

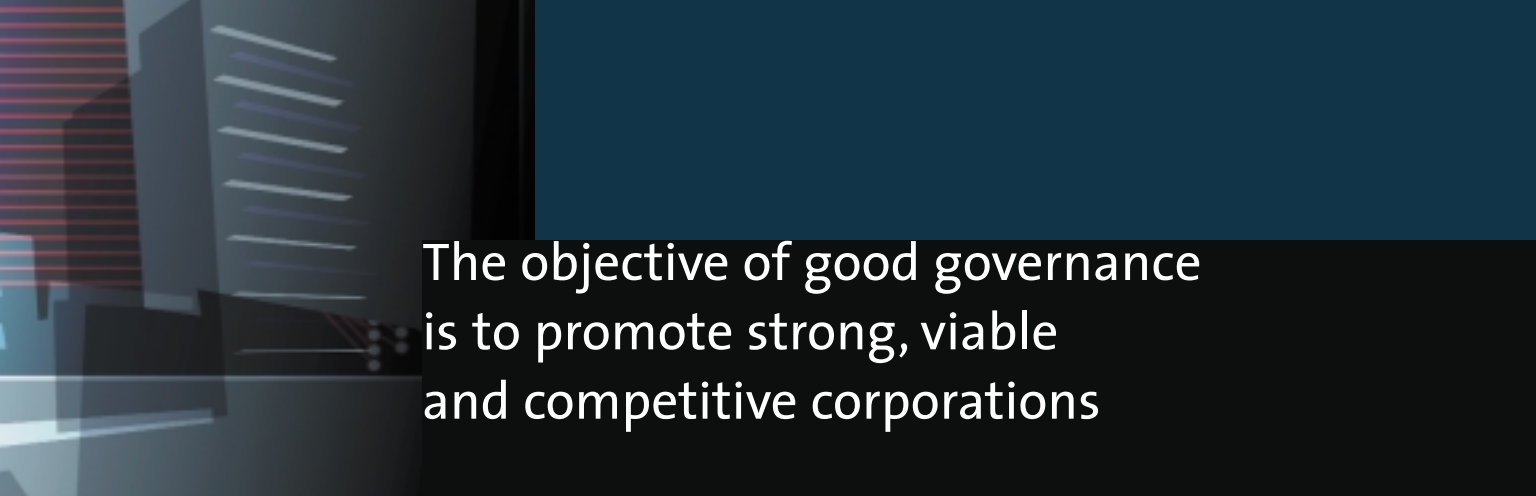
# Beyond Compliance: Building a Governance Culture

Final Report  
Joint Committee on Corporate Governance  
November 2001



Chartered  
Accountants  
of Canada





## The objective of good governance is to promote strong, viable and competitive corporations

A committed, cohesive and effective board adds value, first and foremost, by selecting the right CEO for the company. Beyond this, the board contributes to value by

- setting the broad parameters within which the management team operates, including in particular, strategic planning and risk management, and communications policy;
- coaching the CEO and the management team;
- monitoring and assessing performance, setting the CEO's compensation, and taking remedial action where warranted, including replacing the CEO; and
- providing assurance to shareholders and stakeholders about the integrity of the corporation's reported financial performance.

We believe effective governance is increasingly important if Canadian companies and Canadian capital markets are to prosper in a competitive, global marketplace.

# Table of Contents

2	<b>Committee Members</b>
3	<b>Preface</b>
5	<b>Introduction and overview</b>
7	<b>The objective of good governance</b>
8	<b>The state of governance today</b>
10	<b>The importance of disclosure</b>
12	<b>Improving board effectiveness</b>
13	The importance of board independence
14	Choosing the right directors
16	The requirement for and functions of an “independent board leader”
18	Regular assessment of performance
19	Meetings of the outside directors without management
20	Selecting the CEO, monitoring performance and succession planning
21	Strategic planning and monitoring of opportunities and risks
23	<b>Controlling shareholders and publicly traded subsidiaries</b>
24	Composition of the board of a controlled corporation
25	Role of the board of a controlled corporation
25	Audit committees
26	<b>A board mandate and disclosure</b>
27	<b>Audit committees and the Blue Ribbon Committee report</b>
30	Relationship with and expectation of external auditors
31	Relationship with and expectation of the internal audit function
32	Responsibilities with regard to disclosure of financial and related information
33	<b>Ongoing attention to governance</b>
34	<b>Appendix A: Disclosure requirements and guidelines</b>
44	<b>Appendix B: A position description for the “independent board leader”</b>
46	<b>Appendix C: Blue Ribbon Committee recommendations</b>

# Committee Members

**Guylaine Saucier, CM, FCA**  
Chair of the Joint Committee

**Ralph Barford**  
Chair  
Valleydene Corporation Limited

**Jalynn Bennett, C.M.**  
President  
Jalynn H. Bennett & Associates

**Tullio Cedraschi\***  
President & CEO  
CN Investment Division

**L. Yves Fortier, C.C., Q.C.**  
Chairman & Senior Partner  
Ogilvy Renault

**Brian MacNeill, FCA**  
Chairman  
Petro Canada

**Hon. Frank McKenna, P.C., Q.C.**  
McInnes Cooper

**Tom C. O'Neill**  
Chief Executive Officer  
PricewaterhouseCoopers

**John A. Roth**  
Former President & CEO  
Nortel Networks Corporation and  
Nortel Networks Limited

**C. Alan Smith**  
President  
Aeonian Capital Corporation

**David Sutcliffe**  
President & CEO  
Sierra Wireless

\* Tullio Cedraschi resigned from the Committee in September 2001, upon being appointed a governor of the Toronto Stock Exchange.

# Preface

I am pleased, on behalf of the Joint Committee on Corporate Governance, to submit this final report to our sponsors: the Canadian Institute of Chartered Accountants (CICA), the Canadian Venture Exchange (CDNX) and the Toronto Stock Exchange (TSE). This is a unanimous report from the Joint Committee. I am grateful to my colleagues on the Committee for their contributions, cooperation and support.

In Canada, the 1994 report of the Dey Committee, and subsequent TSE disclosure requirements and governance guidelines, set down a strong foundation for effective corporate governance. Our report builds on that foundation. We focus on ways to improve governance without losing sight of our corporations' need for competitiveness in the global economy. Our recommendations go beyond compliance and propose guidelines, principles and practices that will help directors build healthy corporate cultures in the boardroom, where it counts.

This report is considerably shorter and much more focused than the interim report we published last March. The interim report canvassed a broad range of issues. Building on the Committee's experience, informal discussions, and on the comments and submissions we received, we chose to direct our recommendations at major areas where we believe it is important to change behaviour if corporate governance is to be improved.

Thus, our recommendations are directed not only to our sponsors, but also to all directors, boards and CEOs.

We recognize that continuing improvements in corporate governance depend upon people, relationships and leadership. Progress will be evolutionary and not radical. But steady progress is essential. We therefore urge all directors and CEOs to read this report, reflect on it, and consider what aspects of it can add value to their own governance processes.

With the submission of this report to our sponsors, our work as a committee is finished and we will disband. We expect and hope that our sponsors will implement the recommendations expeditiously and we believe that this will have a positive impact.

On behalf of the Committee I want to acknowledge the assistance and support we received from a number of organizations and individuals.

Our sponsors have been most helpful in providing logistical and technical support to our operations. A particular acknowledgement is due to former CICA president Michael Rayner and the staff of the CICA who worked proactively, diligently and with the utmost professionalism to support our work. I also want to thank Fred Gorbet who served as Executive Director of the Committee and drafted both the interim and final reports. Jim Goodfellow served as Research Director and we are grateful to him and also to Deloitte & Touche for making Jim available to the Committee and for providing facilities and support for many working sessions.

A number of individuals helped us at various stages of our deliberations over the past year. Without implicating any of them in the conclusions of the report, I would like to thank David Beatty, John Dinner, Carol Hansell, Ken Huguesson, Karen Hunter-Payne, Richard Leblanc, and Patrick O'Callaghan. Andrew Fleming, with Ogilvy Renault, reviewed the final draft. We appreciate his observations and comments.

Our Committee is also deeply appreciative of the time and effort that was taken by individuals, organizations and companies to respond thoughtfully and constructively to our interim report. We received more than sixty submissions. These are all available on our Web site ([www.jointcomgov.com](http://www.jointcomgov.com)) and represent a valuable source of information for those interested in governance issues. They were most helpful to us in shaping and focusing our final report.

Guylaine Saucier

*Chair*

*November 2001*

# Introduction and overview

This report focuses on key issues where we believe we can improve governance by encouraging a healthier culture in the boardroom. Our objective is to assist the competitive position of Canadian companies in markets at home and abroad by strengthening governance practices. We believe that good governance contributes to good performance.

In particular, our report focuses on three key issues that go beyond compliance and are fundamental to building a healthy governance culture. These are:

- 1. measures that can be taken to strengthen the capacity of the board to engage in a mature and constructive relationship with management – one that is grounded in a mutual understanding of respective roles and the ability of the board to act independently in fulfilling its responsibilities;*
- 2. the critical role that the board must play in choosing the CEO of the company, in actively contributing to the company's strategic direction, approving a strategic plan and monitoring performance against agreed benchmarks; and*
- 3. particular issues that independent directors' must face in corporations that have significant shareholders.*

Our report builds on the strong foundation set out in the Dey Report of 1994 and the existing Toronto Stock Exchange (TSE) disclosure requirements and governance guidelines. It also reflects the comments and advice we received in response to our interim report. The submissions we received represent the views of a broad cross-section of interested stakeholders and they have been very valuable to the Committee.

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<sup>1</sup> We use the term 'outside director' to mean a director who is not a member of management. An 'independent director', in our terminology, is an outside director who is unrelated and who is also unaffiliated with a significant ownership interest in the company.

In this report we discuss why improving corporate governance is important. We assess where we are after six years of experience with the TSE disclosure requirements and governance guidelines that were issued following the Dey Report. We make suggestions and recommendations that focus on enhancing the value that boards add through changing behaviour in the boardroom. And we review and suggest changes to the current governance disclosure guidelines.

Our terms of reference specifically asked us to recommend how Canada should respond to the new requirements for audit committees and auditors adopted in the United States in response to the recommendations of the Blue Ribbon Committee on Audit Committee effectiveness, and we do so in the last part of the report.



# The objective of good governance

The objective of good governance is to promote strong, viable and competitive corporations. Boards of directors are stewards of the corporation's assets and their behaviour should be focused on adding value to those assets by working with management to build a successful corporation and enhance shareholder value.

A committed, cohesive and effective board adds value, first and foremost, by selecting the right CEO for the company. Beyond this, the board contributes to value in a number of ways discussed below. These include assessing and approving the strategic direction of the company, ensuring that management has in place appropriate processes for risk assessment, management and internal control, monitoring performance against agreed benchmarks, and assuring the integrity of financial reports. When boards add value by fulfilling their responsibilities in these areas, it will result in greater transparency and understanding of a company's situation by its major stakeholders.

In an increasingly globalized world economy, competition is intense and good corporate governance can make a difference to how Canadian companies are viewed. There are benefits to being recognized as a country where excellence in corporate governance receives a high priority; these benefits accrue to individual Canadian companies when operating abroad, as well as to the entire Canadian capital market as viewed by international investors.

# The state of governance today

It is six years since the Toronto Stock Exchange introduced governance disclosure requirements as a response to the Dey Report. The TSE requires that every listed company incorporated in Canada or a province/territory of Canada must disclose on an annual basis a “Statement of Corporate Governance Practices”. This statement must be made in the company’s annual report or information circular and it must contain “a complete description of the company’s system of corporate governance with respect to each of the guidelines”. The disclosure requirement and associated guidelines are set out in Appendix A of this report. The TSE recognizes that ‘one size does not fit all’. There is no requirement that governance practices conform to the guidelines. The only requirement is to disclose actual practice in relation to the guidelines. But the disclosure regulation states clearly that “where the company’s system is different from any of these guidelines or where the guidelines do not apply to the company’s system, [the Statement must contain] an explanation of the differences or their inapplicability.”

What has happened since the publication of the Dey Report and the introduction of the disclosure requirement and associated guidelines?

First, corporate governance practices have improved in many Canadian companies. Our experience as board members participating in a diversity of boards confirms that the guidelines and disclosure regulations have made a substantial difference in specific circumstances. The key benefit of the new regime is that it has resulted, in many cases, in a focused and explicit examination by boards of their roles, responsibilities and behaviour. In our judgment, this has been a healthy development that would not have been as likely to occur without the annual disclosure requirement imposed by the TSE.

Second, notwithstanding this improvement in many companies, further progress needs to be made. Not all TSE-listed companies comply with the disclosure requirement in the spirit in which it is intended. A recent review of disclosure, based upon a major survey of 324 public companies, found that:

*...the quality of reporting against the guidelines must improve. Although reporting against the guidelines is mandatory for TSE-listed corporations, 51% of the companies in this survey did not report their practices against all the guidelines. This is a continuation of a trend that has been apparent since reporting against the guidelines was made mandatory as of June 1995.<sup>2</sup>*

<sup>2</sup> Patrick O’Callaghan and Associates in partnership with Korn/Ferry International, “Corporate Board Governance and Director Compensation in Canada: A Review of 2000”, December 2000, p. 8. The companies surveyed were on one or more of the following lists: The *National Post* 250 (June 2000), The *National Post* Top Financial Institutions (June 2000), The *Report on Business* Top 250 (July 2000), The TSE 300 (at any time during 1999).

In addition, there has been a tendency for disclosure to degenerate into boilerplate – to become less meaningful as well as less complete. One of the merits of disclosure is that it should lead to a discussion of governance practices within the board. This, in turn, should lead to more effective governance and more substantive disclosure.

Third, in 1999 the TSE amended Section 475 of the disclosure requirements to change its heading from “Points to be Addressed” to its current heading of “Complete Disclosure”. The purpose of this amendment was to make it clear, in response to the practice of certain companies, that disclosure must specifically address each of the 14 TSE Guidelines, rather than make a general type of disclosure (See Appendix A).

Fourth, although the TSE has a mandated disclosure regime for its listed companies, CDNX does not. The result is that there is no continuing governance disclosure regime applicable to more than 2,600 public Canadian companies with a combined market capitalization and outstanding debt of more than \$138 billion (as at August 31, 2001). CDNX currently classifies issuers into two different tiers based on standards that include historical financial performance, stage of development and financial resources of the issuer at the time of listing.<sup>3</sup>

And, finally, the world has moved on since 1995. In the United Kingdom, companies listed on the London Stock Exchange have been required, since 1998, to make a “statement of compliance” with the Combined Code in their annual reports.<sup>4</sup> In the United States, significant changes have recently been introduced to the structure and role of audit committees in response to the Blue Ribbon recommendations. Among other things, these changes require that U.S. audit committees have a formal charter that must be disclosed, along with an annual disclosure by the audit committee to shareholders as to whether the audit committee satisfied its responsibilities in the prior year in compliance with its charter.

There is room for further improvement in corporate governance in Canada. We recognize that no governance system can provide absolute assurance that corporations will prosper. But we do believe that better boards can considerably increase the odds of success and that this is worthwhile for companies, for their shareholders and other stakeholders, and for Canada.

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<sup>3</sup> Specific minimum Listing Requirements for each industry segment in each of Tier 1 and Tier 2 have been developed and are set out in CDNX Policy 2.1 “Minimum Listing Requirements”, (January 2000).

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<sup>4</sup> The Combined Code was issued by the Hampel Committee in 1998 and superseded the 1992 Cadbury Committee report on corporate governance. The Combined Code was amended in 2000 to incorporate guidelines for internal control and risk management developed by the Turnbull Committee.

# The importance of disclosure

In the discussion of whether corporate governance should be regulated or whether performance against published guidelines should be disclosed, the Committee is firmly committed to the principle of disclosure.

While there may be a place for regulating some aspects of corporate governance, our view is that disclosure is a much better approach than attempting to regulate behaviour, if one is seeking to build a healthy governance culture. Indeed, we believe that regulation aimed at changing board behaviour may turn out to be counterproductive. An example is regulatory change that has made directors personally liable for obligations of corporations, with only limited recourse to a due diligence defence. While intended to place a greater onus of responsibility on directors, it has in practice discouraged competent and qualified people from becoming directors, particularly in smaller companies; it has also resulted in situations where good directors feel compelled to resign when companies get into trouble – which, ironically, is when they are most needed.

Not only is disclosure preferable to regulation as a tool to change behaviour, it is also appropriate. The evolution of capital markets has clearly shown that disclosure instills discipline and increases efficiency. With regard to corporate governance, we see two important benefits of disclosure. First, disclosure can provide examples of good practice that can assist boards that are looking for ways to become more effective. Second, a requirement to disclose against guidelines can modify behaviour by forcing boards to focus explicitly on their roles and responsibilities and how they are being discharged.

We do not believe that disclosure is a panacea; but in the right circumstances it can be the catalyst that can make a real difference. Some have argued that disclosure increases the legal risk faced by directors. While these concerns may have some validity, we observe that the introduction of the disclosure regime in 1995 does not appear to have led to a significant increase in director liability, and we do not believe that the recommendations that we make in this report will increase director liability (compared to the existing disclosure regime) in any meaningful way.

We believe that good governance benefits all companies – small and large – and that the principles of effective governance do not change as companies get bigger. It is also true that entrepreneurs have a choice about whether or not to seek capital on public markets and, if they do, shareholders can reasonably expect as much accountability from the board of a smaller company as they can from a larger company. We recognize, however, that smaller companies may have more difficulty implementing some of the practices that we suggest because their boards are typically smaller and they sometimes have difficulty attracting and compensating outside directors. As well, disclosure requirements impose a relatively greater compliance burden on smaller companies. For these reasons, smaller companies may need more time and additional resources, including education and training, to make meaningful advances in effective corporate governance. It is, however, in their self-interest to begin to do so.

In Appendix A, we set out the existing TSE disclosure requirement and guidelines and the modifications that we recommend in this report.

### Recommendation 1

*The TSE should revise the guidelines having regard to the proposed amendments in Appendix A of this report. The TSE should identify education, monitoring and enforcement measures that will ensure companies comply with the disclosure requirement.*

*The CDN should introduce, for Tier 1 companies, a disclosure requirement and guidelines along the lines suggested in Appendix A of this report. The CDN should work with Tier 1 listed companies to provide education, training and other support that may be required to assist them in complying with the disclosure requirement within a reasonable period of time. The CDN should monitor compliance and consider enforcement measures if compliance is not satisfactory.*

# Improving board effectiveness

The *Canada Business Corporations Act (CBCA)* states that “the directors shall manage the business and affairs of the corporation”. The Dey Report observed that this description is confusing, as boards today may “supervise, direct or oversee” but the “day-to-day management must be delegated to others”. The Dey Report recommended that, to eliminate confusion, the CBCA be amended to make it clear that the responsibility of directors is “to supervise the management of the business.” We agree with that position and believe that the Act should be amended to reflect this.

The board’s relationship to management is critical to healthy governance. It is a relationship that must continue to be maintained in a delicate balance. What is required is a common appreciation by management and the board of their respective roles, a mutual respect for each party in carrying them out, continuing open dialogue and communication, and strong leadership within the board.

The board selects the CEO and, if it is to add value, it must work with senior management as collaborators in advancing the interests of the corporation. In doing so, it must delegate authority and recognize that, once authority is delegated, management must be free to manage. But the board cannot be too accepting of management’s views. It has the responsibility to test and question management assertions, to monitor progress, to evaluate management’s performance and, where warranted, to take corrective action. It is critical that boards understand their role in this relationship, and collectively define their responsibilities.

It is also important that boards recognize that the exercise of these responsibilities must be ongoing and continuous. A healthy governance culture demands that both management and the board engage in continuing and constructive discussion to delineate their respective roles in changing circumstances.<sup>5</sup>

There are five core functions that boards must be explicitly responsible for:

- *choosing the CEO*, and ensuring that the senior management team is sound, focused and capable of successfully managing the company;
- *setting the broad parameters* within which the management team operates: examples include adopting a strategic planning process and approving a strategic direction; defining a framework to monitor the management of business opportunities and risks; in defined circumstances, approving major

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<sup>5</sup> A good example of how failing to engage in this dialogue can lead to dysfunctional governance cultures is provided in *Board Governance and the Responsibility Virus*, an essay by Roger L. Martin that is available on the Joint Committee Web site at [www.jointcom.gov.com](http://www.jointcom.gov.com).

corporate decisions; and approving a communications policy that includes a framework for investor relations and a public disclosure policy, which may involve a process for monitoring the relationship between the corporation and investment dealers;

- *coaching* the CEO and the management team; the metaphor of a coach is chosen deliberately to underscore that the directors are not players – they should provide direction and advice, but they don't do management's job;
- *monitoring* and assessing the performance of the CEO, setting the CEO's compensation and approving the compensation of senior management, and taking remedial action where warranted, including replacing the CEO if necessary; and
- *providing assurance* to shareholders and stakeholders about the integrity of the corporation's reported financial performance.

## The importance of board independence

Boards must have the capacity, independent of management, to fulfil these responsibilities, and to engage in a constructive and mature relationship with management. This requires a clear understanding of what they should do and what they should not do, and a culture that provides opportunity for both directors and management to feel comfortable when management positions are challenged. We believe that there are four conditions that can materially assist boards in developing such a culture:

- strong board members who are independent of management, provided with appropriate orientation, and who bring an appropriately diverse set of experiences, competencies, skills and judgment to the board. We refer to such directors in this report as outside directors;
- strong leadership within the board from an outside director. We describe the functions that such a director must have as the functions of an “independent board leader” and we discuss this concept in more detail below <sup>6</sup> ;
- a CEO who understands the role of the board and is openly supportive of building a healthy governance culture; and
- regular meetings of the outside directors without management to build relationships of confidence, and cohesion among themselves.

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<sup>6</sup> “Independent board leader” is a term used in this report to describe an outside and unrelated director who carries out certain substantive functions within the board.

Some boards are more advanced than others in developing a culture in which the board can act independently in carrying out its responsibilities. We believe all boards must pay careful attention to this. Where there are deficiencies in the four conditions noted above, or in any other conditions that compromise the independence of the board, then actions should be taken to remedy them.

### Choosing the right directors

We cannot overemphasize the importance of recruitment. If a board is to succeed in adding value, it must bring independent perspectives to the table, set goals for its own work and regularly assess how it is doing in meeting those goals and how the contribution of individual directors might be enhanced.

Recent research has underlined the importance of effective recruitment practices. In Canada's top 250 companies, there are about 1,700 directors. The annual turnover is surprisingly large. In 1997-98, for example, some 391 new directors appeared in the top 250 companies. This number was 283 in the following year and then declined to 173 in 1999-2000. As a turnover rate, the range over the three years is 23% in 1997-98 and 10% in 1999-2000 – all very significant numbers.<sup>7</sup>

The current TSE guidelines suggest that each board should appoint a committee composed exclusively of outside directors, a majority of whom are unrelated, with the responsibility to propose to the full board new nominees to the board and for assessing directors on an ongoing basis. As of 1999, only one-third of boards had established nomination processes consistent with the guidelines and fewer than one in five had any formal process for assessing the effectiveness of boards or directors.

We do not propose any change to the TSE guideline with regard to the composition of the committee that is responsible for recruitment. For boards of smaller companies, which do not have formal committee structures, all the outside directors acting together might carry out this function.<sup>8</sup> We do, however, urge boards to take this guideline more seriously than they appear to have done so far.

We also believe that the recruitment process can be improved.

<sup>7</sup> Unpublished research by the Clarkson Centre for Business Ethics and Board Effectiveness. Information supplied by Professors David R. Beatty & Timothy J. Rowley assisted by You-Ta Chuang and Lee E. Benson from data supplied by the *Financial Post*.

<sup>8</sup> At several places in this report, we talk about board committees. With respect to CDNX companies, our position is that there is no requirement for any committee structure other than the audit committee, which is required by law. The functions that the guidelines suggest be performed by committees may, in our view, be equally well performed by outside directors.



## Recommendation 2

*We recommend that:*

*(1) The full board should engage in a disciplined process to determine, in light of the opportunities and risks facing the company, what competencies, skills, and personal qualities it should seek in new board members in order to add value to the corporation. The results of such a discussion should provide a framework for the work of those directors charged with developing lists of candidates.*

*(2) Boards should actively look beyond traditional sources in seeking men and women with the right mix of experience and competencies. Diversity of background and experience can add value to boardroom deliberations.*

*(3) Boards should ensure that prospective candidates fully understand the role of the board and the contribution they are expected to make, including in particular the commitment of time and energy that the company expects of its directors.*

*(4) Prospective candidates, once identified, should be approached by the “independent board leader”, with or without the CEO, to explore their interest in joining the board.*

In connection with recruitment, we considered whether directors are adequately compensated for the risks and responsibilities they have. In general, the compensation information we reviewed suggests that compensation levels in Canada lag somewhat behind those in the United States. Boards should continue to be concerned that their total remuneration packages are competitive. In particular, we have concerns that the director who is charged with the functions of “independent board leader” and committee chairs may not be receiving compensation that adequately reflects the responsibilities they should be assuming. As well, some form of minimum shareholding requirement for directors is appropriate in aligning director and shareholder interests.

We believe that it is important to emphasize the significance of, and our support for, continuing education for directors. The pace of change is so rapid, and the complexities of modern business are increasing so quickly, that continuing education and lifelong learning are as critical for directors as they are for anyone. This is particularly true in light of the high turnover rates noted above, and the age profile of current directors, which suggests that high turnover rates are likely to continue. Neither ego nor embarrassment should get in the way of equipping oneself to the best of one's ability, in order to do as good a job as possible. Having said this, however, we also believe that educational material – if it is to be useful – must be focused on real and practical issues, and delivered in relatively short sessions by individuals who, by virtue of their stature and experience, can command the respect and attention of corporate directors. We encourage all those who have an interest in developing material of this kind to pursue it vigorously and we urge boards to explicitly consider what measures and resources might be appropriate in their circumstances to enhance the capacity of their members.

#### The requirement for and functions of an “independent board leader”

We received a great deal of comment on our interim recommendation that all boards should have nonexecutive chairs. There was considerable support for this position from many commentators but some submissions expressed strong opposition.

It continues to be our preference that Canadian boards move towards having a nonexecutive chair.

Canadian corporate governance processes and practices evolve in an international context. The issue of a nonexecutive chair does not seem to be an active recommendation in corporate governance reform processes in the United States. Although the practice of having a nonexecutive chair is more

widespread in the United Kingdom, boards in that country typically have more inside directors (i.e. management members) than do Canadian boards. Although we must recognize international practice and be sensitive to how it is evolving, we should be driven by what we feel works best for Canadian corporations.

Those who strongly support a nonexecutive chair believe that, for a board to have the capacity to act independently in fulfilling its responsibilities, it requires strong leadership within the board from an outside director. Others argue there are circumstances where considerable pressures militate against splitting the role of chair and CEO, and that, in such circumstances, alternative arrangements can be found to protect the capacity of the board for independent action.

It is time to move this debate forward. We can do this by focusing attention on the substantive functions that should be performed by an “independent board leader”, regardless of the title that this individual has.

In fulfilling its primary mandate to select and continually appraise the performance of the CEO where the CEO is also the chair of the board, it is crucial that the CEO appraisal is conducted by the “independent board leader” or by a committee composed of outside directors.

When the full board designates an “independent board leader”, the independence of the board is best protected.

This leader must be empowered by the full board to carry out the functions set out in Appendix B, which sets out our views of the areas of functional responsibility that should reside in the “independent board leader”.

The “independent board leader” must be an outside and unrelated director<sup>9</sup>. He or she may have the title of chair, lead director or any other title chosen by the board, so long as it is clear that the title carries with it the responsibility for the functions identified in Appendix B, and that the “independent board leader” is accountable to carry them out and is identified as such.

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<sup>9</sup> The “independent board leader” may be affiliated with a significant shareholder. The term “independent board leader” should not be confused with “independent director” as they refer to different functions. An independent director is the very specific term used in this report to describe those directors that are chosen in accordance with Guideline #2 of the TSE Disclosure Requirements and Guidelines (see Appendix A) to “fairly reflect the investment in the corporation by shareholders other than the significant shareholder”. An “independent director”, therefore, should be an outside and unrelated director who is also not affiliated with the significant shareholder. An “independent director” may, of course, also be an “independent board leader”.

### Recommendation 3

*All boards should have a designated “independent board leader” who is chosen by the full board and who is an outside and unrelated director. This requirement should be a condition of listing on a stock exchange. The independent board leader should exercise those substantive functions (set out in Appendix B of this report) that are essential to ensure the ability of the board to act independently in carrying out its responsibilities.*

*Where the board chair is an outside and unrelated director, the chair should be the independent board leader.*

*Where the board chair is the CEO, the independent board leader should be given an appropriate title and be identified as such in the Annual Report. There should be a position description for the independent board leader, approved by the board. The independent board leader should be appropriately compensated for the additional responsibilities of the position and be assured of the resources and support necessary to carry them out. His or her performance should be evaluated annually against the position description.*

*The desirability of providing for a strong independent board leader should be a consideration in recruiting new board members.*

### Regular assessment of performance

Regular assessment of the board’s effectiveness, and the contribution of individual directors, is essential to improve governance practices. The governance system should include a process for the evaluation of the work of the board, its committees, and individual directors. The focus of such assessments should be on how performance can be made more meaningful in setting and achieving goals that add value. The results of such evaluations should be internal to the board, but disclosure should be made that such evaluations are indeed carried out.

With regard to assessment, we believe that the accountability for ensuring that regular assessments take place should rest with the independent board leader. He or she does not necessarily have to perform such assessments personally, but should ensure that there is a structure and accountability for them within the board.

## Recommendation 4

*The “independent board leader” should be accountable to the board, personally or through delegating to a committee, for ensuring that regular assessments of the effectiveness of the board and its committees, as well as the contribution of individual directors, are carried out. The results of the assessment of the board and its committees should be reported to the full board. Results of individual assessments should be given to individual directors to help them enhance their contribution.*

### Meetings of the outside directors without management

Practices that provide opportunity to build relationships, confidence and cohesion among directors are essential to allow the board to help develop an understanding of its role. One such practice is a regular meeting of outside directors without management present. Such meetings can be used to provide feedback about board processes, including the adequacy and timeliness of information being provided to the board. At times, such meetings might also focus on substantive issues that may be more difficult for some board members to discuss with management present. They can also provide opportunities for the independent board leader to discuss areas where the performance of the outside directors could be strengthened.

It is important that these opportunities occur regularly, even if the meetings are short, so that they become a recognized and accepted governance practice. Any issues arising in these sessions that bear on the relationship between the board and management should be communicated quickly and directly to the CEO by the independent board leader.

## Recommendation 5

*The outside board members should meet at every regularly scheduled meeting without management and under the chairmanship of the “independent board leader”.*

## Selecting the CEO, monitoring performance and succession planning

A board's most important function is to choose the CEO and approve the choices of the CEO for the management team. If the board chooses wisely, it creates the conditions whereby it can add value through coaching and monitoring in a constructive and supportive environment. If it chooses badly, no amount of effort by the board can repair management inadequacies.

The choice of the CEO is so fundamental to the company, and to the effectiveness of governance, that the board as a whole should ensure that it has undertaken appropriate due diligence in selecting a CEO. The board may use any number of processes to come up with recommendations, but all directors must satisfy themselves that a recommended candidate is appropriate for the position.

The board has the responsibility to monitor the performance of the CEO and senior management, and to ensure that succession planning is in place for critical positions. Performance monitoring requires that the board establish a position description for the CEO, setting out his or her authorities and accountabilities, as well as performance indicators agreed upon by the board on a regular basis to provide monitoring benchmarks. Succession planning requires working with the CEO to identify the requirements for critical positions and individuals who can fill those positions on both an emergency basis and over the longer term.

In general, our experience suggests that boards do not take enough time to do a thorough and careful job of appointing the CEO and monitoring his or her performance.

### Recommendation 6

*The "independent board leader" should be accountable to the board for ensuring that the assessment of the CEO and the succession planning functions are carried out and the results discussed by the full board.*

## Strategic planning and monitoring of opportunities and risks

If boards are to add value, they must involve themselves actively and regularly in the functions of strategic planning and risk management. We believe that these functions need to be closely integrated: strategic planning should be based upon an identification of opportunities and the full range of business risks that will condition which of those opportunities are most worth pursuing. Strategic planning is an ongoing process that must be responsive to changes in the external environment and internal developments. Flexibility and responsiveness are critical. In this sense, strategic planning is a much broader concept than developing a business plan and should include assessments of opportunities and risks across a range of areas, as indicated in Table 1 below.

**Table 1:**  
Examples of opportunities and risks to be considered in strategic planning

<i>Area of opportunity/risk</i>	<i>Example</i>
<i>Strategic</i>	Market conditions; new competitors; political/regulatory environment
<i>Operational</i>	Business processes; technology; human resources; business interruption; environmental issues; health and safety issues; crisis management
<i>Leadership</i>	Ability to innovate and motivate throughout organization; choice of CEO
<i>Partnership</i>	Ability to choose appropriate alliances, partnerships and make them work well
<i>Reputation</i>	Quality of products and services; illegal or unethical acts; fraud

Boards' involvement in strategic planning and the monitoring of risks must recognize directors are not there to manage the business, but are responsible for overseeing management and holding it to account. Where the lines are clear, and roles are respected, effective boards will contribute to the development of strategic direction and approve a strategic plan. They will oversee the

processes that management has in place to identify business opportunities and risks. They will consider the extent and types of risk that it is acceptable for the company to bear. They will monitor management's systems and processes for managing the broad range of business risk. And most important, on an ongoing basis, they will review with management how the strategic environment is changing, what key business risks and opportunities are appearing, how they are being managed and what, if any, modifications in strategic direction should be adopted.

There is no single process that works for every board and every company. In our view, it is the joint responsibility of the "independent board leader" and the CEO to develop ways to involve the board in the ongoing processes of strategic planning and risk management that are constructive and appropriate to the circumstances of the company.

The current TSE guidelines, against which disclosure is required, state that:

*"The board of directors of every corporation should explicitly assume responsibility for...*

*a) adoption of a strategic planning process;*

*b) the identification of the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks;"*

It seems to us that the intent of the guidelines could be improved by revisions that reflect the comments made above. In particular, strategic planning and its relationship to opportunities and risks should be viewed in a more integrated way. And boards should involve themselves in overseeing and monitoring management's approach to strategy, opportunity and risk on a regular, ongoing basis.

Boards also need to take this responsibility seriously. The 1999 survey of the extent to which corporate practice among TSE-listed companies followed the guidelines revealed that almost 30% of boards had no input or involvement in strategic planning (other than formal approval of a plan) and almost 40% of boards had no formal process for oversight of risk management.<sup>10</sup>

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<sup>10</sup> "Five Years to the Dey", Report of the Institute of Corporate Directors and Toronto Stock Exchange, 1999. The survey was conducted to assess the impact of the guidelines on governance practices. Chief Executive Officers of 1,250 TSE-listed companies were invited to participate – more than 95% of the issuers on the TSE. In the event, 635 responses (51%) were received. The report concludes that the "survey results are within 3% of the results that would have been obtained had all TSE-listed companies participated." (p. 2).



## Recommendation 7

*The guidelines should be amended to make it clear that the board's responsibility goes beyond the "adoption of a strategic planning process". The board should be responsible for contributing to the development of strategic direction and approving a strategic plan that takes into account an identification of business opportunities and business risks. It should oversee and monitor management's systems for managing business risk. And it should regularly review, with management, the strategic environment, the emergence of new opportunities and risks, and the implications for the strategic direction of the company.*

### Controlling shareholders and publicly traded subsidiaries

Canada's industrial structure is characterized by a great many public companies that are controlled by significant shareholders. Some of these are individuals or families; others are themselves public corporations. These companies have generally performed well and have played an important and beneficial role in helping to build a strong, domestic industrial sector.

Studies of governance have generally not addressed the particular issues that arise when a public company is controlled by a significant shareholder. The law that sets out the responsibilities of directors makes no distinction on the basis of ownership. In this regard, one size does fit all. In practice, however, the role that the board of such a company plays can differ quite dramatically from case to case, depending upon the approach of the significant shareholder.

There are three aspects of parent/subsidiary relations that deserve comment: the composition of the board of a controlled corporation; the role of such a board; and audit committees.

## Composition of the board of a controlled corporation

With regard to the board, current guidelines suggest that the board of a corporation with a significant shareholder be constituted with a majority of unrelated directors, which could include directors having an interest or relationship arising from shareholding. As well, the company should have a number of directors who are not connected with either the corporation or the significant shareholder, which fairly reflects the investment in the corporation by shareholders other than the significant shareholder.<sup>11</sup> We are not recommending any change in this guideline. But we do believe that the definition of a significant shareholder needs to be reviewed.

<sup>11</sup> For the purposes of this report, we define such directors as “independent directors”. See also footnote 9 on p. 17.

The Dey Report and the current guidelines define a significant shareholder as one with an ability to exercise a majority of the votes for the election of the board of directors. In practical terms, this definition means that a shareholder with the ability to exercise less than a majority of the votes, but with a big enough ownership position to exercise de facto control over the election of the board, is not a significant shareholder. In this case, Guideline #2 (see Appendix A) does not apply to protect the representation of other ownership interests on the board, and a board whose members are all affiliated with either the corporation or the de facto controlling interest would be consistent with the governance guidelines. This seems to us to be a result that is unintended and counter to the underlying principles of the governance guidelines.

One way to remedy this would be to substitute a test of de facto control for the current test of majority voting power. But the determination of de facto control is not a straightforward issue and it would be desirable to consider ways in which an operational definition of “significant shareholder” could be developed that would be consistent with the intent of the guidelines and capable of being implemented in a practical way.

### Recommendation 8

*The TSE should review and revise the definition of significant shareholder so that the intent of the existing guideline is met when a de facto control block exists that represents less than a majority of the voting shares.*

## Role of the board of a controlled corporation

There are provisions in law that recognize the conflicts that can arise with regard to protecting the rights of minority shareholders. Over time, the law has been strengthened in this regard and particular governance responses – such as independent committees – can come into play in defined circumstances. As well, the existing guidelines suggest that individual directors should be able “to engage an outside adviser at the expense of the corporation in appropriate circumstances”.

Our concern is not so much with extraordinary circumstances, but with the ongoing process of governance where independent directors of a controlled company may have difficulties from time to time in carrying out what we have described as the core functions of governance. Particularly important, in our view, are the selection of (and ability, where appropriate, to terminate) the CEO and a meaningful involvement in developing the strategic direction for the company. If the board of a controlled corporation is not playing a meaningful role in these functions, then it appears to us that it is more in the nature of an advisory board than a board of directors. Discussions should be undertaken between the board of the controlled company and its significant shareholder to determine the exact nature of the board mandate under consideration, recognizing the legal context and fiduciary responsibilities of board members to minority investors.

### Recommendation 9

*Where a company is a public corporation, the fact that it may be controlled by a significant shareholder does not relieve the independent directors of their responsibilities to ensure that shareholders are protected. The significant shareholder, the controlled corporation, and the directors must be prepared to accept their responsibility to ensure that the proper functions of governance are carried out.*

## Audit committees

With regard to audit committees, we believe that there needs to be close coordination and communication between audit committees of parents and subsidiaries. There should be a common appreciation of the control frameworks and cultures of the entities, and substantial sharing of information. Safeguards should ensure that the sharing of information is not used by the parent to disadvantage minority shareholders of subsidiaries.

## A board mandate and disclosure

We believe that boards should develop formal, written mandates setting out their responsibilities, and the way in which they structure their operations to carry out these responsibilities. The development and disclosure of such mandates is consistent with current disclosure regulations and guidelines.

Guideline 1 now states that every board should explicitly assume responsibility for certain enumerated functions as part of its overall stewardship responsibility. A board mandate would formalize this guideline. The development of such a mandate should focus discussion within the board on defining responsibilities, and hence on understanding the line between board and management accountabilities. We believe such focused discussion would be healthy and lead to more effective governance. At a minimum, we believe that boards should explicitly accept responsibility for the five core functions of governance that we listed above (pp. 12-13). But individual boards may wish to go further in defining their responsibilities. We would also hope that such discussion would lead boards to set goals for their own performance.

We believe it is important that the mandate be disclosed, and that performance against the mandate be assessed. It is not necessary, in our view, to disclose the results of this assessment but there should be disclosure that the assessment has taken place. This position is generally consistent with the current disclosure regulations. Guideline 5 now requires that assessments of board effectiveness be carried out, and the recently amended “complete disclosure” requirement states that disclosure should address the “mandate of the board, which should set forth duties and objectives” (See Appendix A).

### Recommendation 10

*The disclosure guidelines should be amended to make it clear that each board should develop a formal mandate setting out its responsibilities. The regular assessment of board effectiveness recommended above (Recommendation 4, p. 19) should be conducted relative to the mandate, and the guidelines should require disclosure that such assessment has been carried out and the results discussed by the full board.*

# Audit committees and the Blue Ribbon Committee report <sup>12</sup>

The increased focus on corporate governance over the past decade has concentrated attention on audit committees and their role has expanded. In 1998, the U.S. Securities and Exchange Commission, as part of a nine-point plan to better assure credibility and transparency in the financial reporting process, asked the New York Stock Exchange and the National Association of Securities Dealers to sponsor a Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.

Our terms of reference asked us to recommend how to respond to the new U.S. requirements adopted as a result of the Blue Ribbon report.

Our overall approach is to seek as much harmonization with U.S. practices as makes sense. The increasing integration of our capital markets and the benefits of Canadian corporations being able to easily access U.S. sources of capital suggest that this is desirable. At the same time, some of the U.S. approaches appear to us to be excessively “rules-based” and not in keeping with the way in which governance practices have evolved in Canada over the recent past.

In essence, the Blue Ribbon Committee made recommendations with regard to the composition of audit committees, the qualification of members, the requirement to adopt and disclose a formal charter, regular affirmation to shareholders that the committee fulfilled its responsibilities in compliance with its charter, and the relationship between the audit committee and external auditors, including the issue of the independence of auditors. The Blue Ribbon Committee’s recommendations are attached as Appendix C.

These recommendations have been adopted, with some minor modifications, by major U.S. exchanges. This new U.S. regime does not automatically apply to Canadian companies who are also listed on U.S. exchanges. But we understand that many Canadian companies that are listed on U.S. exchanges will be making efforts to comply with the U.S. regime, including specified tests for the independence of audit committee members, mandatory disclosure of an audit committee charter, and a mandatory annual report by the audit committee to shareholders.

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<sup>12</sup> Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, Published by the New York Stock Exchange and The National Association of Securities Dealers, 1999.

Our recommendations go a long way towards adopting the Blue Ribbon proposals, but we do not go as far as the U.S. has gone in some instances. There are three areas, in particular, where we diverge from U.S. practice.

First, we are not proposing a test for the “independence” of audit committee members that is as stringent as that in the U.S. The U.S. approach is “rules-based”. The approach we believe is preferable is to remain within the understood framework of “outside” and “unrelated” directors. These are defined in the existing TSE guidelines and we are not proposing any change to these definitions.

Second, with regard to “financial literacy”, we are following the Blue Ribbon Committee’s recommendation that audit committee members be “financially literate”. U.S. practice has gone in two directions. The NYSE has adopted this recommendation but leaves the definition of financial literacy to the board to determine. The NASDAQ has adopted criteria that determine financial literacy. Our recommendation is that we follow the practice of the NYSE.

Third, with regard to disclosure, U.S. practice now requires disclosure of an audit committee charter and a mandatory annual report by the audit committee to shareholders. The TSE disclosure requirements already require disclosure of the mandates and activities of the board and all committees. We do not see any reason to change the current disclosure requirement, although we emphasize once again that it is important that companies comply with it.

## Recommendation 11

*The governance guidelines relating to audit committees should be amended to reflect the following:*

*(1) Audit committees should be composed solely of outside directors who are also “unrelated”. The definition of “unrelated” and the obligation on boards to disclose and explain their interpretation of “unrelated” should remain as now set out in Guidelines 2 and 3. We further recommend that some flexibility with regard to related directors, but not outside directors, be provided by CDNX for Tier 2 companies that have small boards.*

*(2) All members of the audit committee should be “financially literate” and at least one member should have accounting or related financial expertise. The definition of and criteria for “financial literacy” should be determined by each board.*

*(3) Audit committees should adopt a formal written mandate that is approved by the full board and that sets out the scope of the committee’s responsibilities. This mandate should be disclosed to shareholders, and a regular assessment of the effectiveness of the committee against the mandate should be conducted and reported to the full board. The audit committee mandate should set out explicitly the role and responsibility of the audit committee with respect to:*

- its relationship with and expectation of the external auditors;*
- its relationship with and expectation of the internal auditor function;*
- its oversight of internal control;*
- disclosure of financial and related information; and*
- any other matters that the audit committee feels are important to its mandate or that the board chooses to delegate to it.*

Our view is that any Canadian company that chooses to comply with U.S. audit committee requirements will behave in a way that is consistent with the guidelines and disclosure requirements that we are recommending.

## Relationship with and expectation of external auditors

We believe that the relationship between audit committees and the external auditors could be improved in most companies. Fundamental to such improvement is a mutual recognition that the external auditors are accountable to shareholders, and to the board and audit committee as their representatives. The external auditors are not accountable to management. Both audit committees and auditors need to work hard to improve this relationship, and management needs to understand and support their efforts. We believe the situation in Canada should parallel the recommendation of the Blue Ribbon committee (See Appendix C, Recommendation 6).

### Recommendation 12

*Audit committee mandates should explicitly affirm that the external auditor is accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate and, where appropriate, recommend replacement of the external auditor.*

*Auditors must recognize that their ultimate client is not management, and work constructively and meet regularly with audit committees to build an effective relationship.*

Each board should determine for itself how it will approach the challenge of developing its relationship with external auditors. We believe there are three key outcomes that must be achieved and the audit committee mandate should explicitly recognize them.

- The audit committee needs to assure itself that the auditors are independent. It must have access to all information about the audit firm's relationship with the corporation that is necessary in order to come to a reasonable conclusion.



- The audit committee needs to assure itself that the external auditors are satisfied that the accounting estimates and judgments made by management, and management's selection of accounting principles, reflect an appropriate application of GAAP.
- The audit committee must develop a relationship with the external auditors that allows for full, frank and timely discussion of all material issues, with or without management as appropriate in the circumstances.

Achieving these outcomes will require, in most instances, a change in attitude on the part of auditors and management about the role and importance of the audit committee.

### Relationship with and expectation of the internal audit function

There are many operational aspects of the audit committee's relationship with the internal audit function that are important for the effective oversight of the internal control framework and culture. Where a corporation has an internal audit function, the audit committee should approve its mandate, be satisfied that it has adequate resources to perform its responsibilities, and ensure that the director of internal audit has direct and open communication with the committee.

Where internal audit does not exist, the audit committee has an important oversight role that goes beyond the normal operational issues.

#### Recommendation 13

*The audit committee should periodically request from management a review of the need for an internal audit function and, on the basis of this review, determine whether such a function should be instituted.*

## Responsibilities with regard to disclosure of financial and related information

The audit committee mandate should set out its responsibilities with regard to the disclosure of financial and related information. Due to recent regulatory rulings, there is diverging behaviour in the U.S. and Canada that we believe deserves comment. In the U.S., external auditors (but not necessarily audit committees) are now required to review quarterly financial statements before they are disclosed.

In Canada, the Ontario Securities Commission (OSC) has recently mandated that the board review quarterly financial reports before they are distributed to shareholders. We are aware, however, of instances where financial information was released to the public by way of a press release before the audit committee or the board reviewed the quarterly reports and we do not believe that this is consistent with the intent of the OSC ruling. There is also no requirement in Canada that external auditors review quarterly financial statements prior to board consideration.

### Recommendation 14

*The OSC should revise its regulation to make it clear that either the audit committee or the board should review quarterly financial reports and related financial documents before any public disclosure of the information. Audit committees, as a matter of best practice, should ask external auditors to review this material before considering it.*

## Ongoing attention to governance

Continued improvements in corporate governance are important enough to the success of Canadian companies that focused attention should be given to these issues on a continuing basis. We appear to be developing a tradition of appointing special committees every five years or so to examine where we are and make recommendations. While this is healthy, it would be more productive if such periodic examinations could take place against a backdrop of continuing research and analysis in the area of corporate governance.

There are a number of issues that we considered in our interim report. In prioritizing, and focusing on those that can influence behaviour in the short term, we chose not to deal with all of them. Some of these, such as the issues related to GAAP accounting and the valuation of options, are appropriately on the current agenda of other organizations such as the CSA and CICA. Other issues that deserve to be pursued in more depth through other processes include the implications of the Internet for corporate governance and the appropriate response of regulators to such complex issues as electronic communication and electronic voting; the appropriate role of institutional investors in promoting healthy governance practices; developments in director liability in the U.S. and other countries and implications for Canada; the role of the board in crisis management; and the best way to provide continuing education and training for directors.

### Recommendation 15

*The Canadian Securities Administrators, in cooperation with the TSE, CDNX, the CICA and other appropriate professional bodies, should develop a program to support and encourage ongoing research, analysis and education in the area of corporate governance. They should consider establishing a standing committee or some other permanent structure that would be mandated with overseeing such a program.*

*Against this background, they should consider what arrangements make most sense for periodic reviews of the state of corporate governance in Canada and recommendations about how to improve it*

# Appendix A:

## Disclosure requirements and guidelines

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p><b>Disclosure Requirement</b> <b>Sec. 473</b></p> <p>Every listed company incorporated in Canada or a province of Canada must disclose on an annual basis its approach to corporate governance. This disclosure – a “Statement of Corporate Governance Practices” – must be made in the company’s annual report or information circular. For this purpose, “approach to corporate governance” means a complete description of the company’s system of corporate governance with specific reference to each of the guidelines set out in Section 474 and, where the company’s system is different from any of those guidelines or where the guidelines do not apply to the company’s system, an explanation of the differences or their inapplicability.</p> <p>The Exchange expects that the company’s Statement of Corporate Governance Practices will provide investors with a clear picture of the company’s approach to corporate governance including any divergence from the stated guidelines.</p>	<p>The requirement set out in Section 475 for complete disclosure with respect to each guideline (see below) should be integrated with this section for better clarity.</p>	<p>The guidelines should apply to all companies, regardless of size.</p> <p>Full and complete disclosure be required for all TSE-listed companies.</p> <p>For CDNX Tier 1 companies, CDNX should set reasonable time frames for full and complete disclosure and work with the companies to assist them in developing the capacity to comply.</p> <p>CDNX Tier 2 companies should be encouraged to disclose. It is premature to require this but compliance with the guidelines, and ultimate disclosure, should be a goal.</p>

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p><b>Guidelines</b> <b>Sec. 474</b></p> <p>The following are the guidelines for effective corporate governance.</p> <p>1) The board of directors of every corporation should explicitly assume responsibility for the stewardship of the corporation and, as part of the overall stewardship responsibility, should assume responsibility for the following matters:</p> <p>a) adoption of a strategic planning process;</p> <p>b) the identification of the principal risks of the corporation’s business and ensuring the implementation of appropriate systems to manage these risks;</p> <p>c) succession planning, including appointing, training and monitoring senior management;</p> <p>d) a communications policy for the corporation; and</p> <p>e) the integrity of the corporation’s internal control and management information systems.</p>	<p>As part of the board’s stewardship responsibility, it should develop, approve and disclose a mandate that sets out its responsibilities.</p> <p>The first and most important responsibility is to choose the CEO and this should be explicitly stated.</p> <p>The existing guidelines on strategic planning and identification of principal business risks and opportunities [(a) and (b)] should be rewritten and integrated along the lines of the discussion in the text of the final report and Recommendation 7.</p> <p>Guidelines (c), (d) and (e) should remain, although monitoring management should stand apart from succession planning and receive a higher profile in the mandate.</p>	<p>Succession planning is dealt with more specifically in Guideline #11 below.</p>

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p>2) The board of directors of every corporation should be constituted with a majority of individuals who qualify as unrelated directors. An unrelated director is a director who is independent of management and is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding. A related director is a director who is not an unrelated director. If the corporation has a significant shareholder, in addition to a majority of unrelated directors, the board should include a number of directors who do not have interests in or relationships with either the corporation or the significant shareholder and which fairly reflects the investment in the corporation by shareholders other than the significant shareholder. A significant shareholder is a shareholder with the ability to exercise a majority of the votes for the election of the board of directors.</p>	<p>The definition of a significant shareholder should be reviewed and revised in line with the discussion in the report and Recommendation 8.</p> <p>No other changes suggested.</p>	

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p>3) The application of the definition of “unrelated director” to the circumstances of each individual director should be the responsibility of the board which will be required to disclose on an annual basis whether the board has a majority of unrelated directors or, in the case of a corporation with a significant shareholder, whether the board is constituted with the appropriate number of directors which are not related to either the corporation or the significant shareholder. Management directors are related directors. The board will also be required to disclose on an annual basis the analysis of the application of the principles supporting this conclusion.</p>	<p>No changes suggested.</p>	
<p>4) The board of directors of every corporation should appoint a committee of directors composed exclusively of outside, i.e., non-management, directors, a majority of whom are unrelated directors, with the responsibility for proposing to the full board new nominees to the board and for assessing directors on an ongoing basis.</p>	<p>This guideline should deal only with recruitment.</p> <p>It should also be amended to explicitly incorporate as guidelines, the four improvements to the recruitment process set out in Recommendation 2.</p>	<p>For CDNX companies, we are not recommending the need for any committee structure other than the audit committee as required by law. The functions that the guidelines suggest be performed by committees could, in smaller boards, be performed by the outside directors.</p>

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p>5) Every board of directors should implement a process to be carried out by the nominating committee or other appropriate committee for assessing the effectiveness of the board as a whole, the committees of the board, and the contribution of individual directors.</p>	<p>This guideline should be augmented to say that:</p> <p>(a) the responsibility for ensuring that these assessments are made rests with the director who has the functions of “independent board leader”.</p> <p>(b) the effectiveness of the board and committees should be assessed against their mandates and the results should be reported to the full board.</p> <p>(c) individual assessments should be given to the individuals assessed to help them enhance their contribution.</p>	<p>The “independent board leader” may delegate this responsibility to a committee or committee chair but he or she is accountable for ensuring that assessments take place and for disclosing that assessments have been done. Results of assessments should not be disclosed.</p>
<p>6) Every corporation, as an integral element of the process for appointing new directors, should provide an orientation and education program for new recruits to the board.</p>	<p>No changes suggested.</p>	
<p>7) Every board of directors should examine its size and, with a view to determining the impact of the number upon effectiveness, undertake where appropriate, a program to reduce the number of directors to a number which facilitates more effective decision-making.</p>	<p>No changes suggested.</p>	



Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p>8) The board of directors should review the adequacy and form of the compensation of directors and ensure the compensation realistically reflects the responsibilities and risk involved in being an effective director.</p>	<p>No changes suggested.</p>	<p>Boards should ensure that compensation of the “independent board leader” and of committee chairs reflects the additional responsibilities they have.</p>
<p>9) Committees of the board of directors should generally be composed of outside directors, a majority of whom are unrelated directors, although some board committees, such as the executive committee, may include one or more inside directors.</p>	<p>No changes suggested.</p>	
<p>10) Every board of directors should expressly assume responsibility for, or assign to a committee of directors, the general responsibility for, developing the corporation’s approach to governance issues. This committee would, amongst other things, be responsible for the corporation’s response to these governance guidelines.</p>	<p>No changes suggested.</p>	

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p>11) The board of directors, together with the CEO, should develop position descriptions for the board and for the CEO, involving the definition of the limits to management’s responsibilities. In addition, the board should approve or develop the corporate objectives which the CEO is responsible for meeting.</p>	<p>The position description for the board, and in particular the limits to management’s responsibilities, should be dealt with in the board mandate under guideline 1) above.</p> <p>This guideline should be amended to also require a position description for the director having the functions of “independent board leader.”</p> <p>The guideline should also include the responsibility of the board to undertake succession planning for the CEO, and to work with the CEO to develop succession plans for senior managers.</p> <p>The director with the responsibilities of “independent board leader” should be accountable to the board for ensuring that the assessment of the CEO and the succession planning functions are carried out and the results discussed by the full board.</p>	<p>Outside directors should take primary responsibility for developing these position descriptions, in consultation with the CEO. They should be approved by the full board and be the basis for annual assessments of performance.</p> <p>The “independent board leader” may choose to delegate the assessment and succession planning functions to committees or committee chairs, but he or she should be accountable for ensuring that they are done.</p>

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p>12) Every board of directors should have in place appropriate structures and procedures to ensure that the board can function independently of management. An appropriate structure would be to (i) appoint a chair of the board who is not a member of management with responsibility to ensure the board discharges its responsibilities or (ii) adopt alternate means such as assigning this responsibility to a committee of the board or to a director, sometimes referred to as the “lead director”. Appropriate procedures may involve the board meeting on a regular basis without management present or may involve expressly assigning the responsibility for administering the board’s relationship to management to a committee of the board.</p>	<p>This guideline should be amended to state that:</p> <p>(a) the ability to carry out its responsibilities independent of management requires, among other things, strong leadership within the board from an outside and unrelated director. It is preferable, though not essential, that this leadership come from an outside and unrelated director who is the board chair;</p> <p>(b) every board should be required, as a condition of listing, to have an “independent board leader” who is an outside and unrelated director and who has all the characteristics set out in Recommendation #3 of this report; and</p> <p>(c) outside directors should meet without management present at every regularly scheduled board meeting.</p>	<p>The “independent board leader” could be the board chair, but where the board chair is a member of management or a related director, then an outside and unrelated director must be given the functions of “independent board leader”.</p> <p>It is important for outside directors to have the ability to meet at every regularly scheduled meeting, without having to ask for it. In most cases, such meetings would not last very long but the existence of the opportunity is important.</p>

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p>13) The audit committee of every board of directors should be composed only of outside directors. The roles and responsibilities of the audit committee should be specifically defined so as to provide appropriate guidance to audit committee members as to their duties. The audit committee should have direct communications channels with the internal and external auditors to discuss and review specific issues as appropriate. The audit committee duties should include oversight responsibility for management reporting on internal control. While it is management’s responsibility to design and implement an effective system of internal control, it is the responsibility of the audit committee to ensure that management has done so.</p>	<p>This guideline should be rewritten to incorporate the points made in Recommendations #11, #12 and #13 in the main text of the report.</p> <p>These recommendations deal respectively, with:</p> <p>(a) the composition of audit committees and qualification of members;</p> <p>(b) the mandate of audit committees and the development of a written mandate that would be approved by the board and disclosed;</p> <p>(c) the accountability of external auditors to the board and audit committee as representatives of the shareholder; and</p> <p>(d) the role of the audit committee in deciding whether internal audit functions should be implemented.</p>	
<p>14) The board of directors should implement a system which enables an individual director to engage an outside adviser at the expense of the corporation in appropriate circumstances. The engagement of the outside adviser should be subject to the approval of an appropriate committee of the board.</p>	<p>No changes suggested.</p>	<p>Where the board is small and there is a minimal committee structure, the approval of the “independent board leader” could substitute for that of a committee.</p>

Existing Disclosure Requirements and Guidelines	Proposed Amendments	Comments
<p><b>Complete Disclosure</b> <b>Sec. 475</b></p> <p>The disclosure regarding a company's system of corporate governance relative to each of the guidelines set out in Section 474 should be complete. While the disclosure regarding each guideline may be relatively brief it should address at least the following point:</p> <ul style="list-style-type: none"> <li>■ mandate of the board, which should set forth duties and objectives;</li> <li>■ the composition of the board, whether the board has a majority of unrelated directors and the basis for this analysis; if the company has a significant shareholder whether the company satisfies the requirement for fairly reflecting the investment of minority shareholders in the corporation and the basis for this analysis;</li> <li>■ if the board does not have a chair separate from management, the structures and processes which are in place to facilitate the functioning of the board independently of management;</li> <li>■ description of the board committees, their mandates and their activities;</li> <li>■ description of decisions requiring prior approval by the board;</li> <li>■ procedures in place for recruiting new directors and other performance-enhancing measures, such as assessment of board performance;</li> <li>■ measures for receiving shareholder feedback and measures for dealing with shareholder concerns; and</li> <li>■ the board's expectations of management.</li> </ul>	<p>This requirement for complete disclosure with regard to each guideline should be integrated with the existing disclosure requirement in Section 473.</p> <p>Each of the points enumerated in this section should be reflected in the relevant guideline.</p> <p>Where specific points are not now covered by existing or amended guidelines, for example with respect to:</p> <ul style="list-style-type: none"> <li>■ measures for receiving shareholder feedback and measures for dealing with shareholder concerns; and</li> <li>■ the board's expectations of management;</li> </ul> <p>the TSE and CDNX should consider formulating additional guidelines to incorporate these points.</p>	

## Appendix B:

### *A position description for the “independent board leader”*

An “independent board leader” is an outside and unrelated director who is designated by the full board to be responsible to the board for specific functions. The “independent board leader” is not a title. In companies that have outside directors as board chairs, the functions of the independent board leader would naturally rest with the board chair. In companies where the CEO or another member of management chairs the board, these functions should be explicitly delegated to a specific outside and unrelated director who may have whatever title the board feels is appropriate.

The responsibilities of the independent board leader may vary from company to company, and some responsibilities may receive more emphasis than others depending upon circumstances. In our view, however, the following areas should be generally recognized as the functions for which the independent board leader should be responsible.

#### 1. Providing leadership to enhance board effectiveness

The “independent board leader” should be explicitly accountable for ensuring that the board carries out its responsibilities effectively. This involves

- ensuring that the responsibilities of the board are well understood by both the board and management, and that the boundaries between board and management responsibilities are clearly understood and respected; the board leader needs to ensure that the board does its job and does not try to do management’s job;
- ensuring that the board works as a cohesive team and providing the leadership essential to achieve this;
- ensuring that the resources available to the board (in particular timely and relevant information) are adequate to support its work;
- ensuring that a process is in place by which the effectiveness of the board and its committees is assessed on a regular basis; and
- ensuring that a process is in place by which the contribution of individual directors to the effectiveness of the board and committees is assessed on a regular basis.

## 2. Managing the board

The “independent board leader” should be responsible for:

- setting the agenda of the board, in consultation with the CEO;
- adopting procedures to ensure that the board can conduct its work effectively and efficiently, including committee structure and composition, scheduling, and management of meetings; and
- ensuring that, where functions are delegated to appropriate committees, the functions are carried out and results are reported to the board.

Examples of such functions could include:

- assessing the performance of the CEO;
  - ensuring that appropriate human resource management practices (including succession, development and compensation plans) are in place for senior management;
  - ensuring that succession planning for the board is carried out; and
  - ensuring an adequate orientation and training program for new board members. In boards that do not have governance or human resources committees, the board leader should assume the responsibility for ensuring that such functions are performed.
- approaching potential candidates (with or without the CEO) once potential candidates are identified, to explore their interest in joining the board.

## 3. Acting as liaison between board and management

The independent board leader must work to ensure that relationships between the board and management are conducted in a professional and constructive manner. This involves working closely with the CEO to ensure that the conduct of board meetings provides adequate time for serious discussion of relevant issues and that the corporation is building a healthy governance culture.

## 4. Representing the corporation to external groups

At the request of the board, and with the agreement of the CEO, the independent board leader could represent the corporation to external groups such as shareholders and other stakeholders, including local community groups and governments.

# Appendix C:

## *Blue Ribbon Committee recommendations*

The following are the 10 recommendations put forward by the Blue Ribbon Committee on Audit Committee Effectiveness.

### Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organization in any of the past five years;
- a director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.



## Recommendation 2

The Committee recommends that, in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of independence for listed companies with a market capitalization of \$200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

## Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this report entitled “Financial Literacy”) or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee and, further, that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of \$200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

#### Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

#### Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to all disclosure referenced in this Recommendation 5.

#### Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

## Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

## Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

## Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report, disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have

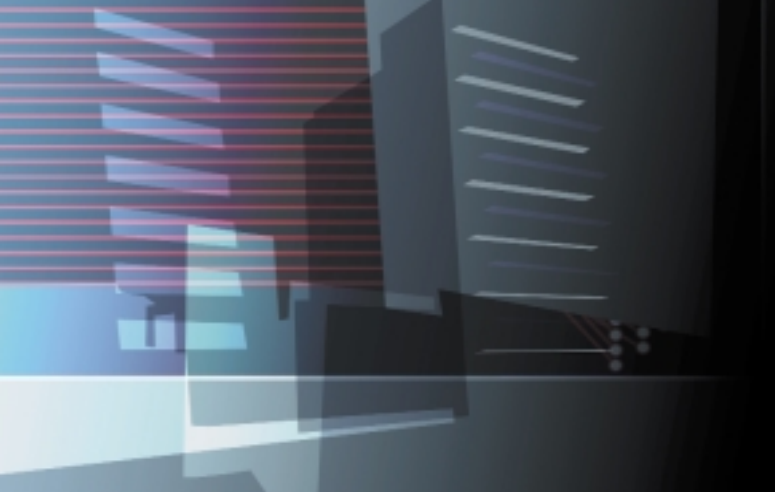
discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

### Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chair, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.



For more information, visit our Web site:  
[www.jointcomgov.com](http://www.jointcomgov.com)