

## Amendments proposed to Canadian public company governance and independence requirements

*Canadian Securities Administrators propose overhaul of corporate governance “best practices” and disclosure requirements and revisit how Canadian public companies assess director independence*

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On December 19, 2008 the Canadian Securities Administrators (the CSA) published a notice (the Notice) of the proposed repeal and replacement of National Policy 58-201 *Corporate Governance Guidelines* (the Governance Policy), National Instrument 58-101 *Disclosure of Corporate Governance Practices* (the Governance Rule) and National Instrument 52-110 *Audit Committees* (the Audit Committee Rule).

Under the proposed repeal and replacement, the governance “best practices” currently set out in the Governance Policy are to be replaced with nine principles of governance. Consequently, the disclosure to be provided under the Governance Rule would be replaced with more general and broad-based disclosure relating to these nine governance principles. The CSA also propose amending the Audit Committee Rule by replacing the bright-line tests for determining independence with a new principles-based definition of independence, arguably providing more discretion to the board of directors in determining independence.

### Proposed amendments to the Audit Committee Rule

#### *A new approach to determining independence*

The most significant proposed change to the Audit Committee Rule is the replacement of the current definition of independence that applies to audit committees and other board members. While the proposed Audit Committee Rule will generally continue to require that audit committees of all non-venture issuers be composed of three independent and financially literate board members, the definition of independence under the proposal is significantly broader and leaves more to the discretion of the board of directors. Under the proposal, a director is independent if he or she:

- > is not an employee or executive officer of the issuer; and
- > does not have, or has not had, any relationship with the issuer, or an executive officer of the issuer, which could, in the view of the issuer's board of directors having regard to all relevant circumstances, be reasonably perceived to interfere with the exercise of his or her independent judgment.<sup>1</sup>

The proposed Audit Committee Rule no longer prescribes relationships that are considered to taint independence. However, the Companion Policy to the proposed Audit Committee Rule advises that in assessing independence, the board should review the directors' business and other relationships with the issuer or its executive officers, applying such materiality thresholds that are appropriate for the issuer and the directors. The proposed Companion Policy also advises that a director's independence could be affected by the following types of relationships:

- > employment by the issuer or an affiliate;
- > family ties or other close association with an executive officer, or active involvement in the day-to-day management of the issuer;

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- > a current or past significant contractual or other business relationship with the issuer or an affiliate (other than as a director) or being a partner, shareholder, director, executive officer or employee of an entity that has such a relationship;
- > being or having been a significant professional advisor or consultant to the issuer or an affiliate of the issuer (including an executive officer or director of such advisor or consultant, or an employee of such advisor or consultant significantly associated with the service provided); and
- > receiving or having received significant compensation from the issuer (other than compensation for acting as a member of the board of directors or of any board committee or fixed amounts of compensation under a retirement plan).

### ***Controlled companies and smaller issuers***

In the Notice, the CSA state that in conducting their review of the current Governance Rule and Policy, they considered the realities of a large number of small issuers and controlled issuers in the Canadian market and have attempted to illustrate how smaller issuers and controlled issuers might interpret and apply the proposed governance and independence principles. For example, with regards to independence, the CSA state that while a control person or significant shareholder is not disqualified from being independent, when making independence assessments boards should consider the nature and degree of the control person's or significant shareholder's involvement with the management of the issuer in determining whether the relationship may be reasonably perceived to interfere with the exercise of independent judgment. The proposed definition of independence captures relationships that are reasonably *perceived* to interfere with the exercise of independent judgment, in contrast to the current definition, which captures relationships that are reasonably *expected* to interfere. In the CSA's view, the concept of perception is broader than that of expectation and is appropriate for the proposed definition of independence.

### ***Independence-related disclosure***

Under the proposed Governance Rule, issuers will be required to provide more disclosure relating to independence matters. In addition to the current disclosure of the names of the directors considered by the board not to be independent and the basis for that determination, the proposed Governance Rule also calls for disclosure of those considered to be independent along with the following information, if any:

- > a description of any relationship with the issuer or any of its executive officers that the board considered in determining the director's independence; and
- > if the director has such a relationship, a discussion of why the board considers the director to be independent.

### ***Other changes to the Audit Committee Rule***

The proposed Audit Committee Rule also restates the restrictions on the provision of non-audit services by the external auditor unless the service has been approved by the issuer's audit committee and on the public disclosure of information contained in or derived from its financial statements, MD&A or annual or interim earnings news releases, unless the document has been reviewed by the audit committee. Currently, these responsibilities rest with the audit committee. The proposed amendments shift the obligation of compliance with these restrictions to the issuer. The proposal also intends to clarify that the requirement for the external auditor to report directly to the audit committee be included under the terms of the issuers' audit engagement agreement. As well, the temporary exemption (for limited and exceptional circumstances) from the requirement that all audit committee members be independent is to be amended under the proposals. The condition that the board of directors determine, in its reasonable judgment, that the *audit committee member* relying on this exemption is able to exercise the impartial judgment necessary to fulfill his or her responsibilities is proposed to be replaced by a condition requiring the board of directors to determine that the reliance on the exemption will not significantly adversely affect the ability of the *audit committee* to act independently and to satisfy the other requirements of the proposed Audit Committee Rule.

### ***Proposed amendments to the corporate Governance Policy and Rule***

The proposed Governance Policy articulates nine core principles that are intended to address a broad range of corporate governance subjects. Each of these is followed by commentary and examples of the types of practices that might satisfy the objectives of these principles. While issuers are encouraged to consider the commentary and examples, the CSA also recognize in s. 1.3 of the proposed Governance Policy that: other corporate governance practices could achieve the same objectives; corporate governance evolves as an issuer's circumstances change; and each issuer should have the flexibility to determine the appropriate corporate governance practices for its circumstances. Similarly, the existing corporate governance disclosure requirements are to be replaced under the proposals with a new set of disclosure requirements that are more general in nature (rather than based on a model of "comply-or-explain") and apply to both venture and non-venture issuers. Under these proposed amendments to the Governance Rule, an issuer will be required to disclose the practices it uses to achieve the objectives of each of the nine principles set out in the proposed Governance Policy. As is currently required, an issuer will also be required to disclose certain factual information, such as the board's composition and information about any of its standing committees.

The following are highlights of the commentary and practices that the CSA have provided in connection with the nine articulated principles. These highlights include references to some of the related disclosure proposed to be required under the Governance Rule.

### **Principle 1 -- Create a framework for oversight and accountability**

*An issuer should establish the respective roles and responsibilities of the board and executive officers.*

The commentary to this principle states that the responsibilities of the board and executive officers should be clearly defined to promote, among other matters, accountability to the issuer and its shareholders and an appropriate allocation of authority. Examples of suggested practices that promote this principle include, among others,

- > adopting a written mandate or formal board charter that details the board's roles and responsibilities and the roles and responsibilities of each standing committee of the board, if any;
- > developing clear position descriptions for the chair of the board, the chair of each board committee and the CEO; and
- > providing directors with the terms and conditions of their appointment.

Required disclosure in the proposal in regards to this principle includes a description of any directors' authority and responsibilities that have been delegated to an executive officer or officers of the issuer.

### **Principle 2 -- Structure the board to add value**

*The board should be comprised of directors that will contribute to its effectiveness.*

The commentary to this principle states the board's composition, structure and practices should facilitate the exercise of independent judgment. Examples of practices include:

- > having a majority of independent directors on the board;
- > having an independent director chair the board or act as a lead director;
- > having an appropriate number of independent directors who are unrelated to any control person or significant shareholder;
- > separating the roles of chair and CEO; and
- > creating committees with an appropriate number of independent directors.

As discussed above, disclosure relating to this principle includes identification of the board members considered to be independent, along with a description of any relationship with the issuer or any of its executive officers that the board considered in determining the director's independence and, where such a relationship was considered, a discussion of why the board considers the director to be independent.

### **Principle 3 -- Attract and retain effective directors**

*A board should have processes to examine its membership to ensure that directors, individually and collectively, have the necessary competencies and other attributes.*

The commentary to this principle advises that the board should be satisfied that appropriate procedures are in place for selecting candidates so that it can maintain a balance of competencies and other attributes. Related practices include establishing a nominating committee to carry out or make recommendations with respect to the recommended procedures

### **Principle 4 -- Continuously strive to improve the board's performance**

*A board should have processes to improve its performance and that of its committees, if any, and individual directors.*

Examples of practices relating to this objective include assessing the board, any board committees and each individual director on a regular basis regarding his, her or its contribution against established criteria and acting upon the results.

Proposed disclosure under this principle includes a description of any practices the board uses that are intended to improve the performance of the board, any board committee or individual directors, including the assessment process and outcomes, if a performance assessment of the board, any board committee or individual directors was conducted during the most recently completed financial year. While disclosure of any assessments is currently required, the proposals expand on this by including disclosure of assessment outcomes.

### **Principle 5 -- Promote integrity**

*An issuer should actively promote ethical and responsible behaviour and decision-making.*

Practices identified under this principle include outlining the standards of ethical behaviour required of directors, executive officers and all employees and adopting a code of conduct. With respect to the scope of a code of conduct, in addition to the matters currently included under the Governance Policy, the proposals also suggest addressing the issuer's responsibilities to securityholders, employees, those with whom it has a contractual relationship and the broader community, monitoring and ensuring compliance with the code.

### **Principle 6 -- Recognize and manage conflicts of interest**

*An issuer should establish a sound system of oversight and management of actual and potential conflicts of interest.*

The commentary to this principle states that conflicts of interest may arise in various situations, include where:

- > there is a significant divergence of interests among shareholders or their interests are not completely aligned;

- > one or more directors cannot be considered *impartial* in connection with a proposed decision to be made by the board;
- > a contract, arrangement or transaction is entered into between an issuer and a control person or significant shareholder;  
or
- > an issuer makes a decision or enters into a contract, arrangement or transaction that will benefit one or more of its officers or directors.

The commentary further states that an issuer should have practices in place to identify, assess and resolve actual and potential significant conflicts of interest. Examples of practices include establishing an ad hoc or standing committee when relevant, comprised of directors that are not directly or indirectly interested in the matters being discussed or considered.

**Principle 7 -- Recognize and manage risk**

*An issuer should establish a sound framework of risk oversight and management.*

The commentary under this principle states that risk oversight and management should focus on identifying “principal risks,” being the most significant areas of uncertainty or exposure that could have an adverse impact on the achievement of the issuer's goals and objectives. Related principles include implementing policies and procedures for the oversight and management of principal risks and requiring the CEO or other executive officer to report to the board on the effectiveness of these policies.

**Principle 8 -- Compensate appropriately**

*An issuer should ensure that compensation policies align with the best interests of the issuer.*

The commentary under this principle states that compensation should be set and structured to reflect a balanced pursuit of the issuer's short-term and long-term objectives. The proposed disclosure would include not only the identification of any compensation consultant or advisor that has assisted the board or the compensation committee since the beginning of the financial year, but also the aggregate fees billed by the consultant or advisor in each of the last two financial years for professional services relating to executive compensation and the fees billed for professional services other than those relating to executive compensation (including, in these circumstances, a description of the nature of the services comprising the fees disclosed).

**Principle 9 -- Engage effectively with shareholders**

*The board should endeavour to stay informed of shareholders' views through the shareholder meeting process as well as through ongoing dialogue.*

The commentary under this principle states that, within the parameters of applicable corporate and securities law, the board should promote a voting process that is understandable, transparent and robust and that facilitates the board obtaining meaningful information on shareholder views. In this respect, examples of practice include:

- > posting on the issuer's website a clear description of the voting process for registered and beneficial shareholders; and
- > giving shareholders the option of voting electronically and giving shareholders or proxy holders the option of attending meetings by electronic means.

Proposed disclosure relating to this principle includes a description of any practices or policies of the issuer that are related to the shareholder voting process or that promote a voting process that is understandable, transparent and robust and that facilitate the board obtaining meaningful information on shareholder views, as well as a description of how directors of the issuer are elected, including if the issuer has adopted a majority or plurality voting standard.

Notably, of the nine principles that are articulated in the proposed Governance Policy, principles 6, 7 and 9 represent new “subject matters” that are not currently directly contemplated under the governance “best practices.”

In addition to disclosure-related amendments, under the proposed Governance Rule an issuer will no longer be required to file a copy of its code of business conduct and ethics on SEDAR. Instead, issuers will be required to provide a summary of any standards of ethical and responsible behaviour and decision-making or code adopted by the issuer and a description of how to obtain a copy of the code, if one has been adopted.

The CSA are inviting comments on these proposals until April 20, 2009.

For further information, please contact your Stikeman Elliott representative, either author listed above or any member of our Corporate Finance and Securities Group listed at [www.stikeman.com](http://www.stikeman.com)

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<sup>1</sup> The current definition of independence in the Audit Committee Rule provides that a director is independent if he or she has no direct or indirect relationship with the issuer which could, in the view of the issuer's board of directors, be reasonably expected to interfere with the exercise of a member's independent judgment (a “material relationship”). The rule then goes on to list individuals that are considered to have such a “material relationship”.