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Canada

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6.11.1 Introduction*

The start of the revolution in corporate governance in Canada is marked for many observers by the work of the Toronto Stock Exchange (TSX) Committee on Corporate Governance in Canada, chaired by Peter Dey, a well-known corporate governance advocate, beginning in 1993. The committee was set up after a number of high-profile corporate failures in Canada and the pressing question that arose about the role of directors in those cases.

The committee released its report, known as the Dey Report – but also, more provocatively, by its title, *Where Were the Directors?* – in 1994. The report established 14 best-practice guidelines for corporate boards. Among other things, the guidelines called for a majority of independent directors and for separating the roles of chairman and chief executive officer (CEO). The guidelines were voluntary, but companies listed on the TSX had to report annually, as a condition of being listed, on whether they were adhering to them, and if not, why not.

* Note: this Introduction is by Beverly Topping, CEO of the Institute of Corporate Directors.

There has been considerable progress since 1994 in strengthening corporate governance in Canada. From being a matter of interest to a few devoted advocates, it is now front and centre for many people involved in the capital markets. Membership in the Institute of Corporate Directors (ICD) has grown 10-fold to over 3,000 individuals. We have developed a formal director education programme that is delivered by leading business schools across the country. As of the fall of 2008 there are more than 1,500 graduates. We have also developed a formal certification process for graduates, the ICD.D; to date, more than 900 directors have achieved that distinction.

At the ICD we believe that director education can play an important role in developing better directors, better boards and, ultimately, better businesses. Research undertaken in 2007 by Professor Michael Hartmann while at the University of Toronto's Rotman School of Management showed that:

- participation in a director education programme has a positive impact on trainees' knowledge, skills and attitudes;
- a director education programme promotes transfer of learning from the classroom to the boardroom;
- a director education programme enhances appointment opportunities for groups traditionally under-represented on corporate boards.

The full research report is available on our website at www.icd.ca.

On the regulatory front there have been significant changes made to various governance requirements. However, there is a sense among many governance observers in Canada that rigorous criminal prosecution of white-collar crime is lagging behind that in some other jurisdictions. A report commissioned by the RCMP (Canada's national police force) and released in December 2007 was sharply critical of the efforts of the RCMP's enforcement. Part of the reason may lie in the lack of a single national securities regulator, with this responsibility being held by various provincial agencies across the country. There have been many efforts over the years to create a single regulator (or a passport system whereby approval in one jurisdiction would be recognized in another), without success so far.

Business is becoming ever more global in scope, as trade and investment barriers continue to fall. As a consequence, many directors need to keep abreast of corporate governance trends and regulatory requirements across multiple jurisdictions. The ICD is a

member of the Global Director Development Circle together with our sister institutes in Australia, New Zealand, South Africa, the United Kingdom and the United States. Collectively we are working on sharing these trends, identifying best practices in corporate governance and providing information for director education programmes. The ICD, for instance, developed a set of 13 Key Competencies for Director Effectiveness (see Appendix A); these have received favourable feedback both within Canada and by our sister organizations internationally.

6.11.2 Legal Framework: Laws, Models and Codes

Corporate governance in Canada is evolving rapidly. Until recently, corporate governance was an area of law defined primarily by the statutes under which companies incorporate, with little in the way of active regulatory oversight. However, the past decade has seen securities regulators and institutional investors increasingly flex their muscles in terms of governance requirements and standards. There is a belief among these market watchdogs that more prescriptive governance requirements would have mitigated the damages suffered by investors in a number of failed publicly traded corporations.

6.11.2.1 Corporate Statutes

In Canada, companies incorporate under either provincial or federal corporate statutes. For the typical publicly traded corporation,[1] there is no significant difference in these statutes in terms of basic corporate governance requirements, with the two key governance duties of directors and officers being: 1) a *duty of care* – that is, a requirement of directors and officers, in fulfilling their roles, to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances; and 2) a *duty of loyalty* – that is, a duty to act honestly and in good faith, with a view to the best interests of the corporation.[2]

In satisfying the duty of care, courts in Canada have imported from the United States the concept of the business judgement rule; that is, as long as directors and officers have made an informed and reasonable decision, courts will not second-guess them by substituting their own business judgement, even if the decision is ultimately not the best one.

In satisfying the duty of loyalty, courts in Canada have made it clear that the duty is owed to the corporation itself, as opposed to any particular constituent of the corporation. For example, it would be improper for a director to take into account the interests of a shareholder responsible for electing that director at the expense of the corporation. A more difficult issue is whether, in the circumstances of a potential merger or acquisition of the corporation, the duty of loyalty requires the board of directors to seek to maximize shareholder value as its primary function. A recent Supreme Court of Canada decision examined this specific question and reiterated that at all times the duty of loyalty requires directors to act in the best interests of the corporation. However, in doing so, the Supreme Court provided directors with broad discretion to determine how to satisfy the duty of loyalty and treated the question as one of business judgment not to be overturned by courts unless the decision taken falls outside the range of reasonableness. The effect of the decision in that case was to uphold a value-maximizing strategy.

6.11.2.2 Securities Regulators

Canadian securities regulators[3] have waded into the governance arena, primarily through two measures: 1) a rule containing a number of mandatory requirements in respect of audit committees, including the composition of audit committees of senior issuers (being those listed on the Toronto Stock Exchange), the responsibility of audit committees to recommend the retainer of the corporation's auditor and the responsibility to oversee the work of the auditor in the preparation of financial statements; and 2) a policy statement outlining what Canadian securities regulators consider to be best corporate governance practices, with an associated disclosure rule requiring public companies to compare their approach against the recommended practices (a so-called comply or explain approach).

Table 6.11.1 sets out the key Canadian sources of governance requirements.

6.11.2.3 Institutional Shareholders

Institutional shareholders in Canada have also become increasingly vigilant in their approach to governance. Many significant institutions have developed proxy guidelines that set out governance

Table 6.11.1 *Key Canadian sources of governance requirements*

Federal and Provincial Incorporating Statutes	Rules and Policies of Canadian Securities Regulators
See, for example, the Canada Business Corporations Act: ■ Section 122 (duty of loyalty / duty of care) ■ Section 115(3) (restrictions on delegation by directors) ■ Section 105(3) (director residency) ■ Section 137(4) (nomination rights) ■ Section 143(1) (right to requisition a meeting)	■ National Instrument 51–102 – Continuous Disclosure Obligations ■ Multilateral Instrument 52–109 – Certification of Disclosure in Issuers' Annual and Interim Filings ■ National Instrument 52–110 – Audit Committees ■ National Instrument 58–101 – Disclosure of Corporate Governance Practices ■ National Policy 58–201 – Corporate Governance Guidelines ■ Multilateral Instrument 61–101 – Protection of Minority Security Holders in Special Transactions.

standards that the institutions will require to be met in order to vote in favour of corporation-nominated directors. Many institutions also retain proxy advisory services that develop their own sets of governance standards in order to advise the institutions on how they should vote.

The Canadian Coalition for Good Governance (CCGG) was established in 2003 to represent Canadian institutional shareholders in the promotion of corporate governance practices that best align the interests of boards and management with those of shareholders. Currently, there are 46 members, who in total manage approximately C$1.4 trillion of assets on behalf of Canadian investors. The CCGG has contributed to the national debate, advocated for certain governance changes and undertaken board governance ratings, to name some activities.

6.11.3 Board Structure and Roles

Under Canadian requirements and practice, the role of the directors is to oversee management's running of the day-to-day operations of the corporation, as opposed to being directly involved in those operations. Under corporate and securities laws, directors

are required to approve certain key matters (that is, there are certain matters that cannot be delegated to management), including: 1) equity issuances; 2) matters that require shareholder approval; and 3) approval of financial statements. In practice, boards typically require approval over a broader set of areas, with specific financial or strategic markers setting out the extent of board involvement and what management may do without board approval or oversight.

The board composition recommended by securities regulators is a majority of independent directors, with a compensation committee and a nominating committee each composed entirely of independent directors. In addition, the audit committee rule requires senior issuers to have an audit committee composed entirely of independent, financially literate members, with a minimum total of three members. Independence is rigorously defined and precludes, among other restrictions, any family members of management, any employees of the corporation's auditor, those who receive compensation from the corporation other than for board work, and members of management of controlling shareholders (in the case of the audit committee). In cases of transactions involving management or significant shareholders, it is also typical for a special committee of independent directors to be formed to review and approve the transaction, with securities regulation mandating such an approach in certain circumstances.

In practice, most large publicly traded companies do in fact have a majority of independent directors, even in the case of family-controlled corporations, a common feature in Canadian public markets. To do otherwise runs the risk of institutional shareholders not supporting corporation-nominated directors, as this is an area of particular concern to them. Board size has also become smaller (with recommended sizes typically in the range of 5–20 members) as governance standards look negatively on larger boards, viewing them as unwieldy. Most Canadian corporate statutes also require a certain number of Canadian resident board members.

The CEO is typically a board member. However, it is much less common than it used to be for the CEO to also be the chairman of the corporation. Today, 84 per cent of boards in Canada have separate and independent chairs, a percentage that is much higher than in the United States, where 8–10 per cent of boards have independent and separate chairs. Indeed, it might be stated that in Canada the debate is over; the accepted best practice is separation.

In those circumstances where the CEO is the chairman, governance best practices dictate that there also be an independent lead director, a practice that is generally followed in Canada.

6.11.4 Shareholder Rights

The primary right of shareholders with respect to the operation of the corporation is to vote on the election of directors of the corporation, as mandated by corporate statutes. Shareholders holding in aggregate at least 5 per cent of the shares of the corporation may also require management to include nominees in the proxy materials circulated by the corporation. In addition, there are no restrictions on shareholders nominating candidates at the meeting of shareholders. In this regard, there are recent examples in Canada of activist investors holding significant shares making surprise nominations at meetings and voting out the corporation-nominated slate of directors. Shareholders holding 5 per cent or more of the corporation's shares may also requisition a meeting.

As noted above, institutions have become more vocal on mandating certain governance requirements to be met before they will vote in favour of the corporation-nominated slate of directors. Furthermore, there is a developing practice in Canada (but by no means a standard practice at this time) of majority voting policies – whereby the corporation has a policy of requiring directors who receive a majority of 'withhold votes' from shareholders in an uncontested election to resign.

Shareholders may also exercise rights derivatively on behalf of the corporation, including the right to cause the corporation to take action against directors and officers who have failed to perform their duties properly. Corporate statutes in Canada also provide shareholders with an oppression remedy whereby shareholders may apply to a court to seek remedies against the corporation or a director if the corporation or director acts in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of the shareholder. Oppression remedy cases are much more common in private company circumstances and tend to be examined through the scope of the reasonable expectations of the shareholder.

6.11.5 Disclosure and Transparency

Canadian public corporations are subject to extensive disclosure requirements. Canadian securities regulators consider it essential to a fair and equitable trading market that shareholders make investment decisions on a fully informed basis and on a level informational playing field. In this regard, public companies are required to provide quarterly and annual financial statements (audited in the case of annual statements) accompanied by a discussion by management of key financial changes. Public companies must also annually disclose an information form that provides a general overview of the corporation's business. In addition, the CEO and Chief Financial Officer (CFO) must personally certify the accuracy and completeness of such quarterly and annual disclosures. Senior issuers are also subject to requirements regarding establishing and reporting on internal financial and disclosure control procedures.

Canadian companies are subject to timely disclosure requirements under which they are required to disclose immediately any material change to the business, operations or capital of the corporation. Such timely disclosure requirements, combined with the periodic disclosure requirements described above, in theory provide investors with a clear snapshot of a corporation's state of well-being at any given time. In practice, however, the determination of when a material change has occurred can be a difficult one, particularly in the case of merger negotiations, where many different stages are involved (confidentiality agreement, non-binding letter of intent, binding purchase agreement, receipt of regulatory approvals, closing). In a recent case, Canadian securities regulators held in this context that the material change generally occurs when both parties have legally committed themselves to the completion of the merger, which is typically at the point of the binding purchase agreement.

6.11.6 Responsibility

Canadian corporations are not subject to general requirements with respect to ethical conduct and social responsibility. However, many industries have their own detailed regulatory requirements that govern various manners of how business is conducted, including extensive regulations in matters involving the environment,

occupational health and safety and employment standards. It is also typical now (and a recommended governance practice of Canadian securities regulators) for corporations to have codes of conduct covering conflicts of interest; proper use of corporate assets and opportunities; confidentiality of corporate information; fair dealing with shareholders, customers, suppliers, employees and competitors; compliance with laws; and reporting of illegal or unethical behaviour.

6.11.7 Directors

As was mentioned earlier, the main duties of directors of Canadian public companies are the duty of care and the duty of loyalty. Breaches of those duties can potentially lead to personal liability pursuant to a derivative action by the corporation or pursuant to an oppression remedy claim by shareholders. In addition, directors in Canada face a myriad of potential statutory liabilities, including liabilities for unpaid wages, unpaid corporation taxes, liabilities for breaches of environmental and occupational health and safety requirements, and liabilities for failing to comply with obligations and standards under pension benefits legislation.

More recently, statutory civil liability for public disclosure violations (including misrepresentations in financial statements and failure to make timely disclosure of material changes) has been implemented, including personal liability for directors and officers for such violations. The legislation also facilitates class-action suits by shareholders for such violations. However, directors and officers are afforded a due diligence defence, and such a defence will succeed if it can be established that a reasonable process was implemented to avoid disclosure violations. This has led the vast majority of Canadian public companies to implement disclosure policies that provide detailed processes that must be followed prior to a document being issued to the public. In addition, many companies now have disclosure committees made up of senior members of management to consider disclosure questions that arise from time to time and report to the board in respect thereof.

It is a recommended best governance practice (of both Canadian securities regulators and institutional investors) that directors have a comprehensive understanding of, first, the roles and duties of directors generally, and second, the corporation's business. Many

public company directors now take rigorous courses such as those offered by the Institute of Corporate Directors, both to orient themselves as to the proper role of a director and to stay current on best governance practices and legal developments in this area.

6.11.8 Executive Pay and Performance

There is little regulation around the topic of executive pay, leaving boards free generally to determine such matters as they see fit, subject to the duties of care and loyalty noted above. However, there are detailed compensation disclosure requirements requiring corporations to report annually on amounts (cash, stock or otherwise) paid to senior officers; and such disclosure requirements are in the process of being enhanced. In addition, there is a general trend towards using objective performance-based standards in order to establish executive pay and bonuses, with a particular focus on longer-term corporate success. In this regard it is not uncommon now for boards or compensation committees to retain outside consultants to advise on executive pay packages.

In 2007 the Institute of Corporate Directors released a Blue Ribbon Commission (BRC) Report on the Governance of Executive Compensation in Canada. The BRC Report noted that executive compensation packages play a key role in determining how executives will run the firm. Accordingly, the BRC Report championed a new standard for transparency about compensation decisions and provided a straightforward process that corporations of any size can follow to ensure that executive pay is tied to the actual performance of the corporation. The report also called for improved financial and human resources literacy among members of compensation committees, and an increase in independence of the committee and its advisers.

Notes

1. Under the corporate statutes, private companies may contractually restrict the roles, and therefore the duties, of directors and officers through unanimous shareholder arrangements and similar agreements. As corporate governance in Canada is primarily focused on public companies, the different circumstances that may apply to non-public companies are not examined in this profile.
2. Canada has a significant number of publicly traded unincorporated vehicles, including trusts and limited partnerships. These vehicles, in their organizational

documents, typically apply similar duties to trustees, directors, officers and similar persons; investment banks require such as a condition of underwriting them.

3. In Canada, securities laws are regulated at the provincial level. However, in the governance area the provincial regulators have generally harmonized their requirements.

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Appendix: ICD Key Competencies for Director Effectiveness and Their Relationship to Specific Tasks

Competency Group: Knowledge Tasks

C1 *Knowledge of Specific Industry, Company and Its Executive Team*. Understands the competitive environment in which the company operates. Understands the company strategy and the respective roles of the executive team in operationalizing this strategy. Tasks T1, 2, 4, 5, 6 (see below for description of the tasks)

C2 *Knowledge of Board and Role*. Understands own responsibilities, accountabilities and liabilities as a director and board member. Is knowledgeable of best practice principles associated with board structure and board processes as set out by the Canadian Coalition for Good Governance. Tasks T1, 2, 4, 5, 6

Competency Group: Analytical and Technical Skills

C3 *Financial Acumen*. Can read and interpret financial reports. Task T1

C4 *Group Decision Making Orientation*. Can identify and diminish 'group think' tendencies and recognizes decision-making biases in board discussions. Tasks T1, 2

C5 *Process Orientation*. Makes decisions and seeks outcomes through the consistent application of a logical sequence of steps. Tasks T1, 3

Competency Group: Thinking

C6 *Independent Thinking Skills*. Maintains own convictions despite undue influence, opposition or threat. Tasks T1, 9

C7 *Open-mindedness/Information-seeking Skills*. Values the diverse opinions of others and builds innovation on the foundation of other people's views. Tasks T1, 3

Competency Group: Personal Style

C8 *Ambiguity Tolerance*. Based on limited information, retains a positive outlook when the group is unable to resolve an issue or reach a conclusion and is willing to make a risk-adjusted decision when the outcomes are uncertain. Seeks decisions that optimize the relationship between risk and reward. Tasks T1, 3, 4, 5, 6

C9 *Effective Judgement*. Applies common sense, measured reasoning, knowledge and experience to come to a conclusion. Tasks T1, 4, 5, 6, 7, 8

C10 *Integrity*. Trustworthy and conscientious and can be relied upon to act and speak with consistency and honesty. Tasks T1, 3

C11 *Self-awareness*. Accurately assesses strengths and weaknesses of self and of others and can manage them successfully. Task T9

Competency Group: Social Style

C12 *Orientation to Resolve Conflict*. Ensures conflict is resolved with justice and fairness in order to restore healthy relationships. Tasks T1, 3, 9

C13 *Effective Communication and Listening Skills*. Gives and receives information with clarity, attentiveness, understanding and perception. Task T9

Tasks

T1 *Understanding and evaluating strategic plans and reports presented by management*. In order to effectively understand and evaluate issues and risks, a director must have some level of knowledge of a firm's capabilities and its competitive environment. Individually, directors must also understand that their responsibility is to oversee the development of the firm's strategic plan and obtain management updates on developments affecting the strategy as opposed to being directly involved in the management process. Some basic level of financial acumen is needed to support this task. Directors must also be able to reach their own independent conclusions based on information provided by management to the board. This will require an ability to think objectively and with an open mind in order to see possible trends and patterns or relationships presented by the data which may not be readily apparent in any communication. Finally, directors must be able to communicate their feedback to management in a clear and logical manner.

T2 *Monitoring financial performance*. Effective monitoring of financial performance requires directors to have some degree of financial acumen, including the ability to read and interpret financial reports. Some industry/company knowledge is required to provide context for the financial data.

T3 *Recognizing and validating management's and fellow directors' underlying decision assumptions*. To be effective in recognizing and validating the decision-making assumptions of others, it is important to have the analytical skills needed to recognize 'group think' dynamics and breakdowns in decision-making logic. Individuals with this skill have a strong level of self-awareness and the ability to examine a situation with a completely objective and open mind in order to reach independent conclusions.

T4 *Selecting, hiring and evaluating top management*. An effective selection and hiring process requires directors to be knowledgeable about the company and its executive team and to make decisions by exercising their best judgement. To establish an effec-

tive evaluation process, directors must have the ability to draw conclusions through the impartial evaluation of other perspectives and views without prejudice or biases.

T5 *Setting and negotiating compensation for top management*. Setting and negotiating compensation requires directors to exercise effective judgement aided by their industry/company knowledge regarding reasonable compensation measures.

T6 *Developing effective succession plans for top management*. An effective succession planning process requires directors to be knowledgeable about the specific needs of the company and executive team and to make decisions using their best judgement.

T7 *Prioritizing relevant risks*. To prioritize risks effectively requires establishing a logical process for first identifying all relevant risks, based on an understanding of the industry/company, and then determining an acceptable relationship between risk and possible reward which should be used to guide a director's decision-making process.

T8 *Ensuring appropriate risk levels*. An effective board ensures that, once prioritized, relevant risks are continuously monitored for appropriateness.

T9 *Supporting an effective and efficient board meeting process*. An effective board meeting process is one that promotes effective and efficient decision making based on clear, consistent and honest communication, effective judgement and reasoned debate. This process strives for consensus but also supports initiative and accepts opposition. When conflict does arise, it is dealt with justice and fairness in order to restore healthy relationships.