Are you governance savvy?

September 1, 2005

The Enron, WorldCom, Adelphi and other similar scandals in the U.S. in the early 2000s made corporate governance a front-page issue. The U.S. Congress responded in part by enacting the Sarbanes-Oxley Act of 2002 to improve corporate responsibility and financial disclosure and prevent accounting fraud. Canada was not far behind.

Motivated in part by the U.S. reforms, the Canadian Securities Administrators ("CSA") and the Toronto Stock Exchange ("TSX") have proposed a series of policies and guidelines intended to restore investor confidence in Canada's capital markets. At the same time, the Ontario government enacted the *Budget Measures Act* of 2003 ("Bill 198") which included amendments to Ontario's *Securities Act* to improve investor confidence in Ontario's capital markets. The purpose of both the guidelines and the Ontario legislation is to ensure that directors are acting in the best interest of the company and its shareholders, and to improve corporate disclosure and transparency.

If you are a director of a public company, it is essential that you comply with your legal obligations to protect yourself from potential liability. Similarly, if you are a director of a private company that is considering going public, you need to understand your legal obligations in advance, as part of the process of going public will include a thorough examination of your company's governance practices.

This article highlights your obligations under the guidelines and under Bill 198 and the new securities rules resulting from the legislation.

Guidelines

The best practice guidelines for corporate governance (the "Guidelines") set out in CSA National Policy 58-201 came into effect on June 30, 2005. As the name suggests, the Guidelines are not mandated and there are no real consequences for failing to comply.

However, National Instrument 58-101 ("NI 58-101") requires companies to disclose whether they follow the Guidelines. If a company doesn't follow the Guidelines, the company must describe what actions it has taken instead.

The TSX also has its own 14-point corporate governance guidelines. However, listed issuers who are subject to NI 58- 101 are required to disclose their corporate governance practices under NI 58-101, and not under the TSX guidelines. This article will not address the TSX guidelines.

The Guidelines of National Policy 58- 201 establish practice standards that fall into three broad categories:

- the composition and independence of the board of directors (the "Board")
- the establishment of committees by the Board
- the development of written charters and codes by the Board.

Here is a summary of the Guidelines.

Board of directors

Composition of board the need for independent directors

The Board should be composed of a majority of independent directors. The chair of the Board should be an independent director, or, failing that, an independent director should be appointed as “lead director”. The independent directors should have regular meetings that are not attended by non-independent directors and management.

How is “independent” defined? A board member is independent if he or she has no “material relationship” with the company. A “material relationship” is one that the board of directors believes could reasonably interfere with the exercise of the member’s independent judgment.

In addition, certain specified relationships are deemed to be material. For example, if a person or one of his or her immediate family members is employed by the company or its auditor or has been employed by them in the previous three years, the person is deemed to have a material relationship and is not independent.

Directors’ qualifications identify the skills you need

Before new directors are nominated or appointed, the Board should consider what competencies and skills the Board as a whole should have, and what competencies and skills existing directors already have. New directors should receive a comprehensive orientation and should fully understand the role of the board and its committees and the nature and operation of the company’s business. All directors should have opportunities for continuing education, both about their roles as directors and about the company’s business.

Independent directors

If an issuer chooses to create compensation and/or nominating committees, each of these committees should be made up entirely of independent directors.

The nominating committee is responsible for recommending new director nominees to the Board. The compensation committee reviews and approves the goals and objectives set for the senior management and evaluates the senior management’s performance against those goals in order to determine compensation. The compensation committee should also review executive compensation disclosure before it is publicly released.

Each of these committees should have a written charter establishing its responsibilities and member qualifications.

Adoption of written charters

The Guidelines require that several key policy and position descriptions be put in writing.

Board mandate

The Board should adopt a written mandate in which it acknowledges its responsibility for “stewardship” of the company. The mandate should include a process to satisfy the Board as to the CEO’s integrity, a strategic planning process, a communications policy, a set of corporate governance principles and the expectations and responsibilities of directors.

Code of ethics

The Board should adopt a written code of business conduct and ethics that applies to its directors, officers and employees. The code should address conflicts of interest, compliance with laws and reporting of illegal or unethical behaviour. Material departures from the code by a director or executive officer will likely constitute a material change that must be reported by the company. The code, and any amendments, must be filed on SEDAR.

Mandatory rules: Bill 198

In Ontario, Bill 198, unlike the Guidelines, creates mandatory rules which must be followed and which may result in harsh sanctions if they are breached. Bill 198, also known as the *Budget Measures Act*, amended the Ontario *Securities Act* to:

- Prohibit conduct that contributes to fraud or a misleading appearance of trading activity
- Prohibit misleading or untrue statements, or statements that omit a required fact, that affect the value of a security
- Give the Ontario Securities Commission ("OSC") more power to make rules relating to audit committees, auditing standards and CEO and CFO certification
- Provide civil liability for secondary market disclosure by giving investors the right to bring an action against those who trade in securities during a time period where there is either an uncorrected representation made by the company or its representatives, or the company fails to disclose a material change.

Bill 198 empowered the CSA to develop three new securities rules to carry out the goals of the legislation.

The three new rules are:

- NI 52-108 *Auditor Oversight*
- Multilateral Instrument ("MI") 52- 109 *Certification of Disclosure in Issuers' Annual and Interim Filings*
- MI 52-110 *Audit Committees*.

Each of these new rules and the civil liability for secondary market disclosure will be discussed separately.

Auditor oversight

This rule is intended to improve public confidence in the financial reporting provided by public companies by promoting high quality, independent auditing. The rule requires public companies to hire auditors that are public accounting firms that participate in an independent oversight program established by the Canadian Public Accountability Board ("CPAB") and are CPAB participants in good standing. If the CPAB imposes any sanctions or restrictions on a participating auditor, the auditor must notify its clients and the securities regulators of the restriction or sanction.

This rule came into force on March 30, 2004.

Certification of disclosure

This rule is intended to improve the quality and reliability of the financial disclosure of public companies. It closely parallels the requirements of the Securities and Exchange Commission in the U.S. and requires CEOs and CFOs of Canadian public companies to personally certify the company's annual and interim filings.

The rule requires public companies to file annual and interim certificates in which their CEOs and CFOs personally certify that the

company's filings don't contain any misrepresentations and fairly present the financial condition of the company. In a phased-in manner, CEOs and CFOs will also be required to personally certify that they are responsible for disclosure controls and procedures and internal control over the company's financial reporting.

The rule does not mandate any specific policies or procedures that must be included in a company's internal controls or disclosure controls and procedures, which are left to the company to determine.

The most recent formulation of this rule came into force on September 15, 2005.

Audit committees

This rule is based in large part on the audit committee requirements under the *Sarbanes-Oxley Act* in the U.S. It requires every issuer to have a fully independent audit committee to which the external auditors must directly report, and governs the composition and responsibilities of the committee.

Composition and qualification

Subject to certain exemptions provided by the TSX Venture Exchange, the audit committee must have a minimum of three members, each of whom must be an independent director and "financially literate". The test for independence is the same as the test for independence of directors discussed earlier. A director is "financially literate" if he or she can read and understand a set of financial statements that present accounting issues that are generally comparable to the issues expected to be raised by the issuer's financial statements. If an audit committee member is not financially literate when he or she is appointed to the committee, he or she must become so within a reasonable period of time. Unlike the U.S. rules, the Canadian rules do not require the audit committee to include an "audit committee financial expert".

Responsibilities

The audit committee must have a written charter setting out its mandate and responsibilities. The audit committee is responsible for:

- Recommending the external auditor and their compensation to the board
- Overseeing the work of the external auditor
- Pre-approving all non-audit services provided by the external auditor
- Reviewing the financial statements, management discussion and analysis ("MD&A") and earnings press releases before they are publicly disclosed
- Being satisfied that adequate procedures are in place for reviewing the company's disclosure of financial information derived from its financial statements
- Establishing procedures for:
    - Receiving and treating complaints the company receives about accounting or auditing matters
    - The submission of employees' anonymous concerns about questionable accounting or auditing matters.

Every audit committee must have the authority to hire and compensate outside advisors and communicate directly with internal and external auditors.

This rule came into force on June 30, 2005.

Civil liability

The sections of Bill 198 amending the *Securities Act* to establish civil liability for secondary market disclosure will come into force on December 31, 2005, making Ontario the first Canadian province to establish civil liability for secondary market disclosure.

Who may be liable

The amendments to the *Securities Act* by Bill 198 are significant because they expand the class of people who may be sued for a company's misrepresentation or failure to make timely disclosure. The reporting issuer, its directors, officers and, notibly, influential persons (including controlling shareholders, promoters and insiders) as well as experts (including auditors and lawyers) may also all be liable.

Causes of action

Under the new provisions, there will be two different causes of action: one for misrepresentation and one for failure to make timely disclosure. In either case, the plaintiff does not have to prove that he or she relied on the misrepresentation or on the issuer complying with its disclosure obligations. This is expected to make it significantly easier for investors to succeed with these types of claims.

There are three types of misrepresentation:

- **Misrepresentation in a core document.** The plaintiff only needs to prove that the misrepresentations occurred. The definition of "core document" depends on whom the action is against. If the action is against a (non-officer) director, core documents include the prospectus, the annual information form, the financial statements and the MD&A. If the action is against an officer, core documents also include material change reports.
- **Misrepresentation in a non-core document.** The plaintiff must prove that the defendant knew of the misrepresentation, deliberately avoided acquiring knowledge of the misrepresentation or was guilty of gross misconduct relating to the making of the misrepresentation.
- **Public oral statements.** The test for liability for statements made by a person with actual, implied or apparent authority to speak on behalf of the company is the same as for misrepresentation in noncore documents. For a failure to make timely disclosure action to succeed against anyone other than the issuer or an officer of the issuer, the plaintiff must prove that the defendant knew a material change had occurred or deliberately avoided acquiring knowledge of it, or was guilty of gross misconduct in connection with the failure to make timely disclosure.

Defences

There are a number of defences available, including:

- Reasonable investigation where the defendant shows a reasonable investigation was conducted and had no reason to believe there was a misrepresentation or failure to make timely disclosure
- Plaintiff's knowledge where the defendant can prove that the plaintiff already knew of the misrepresentation or material change
- No involvement where the defendant can show that he or she had no reasonable grounds to believe a document containing a misrepresentation, other than a document required to be filed with the OSC, was going to be released
- Reliance on experts if the document or public oral statement includes a summary or quotation from an expert, and the defendant can show that he or she had no reasonable grounds to believe that there was a misrepresentation, that the expert's opinion was fairly represented and that the expert had consented to the use of the report or opinion.

Damages

In general, a person who is found liable will be responsible for any losses the investor suffers and a regulatory fine. The losses will generally be calculated as the difference between the price paid or received for a security following the misrepresentation or failure to disclose, and the average price in the ten-day period following the disclosure or public correction.

If more than one person is liable, each defendant will generally only be responsible for the proportionate share of the damages that corresponds to his or her responsibility, as determined by the court. Proportionate liability does not, however, apply to defendants who knowingly participated in the misrepresentation or failure to disclose a material change, who are then jointly and severally liable for the full amount of the damages.

Also, liability for damage awards is capped, except where a defendant knowingly participates in a misrepresentation or failure to disclose a material change. The liability limits for individual defendants are the greater of $25,000 and 50% of their compensation from the issuer in the prior 12 months. The liability limits for corporate defendants are the greater of 5% of market capitalization and $1 million.

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