

Progress Report on Corporate Governance Initiatives

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Corporate governance has been a priority of the OSC for the past few years, just as it has been a key focus of investors, boards and regulators around the world. Much has been achieved in this area and there are still things to accomplish. Some have speculated that the corporate governance phenomenon is a fad; its star burns bright now but will soon fade. I do not believe this to be the case. But I do expect that the nature of the corporate governance debate, the key issues and how they are addressed, will evolve as we go forward.

There are at least two key elements of effective corporate governance. First, there are the rules, legislation, and standards which corporations and their directors, officers and senior management must follow. You could call this the “hardware.” It is vitally important. But it cannot take the place of the “software” — the corporate culture, the attitudes, the “tone-at-the-top” — that ensure proper corporate governance is practiced on a daily basis and in a manner that best serves the long-term interests of the company and its shareholders.

Regulators are in a position to make rules and see that they are enforced. They can fashion those rules so that they contribute to a healthy environment within the boardroom and the company as a whole. But regulators acting alone cannot create the right corporate culture. Leadership by the CEO, the CFO and the board of directors is needed to set the right tone-at-the-top.

First, let’s look at the governance hardware. There’s been a huge investment in this by regulators and corporations alike in Canada, the U.S. and internationally. We have seen substantial repair and strengthening of the governance framework. The process for achieving this got underway in Canada about a decade ago with the release of the Dey Committee Report and associated guidelines for TSE-listed companies. The focus in the U.S. has been more recent with the passage of the Sarbanes-Oxley

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Act. Canada faced an important choice in deciding how to respond to this sweeping piece of legislation. There were those who urged us to adopt the Sarbanes-Oxley approach as a package. Others urged us to do nothing, maintaining that Canada's business climate was different from that of the U.S.

We followed neither of those recommended courses of action. We were not convinced that we have any claim to moral superiority. Bad practices are not a function of geography and are not contained by borders. Further, given the level of integration of North American capital markets, we saw the need for comparable, if not equivalent, rules. Indeed, we were one of the first jurisdictions in the world to do so.

But we also recognized that there are clear differences between the U.S. and Canadian markets. Important differences that make adoption of a Canadian version of the Sarbanes-Oxley Act a non-starter. For one thing, we have a preponderance of small capitalization companies in Canada that need to be dealt with differently. Canadian companies tend to go public at lower levels of capitalization. In addition, there are proportionally more closely held companies in Canada than in the U.S. and they, too, merit distinct considerations.

But differences like these do not mean that our securities laws should be any less robust. Market participants do not want our country to become a haven for those unable to clear the hurdles elsewhere. Canada must both maintain and enhance its reputation as an attractive and secure place to raise investment capital. In the competition for global capital, we must not diminish our high standing by taking the low road.

In the wake of Sarbanes-Oxley, our challenge was to forge an approach as rigorously focused on desired behavioural outcomes as that in the United States, but tailored to Canadian realities.

Having resolved to act while taking into account those differences, we then set out to consult market participants to determine the best way forward.

In response to these developments, we developed four rules, one of which is not yet effective. They are important ingredients of the new hardware of corporate governance and are already having a significant impact on those corporations that must comply. Let me briefly comment on these new rules.

The key elements of the Audit Committee Rule require that:

- public companies have an audit committee which is totally independent of management with members who are financially literate.
- conflicts of interest between management and the issuer's external auditor are managed by making the Audit Committee responsible for overseeing the appointment, compensation, retention, and work of the external auditor.
- the Audit Committee have a written charter describing its mandate and responsibilities.
- the Audit Committee pre-approve non-audit services by the external auditor.
- the Audit Committee review an issuer's financial statements, MD&A (Management Discussion and Analysis), and annual and interim earnings press releases prior to public release.
- the Audit Committee establish "whistle-blowing" procedures for employees and others to raise concerns about the issuer's financial reporting practices or internal accounting controls.

The Audit Committee rule is in effect across Canada (except for B.C.) The most contentious issue was the proposed "financial expert" designation. We rejected this approach in favour of a requirement to disclose, for each member of the Audit Committee, their education and experience in relation to their responsibilities as a member of the Audit Committee. We plan to amend the rule as necessary to address frequently recurring issues.

Secondly, we adopted a certification rule requiring that the CEO and CFO must certify that all financial statements, together with all other financial disclosure issued by the company, does not contain any misrepresentation and fairly presents the financial condition and results of operations of the corporation. The latter goes beyond acknowledging compliance with GAAP. The implications of the "fair presentation" certifications can be considerable. This aspect of the certification is aimed at ensuring that, ultimately, the selection and application of

accounting policies within GAAP is influenced by fairness of presentation considerations as opposed to bottom line enhancement.

Thirdly, all auditing firms of public companies are required to be members in good standing of the Canadian Public Accountability Board (CPAB), the new independent watchdog of auditing practices. CPAB recently issued its first Report which summarizes its findings with respect to the auditing standards and practices of the “Big Four” accounting firms in Canada.

Finally, we have been focusing much of our attention on how boards of directors exercise their governance mandate. We have proposed that the board be composed of a majority of independent directors, that the Chair and the CEO be separate, failing which a lead director be appointed, that the board have a written mandate that, among other matters, imposes on it the responsibility to be satisfied as to the integrity of the CEO and other senior officers, and that the CEO and other senior officers create a culture of integrity throughout the organization.

We have proposed that boards should meet on a regular basis without management present. We have addressed the role and composition of nominating and compensation committees as well as the importance of regular assessments of overall board and director effectiveness.

We have proposed that boards adopt a written code of business ethics that is applicable to directors, officers and employees. That code would address, among other things, such issues as conflicts of interest, protection and proper use of corporate assets, confidentiality of corporate information and timely reporting of illegal or unethical behavior.

With respect to these and other aspects of the corporate governance framework, we aim to codify well-established and accepted good governance practices. These guidelines are not prescriptive. Rather, issuers are encouraged to implement them in a flexible and sensible manner to suit their individual circumstances. Consistent with this philosophy, we propose to introduce a “comply or explain” approach to these practices where the onus is on the company to disclose whether it complies with a practice or explain why it does not and what it does instead to meet the objective.

We have reached consensus with our CSA colleagues on an approach that can be adopted nationally. While there were initially

differences in the regulatory models being advocated by CSA jurisdictions, we committed ourselves to finding common ground. There should be one set of standards for Canada, and we need to shape it jointly. These new proposals, to be published for comment shortly, will also become an important component of the corporate governance hardware.

In concert with us, other capital market participants and their professional advisors have been active in raising the bar on corporate governance. Allow me to point out but a few examples of this multi-pronged approach:

- the Canadian Institute of Chartered Accountants adopted new requirements for auditor independence;
- Canadian accounting standard-setters have led their U.S. counterparts in requiring expensing of stock options. I believe that the importance of this initiative extends beyond accounting presentation and is linked to governance reform. Expensing of stock options, like any other form of employee compensation, will serve as a natural discipline on compensation practices. It should avoid or minimize undue dilution of shareholder value due to overly generous option grants to senior management, favoured employees and directors.
- the Institute of Corporate Directors, in conjunction with the Rotman School of Management, launched a directors education program for board members; similarly, McMaster University teamed up with the Conference Board of Canada to offer a directors program; to date, the level of enrolment in these programs and the calibre of participants has exceeded expectations;
- the Canadian Coalition for Good Governance was formed, representing many of Canada's largest institutional shareholders and is using their influence to work with our largest public companies to identify possible improvements to their governance structure;
- the Canadian Securities Administrators published a new and harmonized national instrument upgrading continuous disclosure requirements and introducing enhanced MD&A;

- the Government of Ontario passed new laws setting higher thresholds for fines and longer jail terms for breaches of the Securities Act; and
- the Government of Canada created Integrated Market Enforcement Teams to deal with white collar crime.

We recognize that best practices in corporate governance will continue to evolve, and accordingly we will revisit our corporate governance policy and disclosure rule after they have been in effect for a reasonable period of time to ensure that the guidelines and disclosure requirements remain appropriate for issuers in the Canadian marketplace.

There will be robust benchmarks and we will not stand idly by if they are not met. We will monitor and enforce the standards that have been adopted. We will ensure that the comply-or-explain approach to corporate governance results in meaningful disclosure based upon which investors can make informed decisions and market discipline can be brought to bear.

The new corporate culture must have zero tolerance for unethical activity. Mistakes in judgment are one thing. But ethical transgressions, conflicts of interest, or breaches of fiduciary duty — these fall into a different category. Transparent ethical boundaries need to be established and respected. The consequences for gross violations of these accepted norms must be — and must be seen to be — swift and proportionate.

But what of the “software” of corporate governance? The fact is that while the initiatives I have described are extremely important, regulatory reform cannot — by itself — translate into good corporate governance.

The health and strength of a company’s governance is a reflection of its culture — the relationship and level of trust between the board and management, tempered by a healthy tension, an attitude of openness amongst senior management, respect for the free expression of concerns by employees and a visible commitment to ethical behaviour, transparency and accountability on a day-to-day basis.

Under corporate law, oversight responsibility for the matters discussed above falls upon the board of directors. It is not their responsibility to actively manage the company. But board members do

have an obligation to know the management team and to be familiar with their operating style.

The board should implement a well thought out compensation strategy for senior executives designed to motivate them in a manner consistent with the long-term best interests of the company and its shareholders. It must not serve as an invitation to cut corners.

Today's boards, more than ever before, are cognizant of their responsibility to engage management, to independently probe its planning and priorities, and to ask the necessary, tough questions.

Similarly, boards are recognizing the importance of establishing policies and procedures to facilitate whistle-blowers stepping forward without fear of repercussion. Indeed, the treatment of whistleblowers, both statutory and otherwise, is receiving attention globally with many jurisdictions creating a direct reporting line between whistleblowers and the audit committee of the board. Why are whistle-blowing procedures and protection for whistleblowers so important? External auditors have long maintained that their role is not to ferret out fraud. This claim is supported by a recent study done by KPMG which said external auditors tend to find between 3 to 5% of public company frauds. Indeed, they maintain that frauds are far more likely to be exposed by whistleblowers and "angry spouses." There is an important message here for corporate boards.

One of the most important changes that has resulted from recent reforms is the nature of the relationship between audit committee members and external auditors. More often than in the past, audit firms are raising issues about financial statement presentation with the audit committee directly, advising them of their questions and concerns. We are seeing a new relationship dynamic emerge between external auditors and audit committees — a direct reporting relationship that is helping to foster more openness and candour and surfacing the issues that need to be aired.

Clearly, we have seen significant progress in enhancing corporate governance standards. It is clear that being a corporate director has become a lot tougher and far more demanding than it used to be.

But while change was called for, it should be remembered that the ultimate goal is to protect the interests of the shareholder and enhance shareholder returns. Shareholders rely on directors who are independent

of management to look out for their interests. But we should avoid insistence on such a degree of independence that directors do not understand the business and are unable to contribute to maximization of shareholder value. Effective oversight of management depends upon having an understanding of the company, the industry and environment in which it operates, and the nature of the business itself. To be truly effective, directors must have business acumen, shareholder orientation and a genuine interest in the company. We need to maintain a sense of balance as we focus on rigorous definitional independence requirements for the board.

A recent example helps to illustrate this concern. The California Public Employee Retirement System, the large and sophisticated U.S. pension fund known as CalPERS, recently challenged Warren Buffet continuing to serve on the board of Coca-Cola. At Coca Cola's annual meeting in April 2004, CalPERS declined to support Mr. Buffet continuing to serve on the board and audit committee. There was much press coverage of the incident at the time.

In the end, the CalPERS resolution was defeated by the shareholders. While CalPERS' actions were, no doubt, motivated by a point of principle, this incident serves as a useful reminder that the goal of good corporate governance is ultimately to benefit the shareholders. And would that goal be advanced or set back by terminating the board and audit committee service of a director of Mr. Buffet's knowledge, stature and experience? This example is a useful illustration of the need for balance. We should not fall back on rigid prescriptions of good governance at the expense of corporate wealth creation.

Before the recent corporate scandals, the relationship between boards and management had fallen out of balance, with too many boards failing to step up to their responsibility to provide critical oversight. Many corrective steps have been taken — by governments, legislators, institutional investor representatives such as CalPERS and the Canadian Coalition of Good Governance, as well as other shareholders, professional associations such as the CICA, individual boards themselves, and regulators. With regard to the relationship between board members and corporate management, we want a "Goldilocks approach" — not too cozy but not too distant, independent yet not uninformed.

There is still work to be done. The new frontier in the governance debate will focus especially on CEO and senior management

compensation. As Warren Buffet said in his letter to Berkshire shareholders, “CEO pay remains the acid test in judging whether corporate America is serious about reforming itself and, to date, the results are not encouraging.” Other areas that are receiving and will continue to receive more attention in future are: board and director evaluations/assessments, processes for director nomination and director education. Last but not least, greater attention needs to be paid to succession planning and to opportunities for more effective partnering between the board and management to deliver strong and sustained performance.

Enron, WorldCom, and other corporate scandals served as a wake-up call. Not just for Corporate America, but for all. We are responding by re-wiring the corporate governance hardware — the laws and standards. It is vital that the corporate world put in place the software — the culture that shapes day-to-day decision-making. Regulation can address structural and process reforms but, in the end, truly effective boards are a function of the skills, competencies and integrity of the board members, how they work together as a team and interact with management, and the leadership skills of the board chair. Finally, our approach to regulatory governance reform should strive for a sense of balance — remembering that the ultimate goals are to serve the long-term best interests of the company and its shareholders and to foster investor confidence in our marketplace.