

# Torys on Corporate and Capital Markets

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## Canadian Securities Regulators Propose New Corporate Governance Rules

By [Cornell Wright](#)

Canadian securities regulators are proposing an overhaul of the corporate governance regime for Canadian issuers.

The proposals feature a new policy that articulates nine high-level corporate governance principles. Issuers will be required to disclose the practices they use to achieve the objectives of each principle. This is a significant change from the current requirement to “comply or explain” against specific governance guidelines, which some issuers have criticized as overly prescriptive.

The regulators are also proposing to introduce a more principles-based approach for determining whether a director is independent for audit committee and other board and committee purposes. The bright-line tests in the current definition of independence will be eliminated. The proposals include guidance regarding the types of relationships that could affect a director’s independence but ultimately leave the determination of independence to the reasonable judgment of the board of directors.

The proposals are open for public comment until April 20, 2009. It remains to be seen how enthusiastically institutional investors and other market participants will react to the proposals. The Alberta Securities Commission has questioned whether the proposals will meaningfully enhance investor protection and whether their introduction so soon after implementation of the current regime is beneficial. In addition, the proposals diverge from the approach taken by U.S. regulators, which could make them less attractive to cross-border issuers.

### Proposed Governance Policy

The new governance policy establishes the following nine core corporate governance principles that apply to all issuers:

1. **Create a framework for oversight and accountability.** An issuer should establish the respective roles and responsibilities of the board and executive officers.
2. **Structure the board to add value.** The board should comprise directors who will contribute to its effectiveness.
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.

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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.
5. **Promote integrity.** An issuer should actively promote ethical and responsible behaviour and decision making.
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.
7. **Recognize and manage risk.** An issuer should establish a sound framework of risk oversight and management.
8. **Compensate appropriately.** An issuer should ensure that compensation policies align with the best interests of the issuer.
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.

Each principle is accompanied by commentary that provides relevant background and explanation, together with examples of practices that could achieve its objectives. The regulators emphasize that the examples are not mandatory and should not be interpreted as best practices or minimum standards. The policy explicitly recognizes that (i) other practices may achieve the same objectives; (ii) corporate governance practices will evolve as an issuer's circumstances change; and (iii) each issuer should have the flexibility to determine practices that are appropriate for its particular circumstances. In practice, that flexibility may be limited by the views of institutional investors and the standards reflected in corporate governance rankings, which issuers often take into account in determining their corporate governance practices.

Significantly, rather than specifying that a board should comprise a majority of independent directors, the proposals identify this as one example of a practice an issuer could adopt to achieve the principle of structuring the board to add value. The proposals treat the composition of the nominating and compensation committees in the same manner. The proposals maintain the requirement for an issuer to have an audit committee that comprises solely independent directors, although independence is determined using the new principles-based definition discussed below.

### Proposed Disclosure Rule

Issuers will be required to disclose the practices they use to achieve the objective of each of the core corporate governance principles. To help investors understand these practices, companies will also be required to disclose certain factual information regarding the composition, roles and responsibilities of the board and each standing committee.

Issuers will no longer be required to file a copy of their code of business conduct and ethics or amendments to the code through SEDAR. However, they will be required to summarize any standards of ethical and responsible behaviour and decision making or code they adopt, and describe how to obtain a copy.

Debt-only issuers and other companies that qualify as "venture issuers" will be subject to the same disclosure requirements as other non-venture issuers.

## Proposed Approach to Independence

The proposals provide that a director is independent for audit committee and other board and committee purposes if he or she (i) is not an employee or executive officer of the issuer; and (ii) 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. The bright-line tests in the current definition of independence will be eliminated. Instead, the proposals include examples of relationships that could affect independence (focusing on relationships covered by the current bright-line tests) and allow the board to apply materiality thresholds that are appropriate for the issuer and the director.

The proposed definition focuses on independence from the issuer and its management since the board's obligation is to oversee management of the issuer's business and affairs. For that reason, employees and executive officers of the issuer are disqualified from being independent. On the other hand, a control person or significant shareholder may be independent if the board determines that the nature and degree of that individual's involvement with management could not be reasonably perceived to impair his or her independent judgment.

In contrast with the current definition, which captures relationships that are reasonably "expected" to interfere with the exercise of a director's independent judgment, the proposed definition captures relationships that are reasonably "perceived" to do so. The regulators think this broader concept of perception is appropriate, given the elimination of the bright-line tests.

The principles-based nature of the proposed definition will put increased pressure on the board's assessment of a director's relationships with the issuer or its executive officers and its judgment as to whether those relationships could be reasonably perceived to affect the director's independent judgment. In determining that a particular relationship does not affect a director's independence, an issuer will risk being second-guessed by institutional investors and corporate governance rankings, which in many cases use more stringent definitions of independence (and may argue that their views best represent the "perception" of independence that is contemplated by the new principles-based approach).

The proposals require an issuer to disclose any relationship with the issuer or any of its executive officers that the board considered in determining a director's independence and, if the director has such a relationship, a discussion of why the board considers the director to be independent. In addition, the proposals require the issuer to disclose any business or other relationship that any director has with any other director on the board.

An issuer's governing statute or constituting documents may impose additional independence requirements. For example, both the *Canada Business Corporations Act* and the *Business Corporations Act* (Ontario) require that a majority of a reporting issuer's audit committee members be directors who are not officers or employees of the issuer or any of its affiliates.

## U.S. Requirements

Canadian issuers are exempt from most of the corporate governance listing standards of the U.S. stock exchanges provided they disclose how their practices differ from those of U.S. companies. The proposals should not affect Canadian issuers' ability to rely on this exemption. However, to the extent that an issuer's practices deviate further from the U.S. requirements as a result of the proposals, the necessary disclosure could become more onerous.

Although the proposals allow for more flexibility in determining a director's independence, Canadian issuers that are listed on a U.S. stock exchange must continue to comply with the audit committee independence rules adopted by the Securities and Exchange Commission under the U.S. *Sarbanes-Oxley Act of 2002* (S-Ox). These rules prohibit audit committee members from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer (other than directors' fees and committee fees) or being an "affiliated person" of the issuer. Although the U.S. stock exchanges have adopted their own audit committee requirements in addition to those imposed by S-Ox, Canadian issuers are exempt from those additional requirements if they provide the necessary disclosure.

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Copies of the request for public comment, proposed repeal and replacement of National Policy 58-201, *Corporate Governance Guidelines*, National Instrument 58-101 *Disclosure of Corporate Governance Practices*, and National Instrument 52-110, *Audit Committees* and Companion Policy 52-110CP, *Audit Committees*, can be found at [www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule\\_20081219\\_58-201\\_rfc.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20081219_58-201_rfc.pdf). 