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Developments in Corporate Governance: Looking Ahead to 2010

By Cornell Wright and Leslie McCallum

A number of developments occurred in corporate governance during 2009. This bulletin recaps some of the key developments affecting Canadian companies and reviews where things stand as we head into 2010.

Canadian Securities Regulators Back Off Overhauling Corporate Governance

Canada's securities regulators have decided not to proceed with their proposed overhaul of the corporate governance regime. The proposals would have introduced a more principles-based regime, including eliminating the bright-line tests in the current definition of independence. Market participants expressed mixed reactions to the proposals, some questioning whether they would bring about meaningful improvements in governance and others expressing concern about introducing significant changes in the face of challenging economic conditions and the upcoming transition to International Financial Reporting Standards.

The regulators are still considering possible changes to the corporate governance regime, but have stated that no changes will take effect before the 2011 proxy season. In 2010, the Ontario Securities Commission (OSC) is planning to review compliance with the existing corporate governance disclosure requirements, as discussed further below. We also expect the regulators to publish proposals in early 2010 aimed at improving communication with beneficial shareholders and access to proxy materials under National Instrument 54-101, *Communication with Beneficial Owners of Securities of a Reporting Issuer*.

By contrast, in the United States, lawmakers and regulators are considering significant corporate governance reforms. Congress is considering such measures as staggered boards, separate chair and CEO roles, independent risk committees, independent compensation committees and compensation consultants, majority voting for directors, clawbacks of executive pay after financial restatements, shareholder voting on golden parachutes (compensation on a change of control), employees hedging their risk from equity-based compensation, and shareholder approval of executive pay greater than 100 times a company's average wage.

In addition, the Securities and Exchange Commission (SEC) has implemented enhanced disclosure requirements addressing the impact of a company's compensation policies on employees' risk-taking incentives (if the risks are reasonably likely to have a material adverse effect on the company), whether the roles of CEO and

To discuss these issues, please contact the authors.

For media calls, please contact Stuart Wood, Chief Marketing Officer, 416.865.8205.

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chair of the board are separate, directors' qualifications, the board's role in risk oversight and potential conflicts of interest of compensation consultants.

The SEC is also proposing proxy access for shareholders of U.S. public companies, meaning that shareholders wishing to nominate a director would no longer have to incur the expense of mailing their own proxy circular. The proposal is controversial and is still being considered by the SEC. The proxy access rule would not affect foreign private issuers, including MJDS (Multijurisdictional Disclosure System) companies, because they are exempt from the U.S. proxy rules. We have not seen any indication that the Canadian regulators are considering a similar proposal.

"Say on Pay" Gaining Momentum

More than a dozen large Canadian public companies have decided to provide shareholders with a non-binding, advisory vote on executive compensation, commencing in 2010. The Canadian Coalition for Good Governance (CCGG), which represents the interests of institutional shareholders, is actively encouraging companies to adopt "say on pay" as a way of giving shareholders an opportunity to express directly to the board their satisfaction or dissatisfaction with the prior year's approach to compensation. The CCGG has published an Engagement and Say-on-Pay Policy that includes a model say-on-pay resolution.

In the United States, a say-on-pay vote is already mandatory for companies receiving federal bailout funds, and legislation has been introduced in the Senate to extend the requirement to all U.S. companies. A number of U.S. public companies have voluntarily decided to provide say-on-pay votes.

Institutional Shareholders Becoming More Activist

The CCGG is in the process of coordinating meetings with directors and compensation committee members at 25 Canadian public companies to discuss their compensation and governance regimes and to encourage the adoption of the CCGG's recommended best practices. The CCGG has published extensive guidance on what it views as effective corporate governance and disclosure practices and is actively promoting those practices in discussions with regulators and public company boards of directors. The CCGG's guidance includes Executive Compensation Principles (which summarize its latest thinking on how to design an effective compensation program that links pay and performance); Best Practices in Executive Compensation Related Information; Best Practices in Disclosure of Director Related Information; and Corporate Governance Guidelines for Building High Performance Boards (the updated version of which is expected to be published early in 2010).

Independence of Financial Advisers

In January 2009, the OSC ruled that HudBay Minerals had to obtain shareholder approval for its proposed acquisition of Lundin Mining. The decision led to the transaction being abandoned. The OSC's reasons for decision included comments about potential conflicts of interest of financial advisers whose compensation is based on the success of a transaction. The OSC expressed the view that a fairness opinion prepared by an adviser who is paid a success fee "does not assist a special committee of independent directors in demonstrating the due care they have taken in complying with their fiduciary duties in approving a transaction." In practice, advisers' fees are negotiated, and there are commercial reasons why boards and their advisers tend to prefer a success-based fee structure. Directors take into account the potential conflict created by those fee structures in assessing how much weight they should give to the opinion, and they disclose the potential conflict so that shareholders can do the same. In light of the HudBay decision, we are seeing more examples of directors and special committees requiring a fairness opinion from financial advisers who are not entitled to a success fee.

TSX Requires Shareholder Approval of Dilutive Public Company Acquisitions

The Toronto Stock Exchange amended its rules, effective November 24, 2009, to require listed companies to obtain shareholder approval when acquiring another public company if the transaction involves issuing more than 25% of the listed company's outstanding shares (on a non-diluted basis). Previously, shareholder approval was generally only required in the case of an acquisition of a private company resulting in dilution of more than 25%. We expect that the new TSX rule, which provides for limited discretionary relief, will have a significant effect on public company M&A transactions in Canada, including higher acquisition costs and increased deal risk.

Regulators Scrutinize Executive Compensation Disclosure

In 2009, the Canadian securities regulators undertook targeted reviews of companies' executive compensation disclosure under the new requirements that came into effect at the end of 2008. The regulators identified deficiencies in many companies' disclosures. Most companies were asked to improve their disclosure in future filings and a handful were required to supplement their existing disclosure. The most common deficiencies were in the disclosure of benchmarking and performance goals and the lack of explanation of key compensation decisions in the Compensation Discussion & Analysis. The regulators summarized the results of their reviews in Staff Notice 51-331 – *Report on Staff's Review of Executive Compensation Disclosure*. We expect that executive compensation disclosure will continue to receive a high level of scrutiny from the regulators in 2010 and companies should therefore leave themselves ample time for review, feedback and comments from external advisers.

Corporate Governance and Environmental Disclosure

In 2009, the OSC undertook a corporate sustainability reporting initiative in response to a private member's motion approved by the Ontario Legislature. The resolution called on the OSC to establish best practice corporate social responsibility and environmental, social and governance reporting standards. During 2010, the OSC intends to issue a staff notice that will provide guidance on compliance with existing environmental disclosure requirements under National Instrument 51-102, *Continuous Disclosure Obligations*. The OSC also plans to conduct a review of the requirements of National Instrument 58-101, *Disclosure of Corporate Governance Practices*, including assessing the adequacy of corporate governance disclosure in information circulars or other documents filed by companies in spring 2010. The OSC plans to invite staff of the other securities regulators to participate in the corporate governance compliance review and the development of the guidance for environmental disclosure.

Insider Reporting Proposals

In December 2008, the Canadian securities regulators published proposals to modernize, harmonize and streamline insider reporting in Canada. The proposals include several changes to the insider reporting regime, which would bring the Canadian requirements closer to those in the United States and United Kingdom by, among other things, significantly reducing the number of persons required to file insider reports and accelerating the filing deadline for insider reports to 5 calendar days, from 10 calendar days. The proposals would also clarify the requirements and facilitate insider reporting for stock-based compensation arrangements by allowing issuers to file an "issuer grant report" similar to the current "issuer event report." We expect the regulators to publish the proposals in final form early in 2010.