the issuer is exempt from these requirements, each member of the audit committee *must* be independent. To be considered independent, a member of the audit committee *must not* have a direct or indirect 'material relationship' with the issuer. A material relationship is defined as one which could, in the view of the board of directors, reasonably interfere with the exercise of that member's independent judgment. Specific categories of individuals who are considered to have a material relationship with an issuer include:

- an individual who is or has been during the prescribed period, an employee or executive officer of the issuer;
- an individual whose immediate family member is, or has been during the prescribed period, an executive officer of the issuer;
- an individual, or immediate family member of such individual, who is or has been during the prescribed period, an affiliated entity of, a partner of, or employed by, a current or former internal or external auditor of the issuer;
- an individual, or immediate family member of such individual, who is or has been during the prescribed period, an executive officer of an entity if any of the issuer's current executive officers serve on the entity's compensation committee;
- an individual who has a relationship with the issuer pursuant to which the individual may accept, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or a subsidiary of the issuer, other than as remuneration for service on the board of directors or any board committee, or as a part-time chair or vice-chair of the board or any board committee. The acceptance of a fee by a person includes acceptance by a prescribed

family member or by a partner, member or officer of an entity that provides specified professional services to the issuer;

- an individual who, during the prescribed period, receives, or whose immediate family member receives, more than CAN\$75,000 per year in direct compensation from the issuer, other than as remuneration for service on the board of directors or any board committee, or as a part-time or vice-chair of the board or any board committee; and
- an individual who is an affiliated entity of the issuer or any of its subsidiaries.

It should be noted that the prescribed period for the above list is three years or, if the time for determining independence occurs within three years of 30th March, 2004, then the prescribed period commences on 30th March, 2004 and ends on the date that such determination is made.

Exemptions to the independence requirement are available in certain circumstances, including:

- for up to 90 days following the issuer's initial public offering, if at least one audit committee member is independent;
- for up to one year following the issuer's initial public offering, if a majority of the audit committee members are independent;
- where the member sits on the board of an affiliated entity;
- to accommodate controlling shareholders where certain prescribed criteria are met, if a majority of the audit committee members are independent;
- for up to two years in certain prescribed exceptional circumstances, if a majority of the audit committee members are independent; or
- for a limited time, where the cessation of independence was beyond the member's control.

MI 52-110 also imposes a number of disclosure obligations on the issuer that *must* be included in its Annual Information Form (AIF). The AIF *must* include, among other things, the text of the audit committee's charter, the name of each audit committee member, whether each member is independent and financially literate, a description of relevant education and experience of each member, policies and procedures adopted with respect to the pre-approval of non-audit services and a categorical schedule of fees billed to the issuer by the external auditor in each of the last two fiscal years.

MI 52-110 applies to each issuer at the earlier of 1st July, 2005 or the issuer's first annual meeting after 1st July, 2004, and applies to all reporting issuers with the exception of investment funds, issuers of asset-backed securities, designated foreign issuers, SEC foreign issuers, subsidiaries of some reporting issuers, exchangeable security issuers and credit support issuers. A 'venture issuer' (being an issuer that does not have any of its securities listed or quoted on a prescribed stock exchange) is either exempt from certain of the proposed rules or subject to different rules. In addition, US listed issuers that comply with the applicable US rules are exempt from almost all of the requirements of MI 52-110.

These new audit committee requirements are expected to improve audit committee value and, consequently, to enhance financial reporting quality.

CEO/CFO certification (MI 52-109)

Under MI 52-109, CEOs and CFOs of reporting issuers *must* personally certify the AIF, annual and interim financial statements and annual and interim management's discussion and analysis (MD&A) filed by the issuer. The officers *must* confirm that, based on their knowledge, the filings do not contain any misrepresentations and that the financial information in those filings fairly presents the issuer's financial position. It is

important to note that executives cannot rely solely on conformity of the disclosure with the issuer's generally accepted accounting principles (GAAP) in making this representation. The securities regulators have indicated that, while fair presentation includes compliance with GAAP, additional disclosure may be required.

In addition, each CEO and CFO *must* confirm the following in their personal certification:

- that they are responsible for internal control over financial reporting and disclosure controls and procedures;
- they have designed, or supervised the design of, internal control over financial reporting and disclosure controls and procedures;
- they have evaluated the effectiveness of those disclosure controls and procedures (only required on an annual basis);
- they have caused the issuer to disclose their conclusions regarding the effectiveness of the disclosure controls in the annual MD&A (only required on an annual basis); and
- they have caused the issuer to disclose in its annual and interim MD&A any change to the internal control over financial reporting that occurred during the issuer's most recent interim period that has materially affected, or is likely to materially affect, such control.

MI 52-109 applies to all reporting issuers, other than investment funds. There are exemptions available for qualifying foreign issuers, certain exchangeable security issuers and certain credit support issuers. For issuers that comply with the certification requirements under SOX in the USA, the certificates filed with the SEC will satisfy the requirements under MI 52-109. While MI 52-109 became effective on 30th March, 2004, transition provisions will allow issuers to ensure that sufficient controls are in place.

During the transition period, CEOs and CFOs may file 'bare' certificates that do not include the certifications regarding disclosure controls and procedures and internal control over financial reporting.

Auditor oversight (NI 52-108)

The Canadian Public Accountability Board (CPAB) (created by securities regulators and the Canadian Institute of Chartered Accountants in July 2002 to conduct annual reviews of the audit practices of accounting firms auditing public companies) has begun establishing an independent oversight programme to assess the adequacy of quality control policies maintained by public accounting firms and evaluate firm compliance with auditing and independence standards. NI 52-108, which became effective on 30th March, 2004, integrates the CPAB function into the securities regulatory framework.

Under NI 52-108, reporting issuers that file their financial statements accompanied by an auditor's report *must* have the auditor's report prepared by a public accounting firm that has entered into the requisite agreement with the CPAB to participate in the oversight programme, whose participant status has not been terminated without reinstatement, and that is in compliance with any restrictions or sanctions imposed by the CPAB. While reporting issuers *must* engage external auditors who are participants in compliance with any restrictions or sanctions, it is the public accounting firms who are most likely to be significantly affected by the introduction of these requirements.

PENDING PROPOSALS

On 16th January, 2004, the OSC published for comment proposed *Multilateral Policy 58-201 — Effective Corporate Governance* (the 'Proposed Policy') and proposed *Multilateral Instrument 58-101 — Disclosure of Corporate Governance Practices* (the 'Proposed Instrument'), which will confirm as best

practice certain governance standards and guidelines, and require issuers to disclose those governance practices they have adopted, respectively. It is expected that the Proposed Policy and Proposed Instrument, when finalised, will be adopted by securities regulators in all provinces and territories, except British Columbia and Quebec. Securities regulators in those two provinces have indicated that they will be releasing their own governance proposals, which, depending on their application, could require reporting issuers in those provinces to comply with multiple sets of governance requirements. While the OSC imposed a deadline of 15th April, 2004 to receive any comments on the Proposed Policy and Proposed Instrument, there is no indication as to a proposed timetable for their implementation once finalised. The OSC has indicated that it intends to review the Proposed Policy and the Proposed Instrument during the two years after their implementation, recognising that corporate governance is continuing to evolve.

Proposed Policy

The Proposed Policy is intended to provide recommendations on governance and is not intended to be prescriptive. Issuers are encouraged to adopt the recommendations but they are intended to be implemented flexibly to fit the situation of an individual issuer. The Proposed Policy would apply to all reporting issuers (including non-incorporated entities), other than investment funds.

According to the OSC, the 'best practices' in the Proposed Policy have been derived from the TSX guidelines (including the most recent proposed amendments), the listing standards of the NYSE and other regulatory, legislative and market driven developments. These recommended 'best practices' include:

- maintaining a majority of independent directors on the board of directors;

- holding separate, regularly scheduled meetings of the independent directors;
- appointing a chair of the board (or where inappropriate, a lead director) who is an independent director;
- adopting a written board mandate;
- developing position descriptions for directors and the CEO;
- providing each new director with a comprehensive orientation, and continuing education opportunities for all directors;
- adopting a written code of business conduct and ethics;
- appointing a nominating committee composed entirely of independent directors;
- adopting a process for determining what competencies and skills the board should possess and each director possesses;
- appointing a compensation committee composed entirely of independent directors; and
- conducting regular assessments of board effectiveness, and the effectiveness and contribution of each board committee and individual director.

Proposed instrument

Similar to obligations existing under the TSX guidelines, the Proposed Instrument will require an issuer to disclose its governance practices, using the 'best practices' standards and guidelines in the Proposed Policy as a reference. The disclosure must explain why the board of directors considers any deviation from the 'best practices' to be appropriate, including any decision not to adopt a written code of business conduct and ethics. Issuers with securities listed on the TSX or on an exchange outside of Canada will have to include their governance disclosure in their AIF. A cross-reference to this disclosure will have to be included in any information circular prepared in connection with a shareholders' meeting at which the election of directors is to be considered. A venture issuer or an unlisted reporting issuer will

generally be required to include its governance disclosure in an information circular prepared in connection with a shareholders' meeting at which directors are to be elected. Venture issuers will only be required to describe their governance practices with reference to the 'best practices' in three areas: the composition of the board of directors; the board mandate; and the adoption of a code of business conduct and ethics.

The Proposed Instrument will also require an issuer that has a written code of business conduct and ethics established as a 'best practice' to: (1) file such code with relevant securities commissions, and (2) publicly announce by way of press release any waiver granted to the directors or officers of the issuer, or a subsidiary, from any filed written code of business conduct and ethics. It is of note that the Proposed Policy will not legally require an issuer to adopt a written code of business conduct and ethics, and, consequently, the filing and public announcement requirements relating to a code of business conduct and ethics will arise only where the board of directors of an issuer chooses to adopt such a code.

The Proposed Instrument will apply to all reporting issuers, with a few exceptions similar to those available under MI 52-110.

CONCLUSION

The OSC's recent initiatives have been a mixture of the guidelines and rules approaches to corporate governance reform. Its New Instruments have introduced certain mandatory rules in respect of auditing and public disclosure similar to those prescribed in the USA under SOX, while its Proposed Policy and Proposed Instrument purport to be less stringent, like their TSX predecessors.

As a practical matter, Canadian companies with securities listed on US stock exchanges or that are otherwise subject to US securities laws will be required to comply with at least some of the US rules, including rules that prohibit companies from making or

arranging personal loans to senior executives and other insiders. Many Canadian companies may choose to comply with some or all of the more stringent US rules, even if they are not required to do so as a matter of law, in order to enhance the appeal of their securities to investors, particularly institutional investors.

Despite litigation reform in the USA, another engine for reform in the USA is an active plaintiffs' bar. Canadian class actions have a long way to go before providing this type of stimulus. Although class actions are becoming more prevalent in Canadian litigation, they are not as numerous as US class action suits and very few of the Canadian class actions have focused on corporate governance, *per se*; therefore, neither the activity in this area nor the creation of new requirements will create a US-style rush to litigation for Canadian-only issuers. Measures are in place to ensure the matter is appropriate for a class action and legal fees are controlled (although success based). Actions do not normally produce significant positive damages in Canada. In addition to a potential class action, however, issuers will face regulators intent on maintaining market integrity that will use a wider array of powers available to them to act on any breach. Perhaps the most effective Canadian corporate governance regulator over time will be the marketplace. In the summer of 2002, a group of Canada's largest pension funds, mutual funds and money managers formed the Canadian Coalition for Good Governance (CCGG) as a vehicle to foster improvements in Canadian corporate governance practices. The CCGG's mission is to represent Canadian institutional shareholders through the promotion of best corporate governance practices and to align the interests of boards and management with those of the shareholder. In September 2003, the CCGG issued 12 governance guidelines that it will apply to Canada's largest publicly traded companies. The guidelines put forward both minimum standards and best practices that

the CCGG expects company boards of directors to consider. 'The guidelines issued by the Coalition raise the bar for good governance standards in Canada. And as shareholders — the Coalition represents 23 leading Canadian institutional investors with more than \$400 billion in assets — we have the voting influence to help encourage boards to follow the best practices of good governance', said Michael Wilson, chairman of the CCGG.¹

Whether guidelines, rules, legislation or the market ultimately sets the standards for corporate governance in Canada remains to be seen. It is likely that a combination

thereof will prevail. Over the next decade, the results of the various approaches, in both Canada and the USA, to regulating corporate governance will undoubtedly provide further insight into the dynamics of the board, management and shareholder relationship.

REFERENCE

- 1 Press release by the Canadian Coalition for Good Governance from Toronto on 16th September, 2003: 'Canadian Coalition for Good Governance sets out guidelines for Corporate Canada'. Available at www.ccg.ca