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Canadian Securities Administrators | Autorités canadiennes en valeurs mobilières

September 29, 2004

BY E-MAIL

The Honourable David Emerson
Minister of Industry
C.D. Howe Building,
5th Floor, West Tower, 235 Queen Street
OTTAWA, Ontario
K1A 0H5

Dear Minister Emerson:

Re: Request for comment on Industry Canada's paper entitled: Towards an Improved Standard of Corporate Governance for Federally Incorporated Companies - Proposals for Amendments to the *Canada Business Corporations Act*

Introduction

The Canadian Securities Administrators (CSA) would like to thank Industry Canada for the opportunity to comment on the proposed amendments to the *Canada Business Corporations Act* (CBCA). Corporate governance issues are a concern to many regulators, both in Canada and internationally. We support efforts to improve the standards of corporate governance with a view to enhancing investor confidence and better guard against corporate wrong-doing. We also appreciate the opportunity to work together in order to strengthen the culture of corporate governance in Canadian companies, and to ensure that our publicly traded companies remain competitive and attractive to investors globally.

As you know, the CSA are a council of the 10 provincial and three territorial securities regulators. Our mandate is to create a securities regulatory system that protects investors from unfair, improper or fraudulent practices and that fosters fair and efficient capital markets by developing a national system of harmonized securities regulation, policy and practice. By collaborating on rules, regulations and other programs, the CSA help avoid duplication of work and streamline the regulatory process for companies seeking to raise investment capital and for others who participate in our capital markets.

The CSA have a keen interest in your proposals given the interplay between corporate and securities law. Corporate law administrators and securities regulators should work together to address three fundamental challenges. First, we should co-ordinate our efforts to ensure that compliance with corporate law requirements does not result in a conflict with securities law requirements, and vice-versa. Secondly, we should eliminate redundant and overlapping requirements to the fullest extent possible. Lastly, we should reduce compliance costs for publicly traded companies, and avoid

creating confusion for companies incorporated under the CBCA resulting from two similar, but not identical, corporate governance regimes in Canada.

We support Industry Canada's efforts to ensure that certain corporate governance related requirements currently contained in the CBCA be updated and strengthened (for example, the requirement that a majority of the directors be independent or that the audit committee be required to recommend the auditors to the board of directors). However, we are concerned that the proposals in Industry Canada's paper may go too far in codifying standards and practices in the CBCA. Such a "one-size-fits-all" regime does not provide the necessary flexibility for the spectrum of Canadian public companies that are, and will be, subject to the CBCA and would obscure the responsibility and accountability of corporate directors and senior management to adopt appropriate governance practices for their companies. We believe that the proposed new national CSA initiative (discussed below) strikes the right balance between enhancing investor confidence and maintaining fair, efficient and competitive capital markets in Canada. This new initiative has a much broader scope than CBCA "distributing companies", is more flexible to adopt and comply with, is significantly easier to modify than legislated standards, and reflects an internationally accepted approach to regulating corporate governance. Accordingly, we believe there is no need to codify the amendments proposed by Industry Canada in the CBCA.

We note that while there are many similarities between the proposed amendments to the CBCA and the CSA initiative respecting corporate governance, there are a number of differences in content and approach. However, rather than commenting specifically on the details of each of the 10 proposed amendments to the CBCA, our comments focus on broader issues and concerns respecting our shared commitment to fostering good corporate governance practices. We also suggest certain other matters that may merit further consideration by Industry Canada.

CSA Initiatives Respecting Corporate Governance

As you are aware, the CSA recently initiated an unprecedented consultative process with our stakeholders to determine how best to strengthen corporate governance standards and enhance investor confidence in our publicly traded companies. With the benefit of feedback from numerous stakeholders and market participants, input from experts and advisory groups, and a review of developments in other countries, we developed three CSA instruments that establish structures and processes that foster greater accountability and transparency at the board level, and that enhance the credibility of the financial reporting process within publicly traded companies. We are referring to National Instrument 52-108 *Auditor Oversight*, Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*, and Multilateral Instrument 52-110 *Audit Committees*. We also published for comment a policy and two instruments on corporate governance practices - proposed Multilateral Policy 58-201 *Effective Corporate Governance* (MP 58-201), proposed Multilateral Instrument 58-101 *Disclosure of Corporate Governance Practices* (MI 58-101), and proposed Multilateral Instrument 51-104 *Disclosure of Corporate Governance Practices* (MI 51-104), together with related forms. Rather than mandating corporate governance practices by way of rule, both proposed instruments would require publicly traded companies to disclose annually the ways in which they address governance matters. MI 58-101 is modelled on the "comply or explain" approach in that it would require that this disclosure be set against the series of best practices set

out in MP 58-201. MI 51-104 would require that actual practices and policies regarding corporate governance be disclosed, without making reference to a set of "best practices."

Since the publication of the two proposed instruments, many commentators expressly stated that public companies would benefit from a single set of requirements adopted and applied by all jurisdictions across Canada. The CSA now expect to have a single national instrument and policy respecting corporate governance guidelines and disclosure published for comment by the end of October 2004.

Key features of the CSA's Proposed National Instrument and Policy

The proposed national policy will contain guidelines respecting corporate governance standards for publicly traded companies. These guidelines represent governance standards that have evolved to date. Although the proposed national policy will apply to all reporting issuers, other than mutual funds, the guidelines in the proposed policy are intended to allow for flexibility in their adoption; they have not been formulated as prescriptive rules. This approach recognizes that a "one-size–fits-all" approach would not adequately accommodate the diversity of Canadian publicly traded companies that, relative to the United States, includes a higher proportion of smaller and closely-held issuers. It also reflects the reality that corporate governance is in a constant state of evolution and that guidelines are, by definition, "evolutionary" in the sense that they are intended to reflect best practices which will continue to evolve over time. The approach is not prescriptive in nature and each company is urged to establish corporate governance practices that address its circumstances. We expect, however, that the related disclosure requirement, including the requirement to disclose relative to guidelines, will elevate corporate governance practices by Canadian companies.

It is anticipated that the proposed national policy will contain the following corporate governance guidelines:

- the board of directors should be composed of a majority of independent directors;
- the chair of the board of directors should be an independent director, or, where this is not possible, an independent director should be appointed as lead director;
- there should be separate, regularly scheduled meetings of the independent directors;
- the board of directors should adopt a written mandate, which should include responsibilities of directors;
- a position description for the chief executive officer should be developed;
- each new director should be provided with a comprehensive orientation, and all directors should be provided with continuing education opportunities;
- a written code of business conduct and ethics should be adopted;

- a nominating committee and a compensation committee, each composed entirely of independent directors, should be appointed;

- the directors should adopt a process for determining what competencies and skills the board as a whole should have, and these should be applied to the recruitment process for new directors; and

- regular assessments should be conducted respecting the board's effectiveness, as well as the effectiveness and contribution of each board committee and each individual director.

The flexibility afforded publicly traded companies by the policy will be tempered by the accountability imposed by the related disclosure instrument. The objective of this instrument will be to provide greater transparency for the marketplace regarding the nature and adequacy of issuers' corporate governance practices. The proposed instrument will require an issuer to disclose those corporate governance practices it has adopted relative to specific corporate governance guidelines set out in the proposed policy. However, because we appreciate that many smaller issuers will have less formal or elaborate procedures for effective corporate governance, the instrument requires more limited disclosure requirements on "venture issuers."

The proposed national instrument will also require every issuer that has a written code of business conduct and ethics to file it (or any amendment to the code) on SEDAR.

In developing the proposed national policy and instrument, we recognize that corporate governance is in a constant state of evolution. Consequently, once the instrument and policy are implemented, we intend to review them periodically to ensure that the guidelines and disclosure requirements continue to be appropriate for issuers in the Canadian marketplace.

The "Disclose Against Guidelines" Approach

The CSA believe that the "disclose against guidelines" approach in the proposed instrument and policy is substantively consistent with the "comply or explain" approach and is preferable to the rules-based approach being proposed by Industry Canada. The merits of the "comply or explain" approach have received broad acceptance both in Canada and internationally. As noted in a recent study published in the *McKinsey Quarterly*,[1] more than 50 countries worldwide have adopted corporate governance codes. These include every G-7 country, except for Japan. It also notes that dozens of countries (including the U.K., Australia, Singapore, the Netherlands and others) have adopted a "comply or explain" approach. The study states as follows:

> Since companies are not required by law to comply with codes of practice, there is clearly a risk they won't work. The evidence, however, suggests that they do. In the United Kingdom, the Cadbury Code has sparked real improvements: for instance, the increasing professionalism of many boards (as measured by their composition, structure, and processes) can be directly related to it...
> ...

[1] Paul Coombes and Simon Chiu-Yin Wong, "Why Codes of Governance Work", The McKinsey Quarterly, 2004 Number 2.

> The attraction of a code (as opposed to a law) lies in its flexibility. Legislating every aspect of corporate behavior would clearly be impossible, and statutory prescriptions would be inappropriate for many governance issues. Moreover, companies need room to maneuver. One that has unexpectedly lost its CEO, for example, could want the chairman to step in while it recruited someone else – which might not be allowed under legislation prohibiting the same person from holding both positions. ... And, crucially, codes can be amended to reflect the changing needs and circumstances much more quickly than legislation.
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> Despite an apparent lack of teeth, codes undoubtedly improve corporate governance. They focus attention on it and often influence broader debates about the regulation of business. They help educate companies, often by collecting and clarifying best practices...
> ...
> Comply or explain requirements have made corporate governance practices much more transparent and forced companies to think about them carefully, since any departure from the code must be publicly justified. Such requirements are particularly effective in countries where the media and activist shareholders monitor corporate behavior, since companies would often rather comply than risk intense media scrutiny of their explanations.[2]

The "disclose against guidelines" approach to corporate governance adopted by the CSA is not only effective in changing corporate culture and behaviour, but it also provides greater flexibility in how it is applied to a variety of different companies. We believe that it:

- strikes the right balance between protecting investors and facilitating fair and efficient capital markets;
- is sensitive to the significant number of small and closely-held publicly traded companies in Canada;
- is reflective of developments internationally; and
- recognizes that corporate governance is in a constant state of evolution and therefore permits governance requirements to be implemented by each company in a way that allows room for innovation and positive change.

Flexibility

One message that was made clear during the recent CSA consultative process is that, in the field of corporate governance, "one-size-does-not-fit-all." Canadian publicly traded companies are extremely diverse. Based on SEDAR profile information, approximately 18% of Canadian listed issuers have market capitalization of more than $100 million, whereas 69% have less than $25 million in market capitalization. Canada also has a higher proportion of closely-held companies than other countries. Given this reality, some practices or standards that are viewed as necessary or desirable by some publicly traded companies and investors may not be necessary and may in fact be inappropriate for some publicly traded companies. It is not clear how the legislated standards proposed by Industry Canada will be sufficiently flexible to reflect this diversity.

[2] *Ibid.*

We also question how a company would seek and obtain exemptive relief under the CBCA from a particular requirement in a situation where flexibility is needed and relief is reasonably warranted. What mechanism or procedures are contemplated to enable federally-incorporated distributing companies to apply for and obtain exemptive relief if the proposed corporate governance standards and practices are codified in the CBCA? Under the CSA instruments that impose mandatory requirements (for example, NI 52-108, MI 52-109 and MI 52-110), relief can be obtained quickly in appropriate situations by way of an application. Under the CSA instruments that impose disclosure obligations only, no relief would be necessary unless relief was sought from the disclosure obligation itself.

As noted in your proposal, legislated standards are more difficult to change quickly to adapt to new circumstances. This observation is particularly relevant in the context of corporate governance practices and standards, which have not only evolved significantly in the past decade, but will likely continue to evolve based on market reaction, actual experience and other developments.

Enforcement

The proposal to "hard-wire" corporate governance standards and practices into the CBCA also raises issues respecting monitoring compliance and, where necessary, taking regulatory action to enforce such requirements. As with other aspects of corporate legislation, is it intended that this area will also be "self-policed" by security holders and other affected persons by making applications to the courts? By contrast, the CSA intend to regularly review the disclosure on governance standards and practices to ensure that the disclosure requirements are followed. We believe that regular monitoring of the required disclosure will lead to greater compliance and will help foster better corporate governance standards and practices over time.

Compliance

Excessive reliance on hard-and-fast rules may be counter-productive since it can lead to a "checklist" approach to compliance without effecting changes in governance culture or behaviour. The call for rules to stamp out real or perceived "bad practices" assumes that rules are a cure-all. While rules can address structural and process reforms, in the end truly effective boards are a reflection of the skills, competencies and integrity of the board members, how they work together as a team and their leadership skills.

Uniformity

While the Industry Canada proposals appear to track the CSA requirements and guidelines, there are some instances where the proposals differ from the CSA requirements and guidelines. For example, the definitions of "independence" are different. If the CBCA were amended as proposed, CBCA publicly traded companies would be required to analyze and accommodate these differences. In our view, the time and cost inherent in this exercise would detract from market efficiency without any measurable benefit accruing to investors or to CBCA incorporated companies. We think it is highly unlikely that a full cost-benefit analysis would find net benefits resulting from an additional layer of regulation being imposed under the CBCA.

As noted by the Securities Subcommittee of the Business Law Section of the Ontario Bar Association, "to the extent it is determined that a rules-based approach is appropriate, any resulting legislative initiative relating to corporate governance reforms should be made in the context of securities law and, where appropriate, stock exchange rules, rather than in the context of corporate legislation."[3] This point is underscored by the fact that the CBCA proposals only address a small subset of publicly traded companies in Canada, of which only 225 are listed on the TSX and approximately 130 are listed on the TSX Venture. In contrast, the CSA instruments and policies apply to more than 5,000 reporting issuers, of which more than 3,700 have equity securities listed and publicly traded on a Canadian exchange.

Imposing requirements under the CBCA that are already addressed by securities legislation would create additional work of questionable value as corporate and securities regulators would be constantly working to ensure that all publicly traded companies in Canada are subject to substantially the same requirements at any given time. We believe there is a need to explore ways to facilitate compliance with corporate and securities law requirements, as well as to reduce compliance costs and minimize any confusion resulting from the need to comply with two sets of requirements. These difficulties will be exacerbated if corporate legislation across the provinces and territories is, in turn, amended.

One alternative would be to incorporate broad governance principles into the CBCA so as to create a minimum standard for matters such as financial reporting, auditing requirements, and the frequency and content of shareholder meetings. Detailed requirements could then, as suggested in your paper, either be incorporated by reference or included under the regulations. While this approach would have the advantage of being more flexible, it does not address the issues identified above and would still necessitate significant coordination between different regulators. The difficulty inherent in achieving the necessary degree of coordination in practice cannot be over-estimated.

Other Considerations

In addition to issues identified above, we suggest that potential reforms respecting the following matters may merit greater consideration by Industry Canada:

- liability of Directors; and
- shareholder voting requirements.

Liability of Directors

An issue that is directly related to corporate governance is the liability of directors and the fact that liability has been imposed incrementally over time under a variety of statutes. Since many corporate governance proposals depend upon the willingness of capable individuals to serve as directors, in an environment where the demands and expectations of directors is greater than ever before, exposure of directors to personal liability under various federal statutes bears consideration.

[3] Securities Subcommittee of the Business Law Section of the Ontario Bar Association letter dated November 13, 2002 to David Brown, Chair of the Ontario Securities Commission.

This issue was specifically referred to in a Report sponsored by The Toronto Stock Exchange on Corporate Governance in Canada (commonly referred to as the Dey Report) in 1994. At the time, it stated:

> Perhaps the most frequent on (sic) theme in the submissions received by the Committee is the concern about the impact on corporate governance of the exposure to personal liability of corporate directors. We have already accepted in general terms the principle that imposing personal liability on directors is an acceptable and effective technique for influencing corporate conduct. In view of the role of the board in the corporation, this conclusion is not surprising. The concern, of course, is that there be an appropriate balance between the need to influence corporate conduct to achieve public policy objectives and the need for effective boards of directors.[4]
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> The liability of directors is not to be confused with the liability of the corporation. What we are focusing on in this discussion is the personal liability of directors for actions of the corporation in which the director may have had some role – although some statutes impose liability on directors even where the director has had no involvement. The concern of corporate governance is that increasing personal liability of directors compounds the difficulty of recruiting qualified individuals to serve as directors. The prestige and the modest director's fee may not be enough to entice individuals to expose their personal assets to liability arising from their position as a director.[5]
>
> The construction of this corporate regulatory scheme has been achieved on an incremental basis. No single body has taken a global view of the exposure of individual directors to personal liability and attempted to consider whether there should be some limitation upon the extent of the exposure. It is a corporate fact of life that corporations and their directors will be exposed to liability under numerous statutes and that the number will increase with the number of jurisdictions in which the corporation carries on business. *We do, however, believe that the departments responsible for the administration of the corporate law in each of the federal and provincial jurisdictions should undertake a review of all legislation enacted in their jurisdiction imposing personal liability upon directors*. This review should be undertaken with the following objectives:
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> (1) In respect of each piece of legislation imposing liability upon directors, a judgement should be made as to whether or not the imposition of this liability is effective in influencing the corporate

[4] The Final Report of The Toronto Stock Exchange Committee on Corporate Governance in Canada entitled "Where Were the Directors: Guidelines for Improved Corporate Governance in Canada", December 1994, paragraph 5.53.
[5] *Ibid*., paragraph 5.54.

conduct in question; obviously if the concern underlying the legislation is not materially advanced by the provision, at least insofar as they relate to directors, the provision should be modified or repealed.

(2) Each piece of legislation should be examined to determine what defences, if any, are available to the directors to defend against allegations of liability. Legislation which does not provide any defence imposes absolute liability on directors. Other legislation may provide a safe harbour for directors enabling them to defend against allegations of liability if the director is able to demonstrate that he or she acted carefully and with due diligence.[6]

Although it has been 10 years since the Dey Report was released, we believe the concerns it raised respecting directors' liability are equally true today. Indeed, the need to address the concerns may be even more valid today considering the need for independent directors to serve on boards of publicly traded companies. Accordingly, we would encourage Industry Canada to undertake a "global" review of personal liability of directors under various statutes as suggested by the Dey Committee a decade ago. In this respect, we note that Department of Trade and Industry in the United Kingdom recently completed an extensive consultation on the issue of directors' liability.[7]

Shareholder Voting Requirements

Under Canadian corporate law, shareholders are currently permitted to vote for or against certain matters identified in the notice of meeting or in the management proxy circular. However, section 54(7) of the Regulation made under the CBCA specifically restricts the voting rights of shareholders relating to the appointment of the auditor or the election of directors to either (a) voting for, or (b) to withholding their votes.

In the context of current debates, particularly in the U.S., relating to shareholder voting reforms, it may be appropriate to re-consider this aspect of corporate law. We note that shareholders in countries like the United Kingdom have the right to vote for or against the directors that have been nominated. We also note that some stakeholders in the United States are suggesting that the voting mechanisms available under U.S. corporate law be reformed to provide more meaningful input from shareholders. For example, one suggestion in the U.S. is to require that more directors be nominated by management than there are positions available on the board.

In the context of these international developments, we encourage Industry Canada to consider whether the voting procedures under the CBCA should be amended.

We appreciate the opportunity to express our views on the proposed amendments to the CBCA and areas that may merit further consideration. We encourage Industry Canada to place greater reliance, where appropriate, on the rules and policies developed by the CSA through our recent public

[6] *Ibid*., paragraph 5.60.
[7] See the "The Director and Auditor Liability: A Consultative Document", available at http://www.dti.gov.uk/consultations/consultation-1366.html.

consultation process. This approach would offer the advantage of addressing issues of harmonizing requirements, eliminating unnecessary duplication and reducing compliance costs for distributing companies in Canada. We would be pleased to discuss any questions you may have regarding our comments or the proposed CSA initiative on corporate governance.

Sincerely,

Stephen P. Sibold, Q.C.
Chair,
Canadian Securities Administrators