Corporate governance in Canada

McMillan Binch LLP
Overview of recent corporate governance reforms

The corporate governance of Canadian reporting issuers (ie, public companies) is regulated by corporate laws and securities laws.

Canadian companies may be incorporated under the federal Canada Business Corporations Act or one of the similar provincial or territorial corporate statutes. These statutes regulate ordinary and extraordinary corporate transactions.

Securities regulation is the responsibility of the provincial and territorial governments, each of which has its own legislation and securities regulatory authority. The provinces of Ontario and Québec have additional rules designed to ensure fair treatment of minority shareholders in connection with certain types of transactions involving related parties.

The provincial and territorial securities regulatory authorities coordinate their activities through the Canadian Securities Administrators (CSA), a forum for developing a harmonised approach to securities regulation across the country. In recent years the CSA has developed a system of mutual reliance which designates one securities regulator as the lead agency when it comes to reviewing applications or disclosure documents from Canadian public companies.

As the largest Canadian public companies are listed on the Toronto Stock Exchange (TSX), the Ontario Securities Commission is generally regarded as the lead securities regulatory authority in Canada.

The TSX and Canada’s junior market, the TSX Venture Exchange, have both recommended non-prescriptive best corporate governance practices, with listed companies obliged to disclose whether (and if not, why not) they have adopted them.

In general, the Canadian approach to corporate governance is influenced by:

• the relatively small size of the Canadian capital markets;

• the large number of small-cap Canadian public companies (more than twice as many companies are listed on the TSX Venture Exchange than on the TSX);

• the concentration of share ownership (over 25 per cent of the largest 300 companies listed on the TSX have a controlling shareholder, while an even larger number have a significant shareholder); and
• the privileged access that eligible Canadian public companies have to the US capital markets. Many Canadian companies can avail of the Canada-US Multi-jurisdictional Disclosure System, a unique regime which allows eligible Canadian public companies to access the US public markets using Canadian disclosure documents (which are subject to review only by Canadian securities regulators), and without becoming subject to the US domestic registration and reporting system. In many cases Canadian continuous reporting documents can also be used to satisfy US continuous reporting obligations.

Canadian corporate governance is currently undergoing significant reform, influenced by recent US initiatives such as the Sarbanes-Oxley Act, and the desire of Canadian securities regulators to maintain investor confidence in the Canadian regulatory system and preserve Canada’s privileged access to the US public markets.

The CSA recently introduced a series of national instruments and policies which affect the corporate governance of Canadian public companies (the CSA Rules). The CSA Rules closely follow Sarbanes-Oxley and the consequential rules and guidelines established by the US Securities and Exchange Commission (SEC) and US stock exchanges. The rules deal with the following issues:

• oversight of external auditors, including pre-approval of audit and non-audit services, prohibited services, audit partner and audit review partner rotation, and cooling-off periods for hiring employees of external auditors;

• chief executive officer (CEO) and chief financial officer (CFO) certification with respect to the accuracy of public disclosure and filings (eg, annual and interim financial statements, and related management discussion and analysis (MD&A)), disclosure controls and procedures, and internal control over financial reporting;

• composition, authority and responsibilities of audit committees, including the requirements that public companies have an audit committee composed of at least three directors, all of whom are independent and financially literate, and an audit committee charter giving the audit committee responsibility for, among other things:

  • appointing the external auditors and setting their compensation (subject to shareholder approval);

  • overseeing the work of the external auditors, including the resolution of disagreements between management and the external auditors;

  • pre-approving audit and non-audit services;

  • reviewing all public disclosure of financial information; and

  • establishing procedures for dealing with complaints with respect to accounting or auditing matters, and for whistleblowing;

• continuous disclosure obligations, including earlier filing of interim and annual financial statements and related MD&A, and expanded interim and annual MD&A; and

• disclosure of corporate governance practices, including disclosure of whether (and if not, why not) public companies have adopted the non-prescriptive corporate governance best practices recommended by the CSA, including:

  • having a majority of independent directors;

  • appointing a chair who is an independent director or, where this is not possible, a ‘lead’ director who is an independent director;

  • adopting a charter setting out the responsibilities and operating procedures of the board of directors;

  • adopting a written code of business conduct and ethics; and
establishing nomination and remuneration committees composed entirely of independent directors.

Under the CSA Rules, a director is considered ‘independent’ if he is independent of management or any other direct or indirect material business or other relationship with the company and its subsidiaries that could reasonably interfere with the exercise of his objective, unfettered or independent judgement or his ability to act in the company’s best interests. He is considered ‘financially literate’ if he has the ability to read and understand a set of financial statements presenting a breadth and level of complexity of accounting issues which are generally comparable to the breadth and complexity of the accounting issues that can reasonably be expected to be raised by the financial statements of the company.

Some of the CSA Rules are currently in effect, with the remainder expected to take effect in 2005. Public companies listed on the TSX Venture Exchange are exempt from some of the CSA Rules.

In addition to the CSA Rules, the Ontario government intends to amend Ontario’s securities laws to make public companies and their directors statutorily liable, subject to a due diligence defence for directors, for misrepresentations contained in their continuous disclosure documents. Currently, public companies and their directors are liable only for misrepresentations contained in prospectuses and other offering documents.

The Ontario government has also amended Ontario’s securities laws to increase the maximum penalties for securities law offences.

Meanwhile, the federal government has amended the Canada Criminal Code:

- to prohibit and impose criminal penalties for insider trading (which is also regulated under provincial securities laws);

- to increase the penalties for public market-related offences and establish aggravating factors to assist courts in imposing penalties that reflect the seriousness of the crime.

**Shareholders’ rights**

**Meetings**

Canadian public companies must hold a general meeting of shareholders every 15 months to elect directors and to appoint auditors and authorise their remuneration. They are also required to hold a special meeting of shareholders to approve other ordinary and extraordinary corporate transactions. Shareholders holding at least 5 per cent of the shares may convene a special meeting of shareholders for any purpose. Subject to certain procedural rules, a shareholder may request that a shareholder proposal be included in the agenda of a meeting of shareholders and voted on at the meeting. Except as may be set out in the constating documents of a company (ie, the articles and bylaws), a quorum for a meeting of shareholders is shareholders holding at least a majority of the outstanding shares present in person or by proxy. Typically, the constating documents provide for a reduced quorum, sometimes as low as two shareholders present in person or by proxy.

**Voting**

Generally, shareholders are entitled to one vote per share. Some Canadian public companies have a dual-class share structure, with one class having multiple voting rights which give the holders of those shares voting control. In most cases shareholders holding the other class of shares have ‘coat-tail’ rights in the event of a takeover bid or similar transaction.

**Election of directors**

The management of Canadian public companies normally nominates director candidates on the recommendation of the board of directors and, where applicable, the nomination committee. Shareholders holding at least 5 per cent of the shares may nominate director candidates before a
meeting of shareholders. Any shareholder may nominate director candidates at a meeting of shareholders. Since management controls the solicitation of proxies for meetings of shareholders, and because of the concentration of share ownership in Canada, management’s nominees are usually elected. Proxy battles are unusual. Shareholders are entitled to obtain lists of shareholders in order to solicit proxies at meetings of shareholders. Typically, directors are elected for a one-year term. Staggered, multiple-year terms of up to three years are permitted.

**Shareholder approvals and protections**

Ordinary corporate transactions require majority approval of the shareholders (over 50 per cent of the votes cast). Extraordinary corporate transactions require special approval of the shareholders (66.6 per cent of the votes cast). Most corporate statutes give shareholders the right to dissent with respect to extraordinary corporate transactions and demand fair value for the shares held by them.

The provinces of Ontario and Québec have securities rules (including approval by a majority of the minority shareholders and independent valuation of the subject matter of the transaction) which apply in certain circumstances and which are designed to ensure fair treatment of minority shareholders in connection with certain types of transactions involving related parties.

Canadian courts have broad remedial powers under Canadian corporate statutes to intervene in transactions which are determined to be oppressive or unfairly prejudicial to shareholders, or which unfairly disregard the interests of shareholders. They also have broad powers to permit shareholders to commence an action on behalf of a Canadian public company or intervene in an action involving a Canadian public company for the purpose of prosecuting, defending or discontinuing the action on behalf of the company. The Canadian courts additionally have broad powers with respect to the conduct and enforcement of these derivative actions.

**Institutional investors as shareholders**

Institutional investors, which own approximately 50 per cent of the shares of Canadian public companies, have recently become more active with respect to corporate governance matters, and have shown an increased willingness to use the courts and regulatory authorities to challenge board decisions and processes.

The Canadian Coalition for Good Governance, which represents Canadian institutional shareholders through the promotion of best corporate governance practices, recently released its Corporate Governance Guidelines for Building High Performance Boards, which are intended to improve the accountability of individual directors, board structures and board processes. Recent coalition initiatives include the use of shareholder proposals to address the use of stock option plans by Canadian public companies. To date, the coalition has focused on the corporate governance practices of major Canadian public companies. It is likely that in the future, the coalition will extend its focus to the corporate governance practices of controlled and small-cap Canadian public companies, including the use of subordinate and multiple voting shares.

**Management structure and the role of directors**

Boards of directors of Canadian public companies are responsible for supervising the management of the company’s business and affairs. The officers (ie, management) are appointed by the board and are responsible for day-to-day management. Except as may be set out in the constating documents, there are no prescribed officer positions. Typically, Canadian public companies have a CEO (usually the president), a CFO, one or more vice presidents in charge of various company businesses or functions, and a secretary (often combined with the office of general counsel). A director may be an officer, and an officer may hold more than one position.

Canadian public companies listed on the TSX must have a board of directors composed of at least three independent directors in order to satisfy
corporate and securities laws requirements for an audit committee composed of at least three directors, all of whom are independent. Some Canadian corporate statutes prescribe a minimum number of resident Canadian (ie, Canadian citizens or permanent residents) directors, ranging from 25 per cent to a majority. Except as may be set out in the constating documents, there is no prescribed upper limit on the number of directors. Directors must be at least 18 years of age, of sound mind and not bankrupt. There is no requirement that directors own shares, although this may be required as a matter of good corporate governance practice. Generally, Canadian public companies have between five and 15 directors. Typically, the CEO is a director, but not necessarily the chair of the board of directors. The CSA Rules recommend that a majority of the directors and the chair of the board of directors be independent, but this is not required.

Except as may be set out in the corporate statutes or the constating documents, boards of directors of Canadian public companies have unlimited powers with respect to the supervision of the management of the company’s business and affairs. The directors owe fiduciary duties of loyalty and care to the company: these require the directors to act honestly and in good faith with a view to the best interests of the company; and to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Directors are liable to the company if they breach their fiduciary duties. They are also liable if they act unlawfully. Directors are entitled to indemnification from the company for lawful conduct. Most Canadian public companies maintain directors’ and officers’ insurance. Directors may be removed from office by majority vote of the shareholders.

Boards of directors of Canadian public companies typically meet at least five times a year. Except as may be set out in the corporate statutes or the constating documents, boards are free to establish their own operating procedures. Typically, the agenda for a board meeting is established by the chair of the board and the CEO (if different), with input from the other directors and senior management, and is sent to the directors, together with supporting materials, in advance of the meeting. The chair of the board usually presides at board meetings. Typically, at every board meeting, the independent directors meet separately from management. Minutes of directors’ meetings are not normally provided to shareholders.

Boards are required to have an audit committee. Usually, boards have other committees to help them with their responsibilities, including a nomination committee (often with a corporate governance mandate) and a remuneration committee. The board (on the recommendation of the remuneration committee, if one exists) sets the remuneration of the CEO and approves the remuneration of the other members of management.

Directors and officers who have conflicts of interest are required to disclose their interest and refrain from voting on any corporate transaction where they have a conflict of interest.

Disclosure

Canadian public companies are required to prepare, publicly disclose and file with the securities regulatory authorities interim quarterly unaudited and annual audited financial statements and related MD&A. They are also required to prepare and file with the securities regulatory authorities an annual continuous disclosure document (the annual information form), setting out all material information with respect to the company (ie, information with respect to the business, operations or capital of the company that would reasonably be expected to have a significant effect on the market price or value of the company’s securities).

Canadian public companies are also required to prepare a management proxy circular in connection with the annual meeting of shareholders. In addition to information with respect to the business to be transacted at the meeting, the proxy circular must include prescribed information with respect to:

- compliance with best corporate governance practices;
• shareholdings of significant shareholders; and
• director and senior officer remuneration and indebtedness, including a report of the board or the remuneration committee on executive remuneration.

Other information may also be provided, such as a summary of the board and committee meetings held and a record of attendance by directors.

Canadian public companies are required to make immediate public disclosure, followed by a filing with the securities regulatory authorities, of any change in the business, operations or capital of the company that would reasonably be expected to have a significant effect on the market price or value of the securities of the company.

Finally, insiders (ie, directors, senior officers and shareholders owning 10 per cent or more of the voting securities) of a company are required to disclose changes in their share ownership.

Currently, Canadian public companies and their directors have no statutory liability for misrepresentations in the company’s continuous disclosure documents, unless they are incorporated by reference in a prospectus or other offering document. However, plans to change this position are underway in Ontario.

**Accounts and audits**

Canadian public companies are required to prepare interim quarterly unaudited and annual audited financial statements and related MD&A. The company is required to send its financial statements and related MD&A to its shareholders, and disclose whether the external auditors have reviewed the interim financial statements. The CEO and CFO must certify that the interim and annual financial statements and related MD&A do not contain any misrepresentations or omit to state any material facts, and that they present fairly in all material respects the financial condition, results of operations and cash flows of the company. The external auditors must report to the audit committee any problems or difficulties they encounter in the course of their audit work, and management’s response. They must also report all alternative treatments of financial information discussed by them and management, the ramifications of such alternative treatments and the treatments preferred by the auditors.

The audit committees of Canadian public companies appoint the external auditors annually, subject to shareholder approval. Under the CSA Rules, the external auditors of Canadian public companies must be accounting firms which participate in the programme of practice requirements and inspections administered by the Canadian Public Accountability Board, and which are in compliance with any restrictions or sanctions imposed by the board. The board was established in 2003 and is responsible for developing and implementing an oversight programme that includes regular and rigorous inspections of the auditors of Canadian public companies. Also, under the CSA Rules, there are restrictions on the non-audit work that may be carried out by the external auditors. These restrictions apply to work that impairs or has the potential to impair their independence and objectivity in relation to the external audit function (eg, work where they participate in activities that are normally undertaken by management, are remunerated through a success fee structure or may be required to audit their own work).

The Accounting Standards Board of the Canadian Institute of Chartered Accountants is responsible for accounting standards in Canada. These standards continue to evolve. The Canadian Institute of Chartered Accountants pays close attention to developments in US and international accounting standards, and for several years has had a project underway to harmonise Canadian accounting standards with international accounting standards.

The external auditors of Canadian public companies are responsible to the company for any negligence in carrying out their work. Negligence does not necessarily extend to the failure to detect fraud. Generally, the duty of the auditors is to the company, not to the shareholders. As a result, the shareholders do not normally have a cause of
action against the auditors for relying on the company’s financial statements in making their investment decisions.

**Enforcement**

Canadian securities regulators have staff dedicated to the enforcement of securities laws. The regulators are limited in the sanctions that they may impose for breaches of securities laws: generally, administrative fines of up to C$5 million, cease-trading orders, disgorgement of improper gains and prohibitions on further participation in the Canadian capital markets. The regulators must look to the courts to impose other sanctions (eg, higher fines and jail terms). Several regulators have expressed frustration about the lack of resources to pursue breaches of securities laws, the lack of cooperation from national, provincial and local police forces in investigating and charging those involved in securities law breaches, and the unwillingness of the courts adequately to punish those convicted of such breaches. However, this situation may be changing. New initiatives are underway to establish joint securities regulator/police taskforces to investigate and charge those involved in securities law breaches. Also, Canadian courts are not immune to the influences of the changing public mood about white collar crimes and the high-profile securities law cases currently being conducted in the United States.

**Corporate social responsibility**

The directors of Canadian public companies have a duty to act in the best interests of the company. Canadian courts have interpreted this duty as meaning that the directors must act in the best interests of the shareholders, unless there is nothing left for the shareholders (ie, upon insolvency), in which case they must act in the interests of those who have a prior claim on the company’s assets (ie, the creditors). In recent years there have been attempts to expand the duty of the directors to a broader group of stakeholders (eg, employees and the communities in which the company’s operations are located). To date, these attempts have had no tangible legal results, either in the corporate statutes or before the courts. Generally, Canadian public companies are aware of the need to act, and the benefits of acting, responsibly in their dealings with governments, their employees and the communities in which they operate. Many of these concepts are included in the codes of ethics and conduct adopted by larger Canadian public companies.

**Summary**

Canadian securities regulators have responded quickly and vigorously to recent events and developments in the United States and elsewhere. The CSA Rules and other Canadian initiatives resemble Sarbanes-Oxley and the consequential rules and guidelines established by the US SEC and US stock exchanges. The principal difference between Canadian and US corporate governance requirements is the non-prescriptive nature of many of the Canadian requirements. This difference is not simply a matter of philosophy. Rather, it is the result of a deliberate cost/benefit analysis based on the fundamental differences between the Canadian and US capital markets.
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