Corporate governance DEVELOPMENTS *in Canada*

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Corporate governance standards in Canada have evolved in a somewhat fragmented fashion. In large part, this has resulted from an environment that has been shaped by provincial and federal corporate statutes, which provide for basic governance standards,[1] guidelines adopted by the Toronto Stock Exchange (TSX) for listed companies,[2] standards adopted by institutional investors individually and through the relatively new Coalition for Good Governance and, more recently, rules and policies of various provincial securities regulators at the initiative of the Ontario Securities Commission (OSC).[3]

Canada, like the US, has seen a marked increase in the intensity of debate and focus on corporate governance in recent years. While the Canadian market has not experienced the same number of highly publicised failures of major business enterprises as the US, the proximity and inter-relationship of the Canadian capital markets to the markets in the US have brought the US issues (and 'solutions' to those issues) to the forefront of the Canadian governance debate. There are strong and diverse views as to whether the US approach is appropriate across Canada's varied capital markets and, as discussed below, legislative and regulatory positions are not emerging with the consistency that has been exhibited in the US in the new governance requirements promulgated under the Sarbanes-Oxley Act of 2002 and the initiatives of the New York Stock Exchange and the NASDAQ.

CHRONOLOGY OF DEVELOPMENTS

The following is a brief outline of the major developments in Canadian corporate governance occurring over the last two years:

- In the Spring of 2002, the TSX published for comment proposed amendments to its corporate governance guidelines in response to the recommendations in the final report of the Joint Committee on Corporate Governance, which was released in November 2001. These amendments principally addressed audit committee composition and function.
- In October 2002, the Government of Ontario introduced Bill 198, which included significant amendments to the Securities Act (Ontario). These

amendments formed part of the response of the Government and the OSC to the passage in the US of Sarbanes-Oxley and, among other things, strengthened the enforcement capabilities of the OSC and empowered the OSC to make rules regarding audit committees and mandatory certification of management.

- In November 2002, the TSX proposed further revisions to its guidelines and to its ongoing listing requirements. These proposals, in general terms, paralleled the similar initiatives of the NYSE.
- In June 2003, the Federal Senate Committee on Banking, Trade and Commerce released a report following its study of the likelihood of corporate scandals of the type seen in the US occurring in Canada and, more importantly, of how such scandals might be avoided. The recommendations of the Committee overlapped in many ways with those proposed by both the OSC and the TSX.
- In June 2003, the OSC released for comment three rules that were intended by the OSC to "restore investor confidence" in Canada's capital markets. Following the pattern set by Sarbanes-Oxley, the rules (as discussed in greater detail below) contemplated: (i) certification of annual and interim disclosures by an issuer's chief executive officer and chief financial officer; (ii) increased independence, competence and responsibility for audit committees; and (iii) support for the Canadian Public Accountability Board (CPAB) in the oversight of external auditors.[4]
- In September 2003, the Canadian Coalition for Good Governance, a not-for-profit corporation representing the interests of various institutional shareholders, released a comprehensive set of 12 guidelines that it intends to use as a rating tool to evaluate corporate governance practices of the companies in which members of the Coalition have an interest.[5]
- In September 2003, the Canadian Institute of Chartered Accountants' Public Interest and Integrity Committee issued a new independence standard that will apply to all members and firms when they conduct an assurance engagement or a specified auditing procedures engagement. While the concept of independence is not new, the standard introduces a systemic, principles-based framework for analysing independence.[6]
- In January 2004, the OSC adopted the 'investor confidence' rules that it had released for comment in Autumn and released for comment a proposed corporate governance policy, which reflects recommendations of the regulators on governance practices but would not have the force of law, and a proposed rule, which prescribes enhanced disclosure in the governance context.[7] Following the pattern established in the US, but stopping short of requiring compliance, the policy contemplated: (i) enhanced roles for independent directors on the board and nominating and compensation committees; (ii) enhanced standards for director independence; (iii) board mandates; (iv) formal codes of business conduct and ethics; (v) formal 'position descriptions' for the chairman, the chairs of board committees, directors generally, and the chief executive officer; (vi) enhanced director orientation and continuing education; and (vii) regular self-assessment by the board. The rule encourages compliance with these recommended standards, by requiring disclosure of: (i) compliance (or non-compliance) with recommended practices and the rationale for any non-compliance; (ii) the role and responsibilities of any 'lead director' and board mandates and committee charters; and (iii) disclosure of adopted codes and amendments to, and waivers of, those codes.

This chronology reflects the continuing differences in the objectives and philosophies of the various stakeholders in Canada. Most simply, some (like the OSC) feel that the Canadian corporate governance framework should be fashioned after the US rules-based approach. This approach recognises that it is difficult for market participants to apply principles and for regulatory agencies to enforce them and that, due to the nexus between the Canadian and US capital markets, Canada cannot afford for market participants to

lose confidence in its markets because its regulatory regime or prevailing practices are perceived to be weaker than the regime or practices in the US. Advocates of the principles-based approach (like the BCSC) feel that the costs of a framework that follows the US model are excessive and that disclosure generally will impose the necessary discipline with greater efficiencies. Although the debate has yet to run its course, it appears that there is shift in the Canadian landscape and that the more rules-based approach championed by the OSC is gaining momentum.

THE INVESTOR CONFIDENCE RULES

Of the various developments in Canadian corporate governance over the last two years, the investor confidence rules (and particularly those relating to audit committees and certification) arguably will have the most immediate impact on Canadian market participants. The rules are, in large measure, similar to those adopted in the US and should not require substantive change to governance practices by issuers that are already subject to the US regulatory regime. They will, however, require other entities that access the public markets in Canada to begin to address the procedural and substantive requirements that have occupied significant amounts of time and resources over the past year for issuers subject to Sarbanes-Oxley.

CEO and CFO certification

The first of these rules (which is patterned on section 302 of Sarbanes-Oxley) will require CEOs and CFOs of all reporting issuers in Canada to certify personally, based on their knowledge, that their company's annual filings (i.e., annual information form, annual financial statements and MD&A) and interim filings (i.e., interim financial statements and interim MD&A) do not contain a misrepresentation and that the company's financial condition is 'fairly presented'.[8] As under Sarbanes-Oxley, this certification will require financial information to be more than GAAP compliant and will require issuers to look more broadly at the financial information that they are presenting to the market.

Additionally, following a one-year transition period, CEOs and CFOs will be required to certify (again in a manner patterned on section 302 and section 402 of Sarbanes-Oxley) that:

- they are responsible for establishing and maintaining disclosure controls and procedures and internal controls over financial reporting;[9]
- they have designed, or supervised the design of, disclosure controls and procedures to provide reasonable assurance that material information relating to the issuer and its consolidated subsidiaries is made known to them, particularly during the period in which filings are being prepared;
- they have designed or supervised the design of internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting in the preparation of financial statements for external purposes in accordance with GAAP;
- they have evaluated the effectiveness of their disclosure controls and procedures (but not internal controls over financial reporting) and have disclosed their conclusions, as well as certain changes in internal controls over financial reporting; and
- they have disclosed any deficiencies to their audit committee and external auditors.

Certain issuers, including those that comply with the annual and quarterly certification requirements prescribed by Sarbanes-Oxley, will be exempt from the certification requirements, provided they file their most recent annual report and signed SEC certifications in Canada.

Role and composition of audit committees

Again following Sarbanes-Oxley, the OSC has proposed a rule (patterned on section 301 of Sarbanes-Oxley) dealing with the role and composition of audit committees. Most basically, the rule requires every reporting issuer to have an audit committee:

- that is comprised of at least three members, each of whom is 'financially literate'[10] and independent;[11]
- to which the external auditors report directly; and
- that is responsible for: (i) recommending to the board the nomination of the external auditor and its compensation; (ii) overseeing the work of the external auditor; (iii) pre-approving all non-audit services to be provided to the issuer or its subsidiaries by the external auditor; (iv) reviewing the issuer's financial statements, MD&A and earnings press releases before they are publicly disclosed; (v) ensuring that there are adequate procedures for reviewing public disclosure of financial information extracted or derived from financial statements; (vi) establishing procedures for the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters; and (vii) reviewing and approving the issuer's hiring policies regarding employees and former employees of the present and former external auditors of the issuer.

Pursuant to the rule, an audit committee will be required to have a written charter that sets out its mandate and responsibilities and that will have to be disclosed in annual filings.

The rule exempts certain issuers (including those listed on the TSX Venture Exchange) from the requirement that members of the audit committee be independent and financially literate. As well, issuers that are listed on a major US exchange or quotation system will be exempt from all of the substantive requirements of the rule, provided that the issuer complies with the requirements of the US exchange or quotation system with respect to the role and composition of audit committees and discloses in its annual information form if the board did not adopt a recommendation of the committee related to the nomination or compensation of the external auditor.

PRACTICAL IMPLICATIONS

The investor confidence rules effectively will require all entities participating in the Canadian public markets to begin to address and respond to the basic requirements and practices that have arisen in the context of Sarbanes-Oxley, if they have not already done so. For some issuers, relatively few changes will be required to their existing governances structures and practices, while others will need to undertake a number of fundamental changes. Some of those changes, particularly those relating to audit committee composition, may take longer to implement than others. Some of those changes, like the establishment of the procedures that will permit certification will require careful analysis, discipline and incremental costs.

In all instances it will be important that issuers, their directors and management adopt responses to these regulatory initiatives that work for, and that will actually be followed by, them. Adoption of 'model' structures, charters and procedures that do not reflect the particular needs or culture of an issuer or that will fall out of use over time have the potential of subjecting issuers, their directors and management to increased costs without commensurate benefits and, potentially, to enhanced liability.

Although formulated in a somewhat more moderate form with 'recommendations' in place of equivalent legal 'requirements' under Sarbanes-Oxley, it is likely that the new Canadian regime will be interpreted, applied and enforced in a manner very similar to the regime established by US regulators. The similarity of terminology, the proximity of the capital markets and the sensitivity of the OSC in comparison with the SEC will make the US standards relevant benchmarks for Canadian governance practices.

Notes:

1. These standards include, among other things, the duty of directors to manage or supervise the management of the company, the duty of care required of directors, qualification of individuals as directors and director residency requirements.
2. The TSX guidelines recommend that, among other things, the board of directors: assume responsibility for the stewardship of the company; be constituted with a majority of individuals who are unrelated to the company; appoint nominating and governance committees generally composed of outside directors; review the compensation of directors; ensure that the audit committee is composed only of outside directors; define the limits to management's responsibilities; and develop corporate objectives that the CEO is responsible for meeting. Compliance with these guidelines is not mandated, although listed companies are required to reconcile their practices against these recommendations annually in materials sent to shareholder.
3. The OSC has been an active participant in the governance debate since the 1980s, when it adopted policies (which now are reflected in the Rule 61-501) to address conflicts of interest in various transactions, including 'insider bids', 'going private transactions' and 'related party transactions' through enhanced procedures such as significant roles for special committees of independent directors and enhanced disclosure.
4. Securities regulation in Canada is undertaken at the provincial and territorial, rather than the federal, level. As a result, in the absence of consensus on the part of the various Canadian securities administrators (CSA), regulatory standards may differ materially between Canadian jurisdictions. Although there has been significant progress by the CSA in adopting uniform, multilateral instruments and policies, divergent regimes and standards exist. In this context, the British Columbia Securities Commission (BCSC) originally did not propose to adopt the investor confidence rules, but now has adopted the rules relating to the CPAB, other than the one relating to audit committees.
5. The guidelines focus on three areas: (i) how individual directors of extraordinary qualities are selected; (ii) how boards are structured to create team governance strengths; and (iii) how boards work to ensure good governance processes. The guidelines contain both minimum standards (i.e., standards that the Coalition normally would expect a public company to meet) and best practices (i.e., a combination of best practices from high performing boards that the Coalition would like to see in most cases and innovative ideas from outstanding boards that may be applicable to other boards).
6. Members and firms now must: (i) consider independence before and throughout each engagement; (ii) consider whether any threats to independence exist; (iii) where threats are identified, consider whether there are safeguards that exist or may be applied to eliminate the threat or reduce it to an acceptable level; (iv) where safeguards are found to be inadequate, decline or discontinue the engagement; and (v) notwithstanding the analysis of threats and safeguards, consider whether there are any prohibitions that would preclude the undertaking or completion of the proposed engagement.
7. Neither the BCSC nor the Quebec Securities Commission currently appears to be inclined to adopt the approach proposed by the OSC in respect of the new policy and rule. With the adoption of the proposed policy and rule, the TSX will cede its jurisdiction in respect of governance practices of listed companies to the OSC and other CSA members.
8. The companion policy to the rule indicates that certification as to "fair presentation" is intended to provide assurance that the financial information disclosed, when viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under GAAP. In this context, fair presentation includes: (i) selection of appropriate accounting policies; (ii) proper application of those policies; (iii) disclosure of financial information that is informative and reasonably reflects the underlying transaction; and (iv) inclusion of additional disclosure necessary to provide investors with a materially accurate and complete picture of financial condition, results of operations and cashflows.
9. The definitions of 'disclosure controls and procedures' and 'internal controls over financial reporting' are similar to the definitions of the corresponding terms under the rules of the Securities and Exchange Commission (SEC) implementing section 302 of Sarbanes-Oxley.
10. A member will be considered to be financially literate if he or she has the ability to read and understand a set of financial statements that represent a breadth and level of complexity of accounting issues that generally are comparable to the breadth and complexity of the issues that reasonably can be expected to be raised by the issuer's financial statements. While there is no requirement to comment expressly on the financial literacy of members of the committee, annual filings will be required to describe the education and experience of each audit committee member that is relevant to the performance of his or her responsibilities and, in particular, any education or experience that would be relevant to an assessment of their financial literacy.
11. A member will be considered to be independent if he or she has no direct or indirect material relationship with the issuer (i.e. a relationship that could, in the view of the board, reasonably interfere with the exercise of independent judgement). The rule permits an independent director of a company to be a member of the audit committee of an affiliated entity, such that independent directors of a parent company would be permitted to serve as members of the audit committee of a subsidiary. The rule also deems certain persons (including those receiving consulting or advisory fees from the issuer or who received such fees during the previous three years) not to be independent.

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