Corporate Governance - The New Rules

Request for Comments

On January 19, 2004, the Ontario Securities Commission ("OSC") released for comment a proposed rule ("Proposed Rule") and a proposed policy ("Proposed Policy") setting forth certain 18 best corporate governance practices and requiring issuers to make disclosures relating to those best practices. These proposals are also being considered by securities regulators in the other provinces and territories of Canada, except for British Columbia and Quebec.

Purpose

In introducing the Proposed Rule and the Proposed Policy, the OSC commented as follows:

The purpose of the Proposed Policy is to confirm as best practice certain governance standards and guidelines that have evolved through legislative and regulatory reforms and the initiatives of other capital market participants. The purpose of the Proposed [Rule] is to provide greater, transparency for the marketplace regarding the nature and adequacy of issuers' corporate governance practices.

Background

The introduction of the Proposed Rule and the Proposed Policy for comment continues a process of evolution of corporate governance practice that began in Canada about ten years ago. This process included, among others, the significant developments noted below.

In 1994 a committee sponsored by the Toronto Stock Exchange ("TSX") published a report entitled "Where Were the Directors?" (the "Dey Report"). It recommended 14 corporate governance practices for listed companies to consider.

In 1995, the TSX adopted these as "best practice guidelines" which were not mandatory but required listed companies to disclose, annually, their approach to corporate governance with reference to them, explaining any differences.

In 1999, the Institute of Corporate Directors and the TSX sponsored a report entitled "Five Years to the Dey," which evaluated compliance with the Dey Report's best practice guidelines. It found a shortfall in practice in some important areas, although it found that most companies took the guidelines seriously.

In July 2000, the Canadian Institute of Chartered Accountants, the TSX and the TSX Venture Exchange, (then the Canadian Venture Exchange) established the Joint Committee on Corporate Governance (the "Saucier Committee"). The final report of the Saucier Committee, issued in November 2001, proposed a number of amendments to the TSX guidelines to make them commensurate with international developments. In response to this, on April 26, 2002, the TSX proposed changes to its guidelines.

June 23, 2002, the federal Senate Committee on Banking Trade and Commerce issued a report proposing changes to the *Canada Business Corporations Act* and other legislation to improve the regulation of corporate governance in Canada and to restore investor confidence.

In July, 2002, the *Sarbanes-Oxley Act* ("SOX") was enacted in the United States, implementing a broad range of changes in corporate, securities and criminal law, among other things, aimed at restoring public confidence in American capital markets following a number of corporate failures in reporting scandals.

About that time, the OSC initiated a review of SOX and other American and international reforms to see what regulatory changes the OSC should adopt.

On November 4, 2003, the Securities and Exchange Commission ("SEC") of the United States approved new corporate governance rules for companies with securities listed on the New York Stock Exchange ("NYSE") and, as well, on the NASDAQ stock market.

These constitute some of the background in which the OSC developed the Proposed Rule and Proposed Policy.

Rule and Policy Context

The Proposed Rule and the Proposed Policy must be considered in light, not only of the historical developments mentioned previously, but also in light of other rules and policies recently adopted and proposed for adoption by the OSC and the other Canadian securities regulators. The Proposed Rule and Proposed Policy form part of what has been designed to be an integrated system of regulation of issuer disclosure. In particular, the Proposed Rule and the Proposed Policy must be considered in relation to the following principal regulatory developments.

Recently, *The Ontario Securities Act* ("OSA") was amended with the objective of improving corporate accountability, public company disclosure and investor confidence. Among other things, these amendments created a scheme imposing civil liability relating to inadequate secondary market disclosure, i.e. information released to the market which is not related to the offering of securities by the issuer. The civil liability provisions have not yet been claimed in force. Bill 41, containing those provisions, died on the order paper when Premier Ernie Eves called a provincial election in Ontario. As a result of the election of a new Liberal government under Premier Dalton McGuinty, it is not clear if or when these revisions will be proclaimed. Knowledgeable commentators currently expect this to happen in the first half of this year.

On December 19, 2003, the Canadian Securities Administrators adopted a new rule and a new policy concerning continuous disclosure requirements for reporting issuers other than investment funds. The rule and the policy attempt to harmonize, simplify and improve previously existing continuous disclosure requirements. Various aspects of this rule and policy come into effect on different dates, commencing January 1, 2004.

On January 19, 2004, the securities regulatory authorities in all provinces and territories of Canada, other than British Columbia (in certain cases), published three final rules which are to come into force on March 30, 2004, which are known as the "Investor Confidence Rules". The Investor Confidence Rules require chief executive officers and chief financial officers to certify certain disclosures in the annual and interim filings made by issuers, impose certain rules in respect to audit committees and constraints on the oversight of auditors.

Toronto Stock Exchange Rule

When the Proposed Rule and the Proposed Policy are adopted, the TSX will revoke its corporate governance guidelines and related disclosure requirements. Of course, those apply only to issuers listed on the TSX.

Application

The Proposed Policy applies to all reporting issuers, other than investment funds. Accordingly, it affects issuers that are not corporations. For example, it applies to income trusts.

"Reporting Issuer" is a term defined in the OSA. Principally, the term includes any issuer that filed a prospectus under the Act, filed a securities exchange take-over bid circular under the Act before December 14, 1999, or is listed on a recognized stock exchange in Ontario.

Voluntary Ð Not Mandatory

Continuing the approach taken by the TSX, the Proposed Rule and the Proposed Policy provide guidance and flexibility, rather than establishing mandatory requirements. In this connection, the OSC comments:

Although the Proposed Policy applies to all reporting issuers, the recommendations and the Proposed Policy are not intended to be prescriptive. Instead, we encourage issuers to adopt the suggested measures, but they should be implemented flexibly and sensibly to fit the situation of individual issuers.

Ongoing Review

Noting that corporate governance is in a constant state of evolution, the OSC has indicated that it will review the Proposed Policy and the Proposed Rule in the first two years of their adoption to ensure that they continue to be appropriate for issuers in the Canadian marketplace.

Recommended Best Practices

The 18 recommended best practices include those described below. We have used the numbering system used by the OSC.

Composition of the Board

1. The majority of the Board of Directors should be "independent" as discussed below.

2. The independent board members should hold separate, regularly scheduled meetings separate from management.

3. The chair of the board should be an "independent director." Where this is not appropriate, an independent director may be appointed to act as "lead director." The chair or lead director should act as effective leader of the board and ensure that the Board's agenda will enable it to successfully carry out its duties.

Board Mandate

4. The board should adopt a written mandate in which it explicitly assumes responsibility for the stewardship of the issuer, including responsibility for:

(a) To the extent feasible, satisfying itself as to the integrity of the CEO and other senior officers and that they create a "culture of integrity" throughout the organization;

(b) Adopting a strategic planning process, including approval, at least annually, of a strategic plan which takes into account, among other things, the opportunities and risks of the business;

(c) Identifying the principal risks of the issuer's business and ensuring implementation of appropriate systems to manage them;

(d) Succession planning (including appointing, training and monitoring senior management);

(e) Adopting a communication policy for the issuer;

(f) Ensuring the integrity of the issuer's internal control and management information systems; and

(g) Developing the issuer's approach to corporate governance, including developing a set of corporate governance principles and guidelines that are specifically applicable to the issuer.

The written mandate of the board should also set out:

(i) Decisions that require prior board approval;

(ii) Measures by which security holders can provide feedback; and

(iii) The board's expectation of management.

Position Descriptions

5. The board should develop clear position descriptions for directors, including the chairs of the board and each board committee. The board, together with the CEO, should develop a clear position description for the CEO, including delineating management's responsibilities. The board should also develop or approve the corporate goals and objectives that the CEO is responsible for meeting.

Orientation and Continuing Education

6. The board should ensure that all new directors receive a comprehensive orientation, ensuring that all new directors fully understand the role of the board and its committees, the contribution expected from individual directors (including commitment and time and energy) and the nature and operations of the issuer's business.

7. The board should provide continuing education opportunities for all directors, so that they can maintain or enhance their skills and abilities and ensure that their knowledge and understanding of the issuer's business remains current.

Code of Business Conduct and Ethics

8. The board should adopt a written code of business conduct and ethics (a "Code"). It should be applicable to directors, officers, and employees of the issuer. The Code should constitute written standards that are reasonably designed to deter wrongdoing and should address the following issues:

(a) Conflicts of interest;

(b) Protection and proper use of corporate assets and opportunities;

(c) Confidentiality of corporate information;

(d) Fair dealing with the issuer's security holders, customers, suppliers, competitors and employees;

(e) Compliance with laws, rules and regulations; and

(f) Reporting of any illegal and unethical behaviour (commonly called "whistle blowing").

9. The board should be responsible for monitoring compliance with the Code. Waivers, including implicit waivers, in favour of directors or senior officers should be granted by the board (or a board committee) only.

Nomination of Directors

10. The board should appoint a nominating committee composed entirely of independent directors.

11. The nominating committee should adopt a written charter. It should clearly establish the committee's purpose, responsibilities, member qualifications, member appointment and removal, structure and operations (including any authority to delegate to individual members and subcommittees) and manner of reporting to the board.

The nominating committee should have authority to engage and compensate any outsider advisor that it determines to be necessary to permit it to carry out its duties.

If an issuer is legally required, by contract or otherwise, to provide third parties with the right to nominate directors, the selection and nomination of such directors need not involve the approval of an independent nominating committee.

12. Prior to nominating or appointing individuals as directors, the board should, firstly, consider what competencies and skills the board, as a whole, should possess; and secondly, assess what competencies each existing director possesses, considering the board as a group and paying attention also to the personality and other qualities of each director, as these may ultimately determine the boardroom dynamic. The board should also consider the appropriate size of the board, with the view to facilitating effective decision making.

In carrying out each of these functions, the board should consider the advice and input of the nominating committee.

13. The nominating committee should be responsible for identifying individuals qualified to become new board members and recommending to the board the new director nominees for the next annual meeting of shareholders.

14. In making its recommendations, the nominating committee should consider the competencies and skills that the board considers necessary for the board as a whole, to possess, that it considers each director to possess and those which each new nominee would bring to the board.

Compensation

15. The board should appoint a compensation committee composed entirely of independent directors.

16. The compensation committee should have a written charter. It should establish the committee's purpose, responsibilities, member qualifications, member appointment and removal, structure and operations (including any authority to delegate to individual members or subcommittees) and manner of reporting to the board. The compensation committee should be given authority to engage and compensate any outside advisors that it considers necessary.

17. The compensation committee should be responsible for:

(a) Reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO's performance in the light of these and making recommendations to the board with respect to the CEO's compensation level based on this evaluation;

(b) Making recommendations to the board with respect to non-CEO compensation, incentiveÐcompensation plans and equity-based plans; and

(c) Reviewing executive compensation disclosure before the issuer publicly discloses this information.

Regular Board Assessments

18. The board should regularly assess its own effectiveness, as well as the effectiveness and contribution of each board committee and each individual director.

An assessment should consider:

(a) The board's written mandate;

(b) The charter of each board committee; and

(c) The position description(s) applicable to each individual director, as well as the competencies and skills each individual director is expected to bring to the board.

Meaning of Independence

(1) For the purpose of the Proposed Policy, a director is independent if he or she has no direct or indirect material relationship with the issuer.

(2) A "material relationship" is a relationship which could, in the view of the issuer's board, reasonably interfere with the exercise of a director's independent judgment.

(3) Notwithstanding the view which might otherwise be taken by the issuer's board of directors, the following individuals are considered to have a material relationship with an issuer:

(a) An individual who is or has been an employee or executive officer of the issuer, unless the prescribed period [three years] has elapsed;

(b) An individual whose immediate family member is or has been an executive officer of the issuer, unless the prescribed period has elapsed;

(c) An individual who is, or has been, an affiliate of a partner or employed by, a current or former internal or external auditor of the issuer, unless the prescribed period has elapsed with the person's relationship with the internal or external auditor, or the auditing relationship has ended;

(d) An individual whose immediate family member is, or has been, an affiliated entity of, partner of, or employed in a professional capacity by, a current or former internal or external auditor of the issuer, unless the prescribed period has elapsed;

(e) An individual who is, or has been or whose immediate family member is, or has been, an executive officer of an entity if any of the issuer's current executive officers serve on the entity's compensation committee, unless the prescribed period has elapsed;

(f) An individual who receives, or whose immediate family member receives, more than $75,000 per year in direct compensation from the issuer, other than his remuneration for acting in his or her capacity as a member of the board of directors or any board committee or is a part-time chair or vice chair of the board or any board committee, unless the prescribed period has elapsed since he or she ceased to receive more than $75,000 per year in such compensation.

This definition of independence is generally consistent with the definition in the new rule and policy applicable to audit committees. It is slightly more relaxed than the definition of the term "independence" for the purpose of membership in audit committees. This is also the case in the United States. Unlike the NYSE and NASDAQ listing standards, association by an individual with a company that has a business relationship with the issuer is not deemed to be a "material relationship." This, instead, will be a question for determination by the issuer's board.

<u>Compliance - Disclose and Explain</u>

The Proposed Rule governs all reporting issuers, other than those defined in the Proposed Rule to be investment funds and certain other foreign or special-purpose issuers, i.e. issuers of asset-backed securities, designated foreign issuers, SEC foreign issuers, exchangeable security issuers and credit support issuers.

An issuer other than a venture issuer (discussed below) must disclose, in its Annual Information Form ("AIF") in prescribed form, its compliance with the recommended practices. In effect, the issuer is required to disclose

whether it complies with each best practice and if it does not, then to state that fact and explain why the board believes this to be appropriate.

When management of an issuer solicits proxies from the security holders of the issuer for the purpose of electing directors, its management information circular must include a cross-reference to the issuer's AIF that contains such information.

Venture Issuers

The term "venture issuer" means "an issuer that does not have any of its securities listed or quoted on any of the capital TSX, a U.S. marketplace, or a marketplace outside of Canada or the United States of America." The term "U.S. marketplace" means "an exchange registered as a Ônational securities exchange' under Section 6 of the 1934 *Act* or the NASDAQ stock market." Accordingly, any issuer whose securities are listed or quoted on any stock exchange in Canada other than the TSX is a "venture issuer". TSX issuers are not venture issuers.

The rules require that if management of a venture issuer solicits proxies from its security holders for the purpose of electing directors, the management information circular must include the required disclosure. If a venture issuer is not required to send a management information circular to its security holders, it must provide such disclosure in its AIF or annual Management Discussion and Analysis ("MD&A"). Venture issuers are required to disclose information relating to only three items: Composition of the Board, Board Mandate, and Code of Business Conduct and Ethics.

Change of Regulator

A recent report indicated that 20% of issuers failed to disclose their compliance with each of the TSX guidelines. It was difficult for the TSX to enforce even these disclosure requirements as its ultimate sanction was de-listing the company, something that that stock exchanges are usually quite reluctant to do, as their business is to provide such listings.

The OSC and other securities regulators have much broader means of ensuring compliance and implementing sanctions. Failure to comply with the new disclosure requirements could subject the issuer to enforcement proceedings and sanctions. As has been the case with other rules and policies, it may be expected that the regulators will conduct regular reviews of the corporate governance disclosures of issuers. It may also be expected that they will look at whether the issuers simply pay "lip service" to these requirements or whether they really attempt to come to grips with them. They will also likely assess how effectively issuers comply with the practices they adopt. These reviews may result in changes to the requirements or the enforcement and penalty provisions.

Apart from such compliance audits by regulators, formal and informal audits may be expected by institutional investors, their umbrella groups (such as the Canadian Coalition for Governance) and the marketplace generally. Because an issuer's corporate governance rules will be public and, consequently, more visible than was previously the case, the prospect of litigation or enforcement proceedings involving allegations of non-compliance may be increased. This may be a more effective motivator to improve performance. Increased regulatory scrutiny might also lead to proceedings taken in the public interest where governance practices are alleged to be abusive of expectations of securities markets. These types of proceedings have been brought by the OSC and other securities regulators in the past in situations in which they have considered it appropriate, even though no explicit breach of statute, rule or policy was found to exist.

Comment Period and Effective Date

The comment period expires April 15, 2004. Where there is no scheduled implementation date, past practice would suggest that it might become effective sometime mid-year. In view of the long period of development these proposals have had, it may be expected that the Proposed Rule and the Proposed Policy will be adopted, more or less, in the form proposed, although perhaps with some relatively minor changes.

What Issuers Should Do

The board of each issuer should consider the most appropriate method of regulating its corporate governance in all the circumstances, including the nature, complexity, stage of development, size and sophistication of its business and organization, its compliance policies in relation to other regulatory requirements, such as continuous and financial disclosure matters, and various other matters relating primarily to the issuer itself. It should do this by examining these issues against the recommended corporate governance practices and the past experience of the issuer, the board and individual directors. It should then perform a "gap analysis,"

measuring the extent to which it now complies with its own conclusion as to what should be its own "best practice" corporate governance practices, as well as the recommended ones, and then should develop, or cause to be developed, a plan for how to move the issuer into compliance with its own guidelines. It should provide a written record of its reasoning.

This process will be simplified for venture issuers, which are only required to consider three of the guidelines. However, in view of the impact of the other regulatory initiatives discussed under the heading "Rule and Policy Context" above, venture issuers would be wise to examine all of the guidelines as suggested here.

While issuers which currently comply with the NYSE listing rules or those proposed, but not adopted by the TSX in its April 26, 2002 guidelines will effectively comply with the new guidelines, because of the prospect of sanctions in appropriate cases, it would still be prudent to conduct the review previously suggested. It will simply be much less onerous.

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CAN WE HELP?

If you would like copies of the Proposed Rule and the Proposed Policy or any further information, would like to provide comments to the OSC or otherwise, or would like assistance concerning how you should respond to these initiatives, please contact:

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