Corporate

Bulletin

A Report on Corporate Governance

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Corporate Governance – A "Made-in-Canada" Approach

The spillover from recent corporate and accounting scandals in the United States is fuelling a corporate governance debate in Canada. The U.S. Congress responded to these scandals through the *Sarbanes/Oxley Act* (SOX), which President Bush signed into law in July, 2002. SOX aimed to deter and punish corporate and accounting fraud and corruption by toughening standards in a number of areas, including corporate disclosure and corporate governance and by imposing personal responsibility on senior executives. Canadian capital markets stand in the shadow of New York and Chicago and many Canadian issuers depend on continued access to the US market. So it's not too surprising that pressure is building for a Canadian version of SOX.

David Brown, Chair of the Ontario Securities Commission (OSC), has indicated that the OSC is looking closely at SOX. Brown's working assumption is that it makes regulatory sense to harmonize with the US initiative unless there are cogent reasons for not doing so. Brown has sent an open letter to a number of market participants seeking their advice and views on crafting a Canadian response to SOX. That process will take time.

More recently, an important governance - focused response came from Canadian CEOs working through the Canadian Council of Chief Executives (CCCE). They endorsed a statement entitled *Governance, Values and Competitiveness: A Commitment to Leadership* released in September, 2002. They argue that while they accept that some action must be taken in Canada to restore confidence in the capital markets, to adopt the American model wholesale would be a mistake. The Canadian preference is for a voluntary "guidelines" approach; an expression of values, rather than a set of hard and fast "rules". The CCCE believes that while governments have a role to play in improving corporate governance, in Canada market mechanisms are best. The government role is to prosecute violations of existing laws and regulations – and current conditions dictate getting serious on prosecutions.

The CCCE's nine recommendations to chief executive officers and boards of directors form a voluntary code of conduct for improved corporate governance:

Each is described below:

Chief Executive Officers

1. Trust and Accountability

Chief executive officers must report clearly and accurately on the results of the decisions they make and be accountable for their actions. This principle suggests further actions to increase accountability:

(a) **Compensation** – Executive compensation should be tied to both short-term and long-term performance. Boards should consider shifting compensation models to link them to sustained appreciation in shareholder value.

(b) Insider Trading – The rapid dissemination of insider trading information is key to fair markets. CEOs should report all transactions involving company stock, related derivatives and the exercise of options within two business days.

(c) Certification – Chief executive officers should be prepared to certify all annual and quarterly reports, similar to that required by SOX, confirming the accuracy and interpretation of the information and the internal controls implemented to ensure accuracy.

(d) Enhanced Enforcement and Penalties – Canada's existing rules and regulations ensure that any material misrepresentation by a chief executive officer would have significant consequences through the courts and regulatory bodies. But the CCCE suggests more stringent enforcement of these rules and regulations and legal penalties to reflect the seriousness of the offence.

> The Ontario Finance Minister went further with her October 10, 2002 announcement that the Ontario government intends to introduce legislation to require senior management certification of financial statements, increased fines for insider trading and other securities - related offences.

(e) Sanctions within Compensation – Just as bonus schemes often provide incentives to chief executive officers for meeting performance targets, compensation agreements could include sanctions to complement and reinforce legal and regulatory penalties.

2. Code of Ethics

Written codes of ethics or conduct should be adopted. The codes should deal with issues such as relationships with stakeholders and the media, compliance with the spirit and letter of the law, conflicts of interest and insider trading. Code compliance should be a condition of employment, and the code should include an effective reporting and enforcement mechanism, so that employees can report branches without fear of retribution.

3. Corporate Citizenship

Participation in broad collective initiatives, both within Canada and globally, should be encouraged so companies can build their corporate reputation and enhance public trust in the free enterprise system.

Boards of Directors

4. Board Independence

To ensure board independence and its ability to evaluate objectively the CEO's performance, the Code proposes that:

- a majority of the board be independent of management;
- a majority of the audit, compensation, nomination and governance committees be composed of "independent" directors;
- each committee should report to the full board on a regular basis;
- directors should have an obligation to make enquiries whenever necessary and have access to outside advisors as required;
- the board should consider separating the position of chief executive officer and board chair; and
- where the positions of chief executive officer and board chair are not separated, independent directors should elect a lead director to preside at all meetings where management is not present.

5. Board Recruitment and Development

The board should bring together a range of skills and competencies, taking into consideration such factors as employment obligations, other board commitments, character and other personal qualities. Directors should understand the level of commitment required and be informed of the expectations of the company. In addition, all directors should be familiar with the company's strategic plan, any significant financial, accounting or risk issues, compliance programs, conflict policies and internal and external auditors of the company. Director education is a must.

6. Audit Committee

Each member of the audit committee should be financially literate – accounting principles are the language of governance. The committee must have full access to all books and records of the company. There should be an effective separation of the internal and external audit functions and the committee should hold regular sessions with both the internal and external auditors without management attendance.

7. Assessment and Compensation Practices

The board should regularly assess its effectiveness as a whole and its members individually. It should ensure that director compensation accurately reflects the responsibilities that directors must shoulder. Loans of a personal nature to directors or executive officers should be prohibited, except for those made for a specific corporate purpose.

8. Equity Compensation

Compensation practices should provide for a meaningful portion of the compensation of directors in the form of long-term equity. This should ensure that management has a significant incentive to focus on sustainable growth in shareholder value. Alternatively, the board could require that directors buy and hold a meaningful amount of stock as long as they remain on the board.

9. Transparency and Disclosure

Companies must not only practice good governance, but must also be seen to be doing so. To this end, each board should disclose its corporate governance guidelines in its annual report, management information circular or through other publicly accessible means. Detailed disclosure rules are provided in the Code, including a recommendation that companies disclose all fees paid to auditors and any affiliated firms or organizations as well as all sources and forms of executive compensation.

The CCCE statement also offers suggestions to other key players in the corporate governance arena such as auditors and accounting firms, institutional shareholders, analysts and investment dealers, educational institutions, media and information distributors, and governments and regulators.

What's Next?

Legislative change seems inevitable, but the pace will be slow as each province has its own priorities. Until new laws are enacted the CCCE statement will be persuasive, and at worse a yardstick by which all public companies' governance activities will be measured.

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