"Where Were The Directors?"

Guidelines For Improved Corporate Governance In Canada

Report Of

The Toronto Stock Exchange Committee on Corporate Governance in Canada

December 1994

TABLE OF CONTENTS

COMMITTEE MEMBERS

Peter Dey, Q.C.
Committee Chair
Morgan Stanley
(formerly Osler, Hoskin & Harcourt)

Robert D. Brown, F.C.A.
Price Waterhouse

Ron Daniels
Faculty of Law
University of Toronto

Wendy K. Dobson
Centre for International Business
University of Toronto

Thomas E. Kierans
C.D. Howe Institute

David S.R. Leighton
School of Business Administration
The University of Western Ontario

J. Edward Newall
NOVA Corporation of Alberta

Purdy Crawford
Imasco Limited

Jean-Claude Delorme
Caisse de dépôt et placement du Quebec

K. Michael Edwards
Richardson Greenshields of Canada Ltd.

Claude R. Lamoureux
Ontario Teachers' Pension Plan Board

J. William E. Mingo
Stewart McKelvey Stirling Scales

Michael E.J. Phelps
Westcoast Energy Inc.

PREFACE

In Canada's complex market economy, the corporation is one of the principal vehicles for risk-taking and one of the major sources of change. The performance of our corporations is therefore of vital interest to us all. Well-functioning corporations are a key agent of wealth creation and social progress. Dull, underperforming and uncompetitive corporations represent mismanaged resources and can impede social progress.

When the economy is booming, these distinctions tend to become blurred. Instead, it is during recessions – and often with severe social consequences – that underperforming and poorly-managed corporations get into trouble. The response of the corporate sector to the stresses of the 1990-91 recession has been uneven. Investors and other parties interested in the welfare of corporations which failed or which have been significantly restructured have frequently been dissatisfied with the performance of their boards of directors and managements. They have asked the question, which we have featured in the title of our Report, "Where were the directors?".

We answer this question by taking a prospective look at the governance of corporations and by making proposals for restructuring Canada's boards of directors. These proposals are made in the context of the challenges that must be met in the turbulent and competitive world economy of the 21st century.

Our proposals, if accepted, are designed to meet growing expectations concerning the manner in which boards of directors are constituted, and the relationships between the board and management and between the board and shareholders. We propose a set of guidelines which focus on the board of directors and the quality of its members. A significant challenge for the corporate sector arising with the implementation of our recommendations will be to expand the pool of qualified directors available to constitute the boards of directors.

Upon delivery of our proposals to The Toronto Stock Exchange, our Committee will be disbanded. We nevertheless believe that a successor committee should be appointed within an appropriate time to monitor developments in corporate governance and to evaluate the continued relevance of our recommendations. It is important that the corporate sector continue to prove to investors, other stakeholders and the public sector that the governance of corporations is a top priority.

We hope that the process of the Committee for developing our proposals has enabled us to respond constructively to the challenge of our mandate. Although our budget was modest, in the context of the task at hand, the support of our sponsor, The Toronto Stock Exchange, has been generous. Its sponsorship of the project gave credibility to the exercise which it would not have enjoyed otherwise.

Our process involved the release of a Draft Report in May 1994, receipt of comments on the Draft Report and the release of this Report. The response to the Draft Report was generally positive. The Committee is grateful for the constructive comments on the Draft Report which were taken into account in preparing this Report. Although there have not been many changes to the Draft Report, the changes that have been made are significant. A summary of these changes is included in Appendix A.

We benefitted from approximately 150 very thoughtful submissions in response to our initial invitation for comments and our request for comments on the Draft Report – submissions from participants in all aspects of corporate governance in Canada. We also benefitted from numerous conversations with interested parties, both through the public meetings we conducted in the fall of 1993, the meetings on the Draft Report organized by the Conference Board of Canada in June 1994 and through numerous informal meetings. We wish to express our sincere thanks to all who provided their views to us. A flavour for these views is provided in the extracted quotations included throughout the Report. These extracts are simply a representative sample of the views received. They are not quoted to reflect or support the views of the Committee and are not necessarily endorsed by the Committee.

We also relied upon the breadth and depth of experience of the Committee members, all of whom are active in the corporate sector: some as investors; others as advisers; some as CEOs; some as independent directors; and two as academics concerned with corporate governance. Achieving a consensus within this group was not always easy and required good-spirited co-operation on the part of all members.

We wish to acknowledge the time volunteered by a number of members of the Chair's former law firm, Osler, Hoskin & Harcourt, who undertook the logistical tasks of inviting and organizing the submissions and of conducting research into a number of issues raised by the Committee. The names of these individuals are set out in Appendix B. The Chair of the Committee would also like to acknowledge the assistance and support of his former partner, David W. Drinkwater, who was instrumental in the early development and organization of the project and of the assistant to the Chair, Karin Schwarz, who managed the logistics of organizing the Committee and of producing the manuscript.

Peter Dey

Peter Dey, Chair
December 20, 1994

I. SUMMARY

Final Report

1.1 This is the Final Report of the Committee and is being released after reviewing and considering the comments received on its May 1994 Draft Report. We stress the importance of this project as an initiative of the private sector and are hopeful that the recommendations in this Report will have a higher level of acceptance because the business and financial community has had a full opportunity to comment on the issues considered and the proposals contained in the Draft Report.

1.2 If The Toronto Stock Exchange accepts our recommendation to make the proposals applicable to listed companies incorporated in Canada or a province of Canada, we suggest that these listed companies be required to describe their systems of corporate governance with reference to the guidelines commencing with companies with year ends as of June 30, 1995.

State of Corporate Governance in Canada

1.3 Implicit in our willingness to undertake the project was our view at the outset that the state of corporate governance in Canada should be reviewed and should be improved.

1.4 While there are numerous Canadian public companies which are well governed and provide a high standard of corporate governance, we believe there have been several instances of corporate breakdown attributable in part to ineffective governance. Some of these instances have been extensively reported in the media. Others have not. We believe there is a need for improved governance and, although improved governance would not necessarily have prevented corporate failures or large writedowns of assets, had these corporations been more effectively governed we believe the risk of these failures and the magnitude of the losses that occurred would have been significantly reduced.

1.5 Shareholders and other investors have experienced cause for concern regarding the general efficacy of the governance of our corporations. Although this Committee has not been established to judge historic events, we have observed that these events have contributed to a scepticism in many quarters about corporate governance in Canada.

1.6 The responsibility for ineffective governance is shared by the board and by the shareholders. Some boards have not been willing to make governance a high priority and shareholders have, by and large, been passive on matters of governance. Although we see increasing signs of shareholder arousal, shareholders in many instances have received the governance they deserve.

Implementing Our Recommendations

1.7 If The Toronto Stock Exchange adopts our recommendation for a listing requirement, each listed company incorporated in Canada or a province of Canada would be required to describe in its annual report or information circular its system of corporate governance with reference to the guidelines which we have proposed. This disclosure would include an explanation of the differences between the company's system and the guidelines.

1.8 Although the proposals in this Report are intended for public corporations, we believe that private corporations, many of which affect large sectors of the public to whom governance of the corporation is important, will find a number of our recommendations relevant to their operations.

1.9 We are not recommending that the Exchange require listed companies to comply with the guidelines. The proposal to require disclosure of differences between the companies' governance systems and the guidelines will, at a minimum, require all listed companies to examine the adequacy of their systems of governance. The disclosure approach will allow each company to develop its own system of governance, reflecting its own circumstances.

1.10 This flexibility is particularly important because of the wide range of corporations which would be subject to these guidelines. The large, widely-held public company should not generally have difficulty satisfying the governance guidelines and therefore, as a general rule, may have difficulty explaining major departures from the guidelines. The smaller company, perhaps led by an entrepreneur who has recently taken the company public, may have more difficulty in satisfying the guidelines or may even choose to adopt a system of governance which materially departs from the guidelines. We accept that the decision to depart from the guidelines may be made for supportable reasons, i.e. the board may believe that its existing system of governance is more effective in the pursuit of shareholder value or, that adoption of all of the guidelines would be too costly for a smaller enterprise or, that governance constraints may result in less risk-taking which may translate into less creation of wealth. Adoption of a system of governance different from the guidelines should not in itself give rise to liability. Nevertheless, we are sufficiently confident of the soundness of our approach that we believe the guidelines should serve as a baseline against which governance practices can be evaluated.

1.11 We recognize that the principal objective of the direction and management of a business is to enhance shareholder value, which includes balancing gain with risk in order to ensure the financial viability of the business. A system of corporate governance is only as good as its contribution to the attainment of these objectives. We believe that effective corporate governance will, in the long term, improve corporate performance and benefit shareholders. Improved corporate performance is not only in the best interests of shareholders but also serves the public interest generally. The credibility of the corporate sector depends on, amongst other things, effective governance. This credibility is essential if business is to make a full contribution to Canadian economic and social life.

Principal Recommendations

1.12 The approach we have taken in this Report is to identify what we regard as the principal responsibilities of the board of directors. These responsibilities relate to the stewardship of the corporation; the strategic planning process; the identification and monitoring of the principal risks of the business; the appointment, development and succession of senior management; the implementation of an effective communications policy and the adoption of relevant and reliable internal systems to enable the board to fulfill these responsibilities.

1.13 With an understanding of these responsibilities, we then make our principal recommendations which focus on increasing the effectiveness of the board. We do this in two ways. First, we address the constitution of the board and propose that a majority of directors on each board be unrelated directors. Unrelated directors are individuals who are free of relationships and other interests which could, or could reasonably be perceived to, materially interfere with the exercise of judgment in the best interests of the corporation. In this Final Report we conclude that a significant shareholder is not a related director and a director who has a relationship with or interest in a significant shareholder, other than through the corporation, is not a related director. We amended the Draft Report so that the significant shareholder is not a related director in order to address concerns that the significant shareholder not be constrained in implementing its strategy for the corporation by the definition of related director. We propose that each board of directors should apply this standard to its members and disclose on an annual basis whether the corporation has a majority of unrelated directors supported by an analysis of the issue. If a corporation has a significant shareholder, the board should, in addition to having a majority of unrelated directors, include a number of directors who do not have either a relationship with or an interest in the corporation or the significant shareholder and which fairly reflects the investment in the corporation of shareholders other than the significant shareholder. A significant shareholder is the shareholder with the ability to exercise a majority of the votes for the election of the board of directors.

1.14 Second, we prescribe a number of governance-related functions to be carried out by the board, normally through board committees. These functions include (i) the process of constituting the board, which would entail recruiting new directors and assessing the effectiveness of the existing board and the contribution of its individual members (ii) assessing management, which would entail meeting with management to establish objectives and meeting independently of management to monitor management's progress in relation to these objectives and (iii) establishing and administering the corporation's system of governance.

1.15 We have a general concern about the legislation creating the extensive system of director liability for corporate conduct. We accept that personal liability of directors is effective in influencing corporate conduct and that directors not satisfying the relevant standard of conduct should incur liability. However, because our proposals depend upon the availability of capable individuals of integrity to serve as directors, the extent of individual director liability should be reasonable and should not discourage qualified individuals from serving as directors. We have invited federal and provincial governments to review legislation imposing personal liability upon directors, both as to the effectiveness of the legislation in influencing corporate conduct and as to the fairness of the application to individual directors. We have recommended that in all circumstances directors must be provided with an effective due diligence defence.

1.16 We then address the relationship between the board and shareholders. Although this relationship is less complex than the relationship between the board and management it is nevertheless important — the corporation is owned by the shareholders who delegate supervision of management to the board, who in turn delegate management responsibility to the management of the corporation. We encourage two-way communication between the corporation and its shareholders. We recognize the legitimate interest of shareholders in communicating their expectations to the corporation and, in particular, the interest of holders of significant blocks of shares who may be forced to make a longer term commitment to a corporation as a result of the lack of liquidity in the market for the securities of some corporations.

1.17 Our final recommendation concerns the importance of the quality and timeliness of information published by corporations. We support the examination by Canadian securities administrators of the imposition of civil liability upon boards of directors for the accuracy of corporate disclosures concerning material changes in the business and affairs of corporations. We do not, however, support this extension of civil liability to directors unless our more general concerns about personal liability of directors for corporate conduct are also addressed.

GUIDELINES FOR IMPROVED CORPORATE GOVERNANCE

The following are the proposed guidelines for effective corporate governance:

(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:

(i) adoption of a strategic planning process

(ii) the identification of the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks;

(iii) succession planning, including appointing, training and monitoring senior management;

(iv) a communications policy for the corporation; and

(v) the integrity of the corporation's internal control and management information systems.

(paragraphs 4.2, 4.3 and 4.6)

(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. (paragraphs 5.7 and 5.8)

(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. (paragraph 5.18)

(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. (paragraph 5.25)

(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. (paragraph 5.27)

(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. (paragraph 5.36)

(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. (paragraph 5.42)

(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. (paragraph 5.50)

(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. An inside director is a director who is an officer or employee of the corporation or of any of its affiliates. (paragraph 6.3)

(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. (paragraph 6.4)

(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. (paragraph 6.12)

(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. (paragraph 6.15)

(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 communication 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. (paragraphs 6.20 and 6.21)

(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. (paragraph 6.29)

Other Recommendations

The implementation of our proposals is based upon our recommendation to The Toronto Stock Exchange that the Exchange adopt, as a listing requirement, the disclosure by each listed corporation incorporated in Canada or a province of Canada of its approach to corporate governance, on an annual basis commencing with companies with June 30, 1995 year ends. (paragraphs 8.1 and 8.2)

In addition, the Report contains recommendations for legislative reform which are summarized as follows:

(1) We recommend that the governing corporate statutes be revised to eliminate any possible interpretation of the directors' responsibility as being to manage the business day-to-day. Rather, the statutes should describe the responsibility as being to supervise the management of the business. (paragraph 4.10)

(2) The government departments responsible for the administration of the corporate laws in each of the federal and provincial jurisdictions should undertake a review of all legislation enacted in their particular jurisdiction imposing personal liability upon directors. Following the review, all legislatures should repeal or modify legislation imposing personal liability on directors which no longer serves the purpose for which it was enacted and legislation not so repealed should be amended if necessary, to ensure directors are provided with an effective due diligence defence. (paragraphs 5.60 and 5.62)

(3) We recommend that the issue of legislated civil liability upon directors in respect of timely and continuous disclosure by corporations should be examined by Canada's securities administrators and any proposal should afford the business and financial community with an opportunity to comment. We would not support any recommendations to legislate civil liability of directors for timely and continuous disclosure, unless our general recommendation concerning civil liability of directors is also accepted and implemented. (paragraphs 7.16 and 7.17)

II. CORPORATE GOVERNANCE

Meaning of Corporate Governance

2.1 What do we mean by corporate governance? The definition of corporate governance which we developed at the beginning of our exercise has evolved into the following:

> "Corporate governance" means the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value, which includes ensuring the financial viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board of directors and management. The direction and management of the business should take into account the impact on other stakeholders such as employees, customers, suppliers and communities.

"The most significant risks to the viability or survival of a company often result from the unanticipated consequences of strategic decisions, such as entry into new markets and other responses to competitive conditions. The board needs to be continually updated on changes in the company's environments and other strategic issues, so that it can deal promptly with actions proposed by management to address new opportunities and threats."

The Canadian Institute of Chartered Accountants, November 4, 1993.

2.2 The following are the key ingredients in our definition of corporate governance:

(1) Structure and process – The definition acknowledges the obvious, i.e. that the business and affairs of every corporation must be directed and managed. Direction and management of a business is achieved within a set of rules which creates a structure and is effected through a process which involves the parties who have the power to direct and manage the business.

The structure is created by the legal and administrative framework within which the corporation functions, including the corporation's governing corporate statute, the corporation's articles, by-laws, resolutions of the board and shareholders and other policies and procedures which are adopted by the corporation, laws of general application and community standards.

The process refers to the system for decision-making by the parties charged with directing and managing the business of the corporation and for making these decision-makers accountable.

(2) The objectives – We define the principal objective of directing and managing the business and affairs of the corporation as enhancing shareholder value.

Ultimately, the owners of the business, the shareholders, expect to receive an appropriate return on their investment. We amended our initial definition of corporate governance to de-emphasize the time horizon for enhancing shareholder value. We nevertheless believe that corporate strategies should be developed by taking a longer term view of the direction of the corporation and that the legitimate interest of the corporation's owners in shorter term returns are best served by a sound long term strategy.

We underline the importance of ensuring the financial viability of the business within the objective of enhancing shareholder value in order to emphasize the board's obligation to pursue shareholder value responsibly. The board must balance the implications for the financial viability of the business – a feature which must exist day in and day out – against the opportunities for generating value by pursuing particular strategies.

(3) THE PRINCIPAL PARTIES – The power for governing a corporation is allocated amongst the shareholders, the board of directors and management. The shareholders are the owners of the business. The board of directors is legally and practically charged with the responsibility of directing and managing the business of the corporation on behalf of the owners. The board delegates aspects of this responsibility to management. Each of these parties has a distinct role in the corporate decision-making process. It is fundamental that each party discharges its particular responsibilities and not confuse its responsibilities with those of another party in the process. Good corporate governance requires an effective system of accountability by management to the board and by the board to shareholders. Good corporate governance also requires vigilance by the board in overseeing management and vigilance by the shareholders in assessing corporate performance, with particular emphasis on the role of the board of directors. Good corporate governance ensures that the interests of all shareholders are protected and, in the circumstances where there is a significant shareholder, ensures that minority shareholder interests are protected.

"Simply stated, governance relates to "where a corporation is going" and management relates to "getting a corporation there". Accordingly, the traditional definition should be amended to reflect these distinctions."

H.G. Schaefer, Chairman, TransAlta Corporation, September 24, 1993.

(4) OTHER STAKEHOLDERS – A system of corporate governance also recognizes the role of other stakeholders. We have already identified the responsibility of the board to manage the corporation to enhance value for shareholders – in contrast to managing in order to address the interests of stakeholders, including employees, the community, suppliers, creditors and customers. Notwithstanding the primary responsibility of the board, the longer term interests of shareholders will not be well served if the interests of other stakeholders are not addressed. Creating shareholder wealth in a market economy will usually be in the best interests of stakeholders generally.

"The primary responsibility of the Board of Directors is to shareholders. That is not to say that they can totally ignore the interests of other stakeholders in the corporation such as employees, customers, creditors, etc. However, it is likely that the most effective board would be one in which the chairman began the meeting by saying "what can we do for the shareholders today?"

Bruce S. MacGowan, Chairman, Templeton Management Limited, September 14, 1993.

DYNAMIC CONCEPT

2.3 Corporate governance is a dynamic concept. In our recommendations, we try to recognize that the circumstances of each corporation will be different and that these circumstances will be constantly changing. An effective system of governance must not inhibit a corporation's ability to develop and to respond to its circumstances and to change. We were continually reminded in the course of our process that "one size does not fit all" or that "there is more than one road to Rome". We were also reminded of the differences between the more junior or emerging company and the mature public company.

2.4 Corporate governance should not frustrate the legitimate pressures for growth and development within the corporation. Each corporation should be encouraged to develop its own approach to corporate governance, within a broad set of general principles, although, as is apparent from our recommendations, each corporation should also be required to explain, interpret and justify its particular approach to corporate governance to its shareholders.

2.5 In the course of this Report, we will develop one of our central themes, i.e. each publicly-held corporation should undertake an ongoing assessment and enhancement of its approach to governance.

Limitations of Corporate Governance

2.6 Having said this, we also recognize the limitations of corporate governance. First, corporate governance is not an end in itself. Corporate boards and managers cannot become preoccupied with the concept to the detriment of the operation of the business. Instead, corporations must pursue the objective of enhancing shareholder value.

2.7 While good corporate governance will not, in and of itself, guarantee good corporate performance, we are convinced that effective corporate governance does make an important contribution to corporate success and to enhancing shareholder value. An enlightened approach to corporate governance is recognized in the investment community and facilitates many aspects of the direction and management of the business of a corporation. On a practical level, good corporate governance contributes to the effective functioning of boards of directors, e.g. attracting and retaining good directors and good corporate officers, establishing a due diligence defence, obtaining directors' and officers' insurance at improved rates, etc. We also are confident that over time poor corporate governance will lead to poor corporate performance.

2.8 Not only is good corporate governance recognized outside the corporation, we also believe that the approach taken by a board of directors to corporate governance will set a tone which can permeate the entire organization and enhance the decision-making processes employed at all levels in the organization.

Recommendations

2.9 The recommendations in this Report focus primarily upon making a board of directors more effective, particularly in the manner in which it is constituted but also in its relationships, both to management and to shareholders.

2.10 We have identified a set of guidelines intended to assist corporations in designing their approach to corporate governance. Even if we had the authority, we would not mandate compliance with these guidelines. As we said above, every corporation is unique and every corporation should design its own approach to corporate governance. We are, however, recommending to our sponsor, The Toronto Stock Exchange, that it require listed companies incorporated in Canada or a province of Canada to disclose, on an annual basis, their approach to corporate governance with reference to the guidelines and an explanation of the differences between the companies' approach and the guidelines. We are making this recommendation because we believe it will require each corporation to review its own approach to governance, which should result in improved governance and hopefully improved performance.

2.11 We want to underscore the importance for those who design corporate governance systems of going beyond our guidelines and understanding the principles reflected by the guidelines. We also emphasize the importance to the corporation of the process for designing its own approach to governance. In some respects the end product is secondary.

"Implicit in your report is a long-term association between strong corporate governance and corporate performance. You argue that in the normal case, corporations that conform to the standards of governance that you have set will perform more effectively over the longer term in the interest of shareholders....While I concur in your judgement, I believe it is fair to say that the empirical evidence and other research findings in support of this point, particularly in the Canadian context, are very scarce. Canada has suffered from a paucity of research on corporate governance, corporate law, corporate finance, and corporate performance....I believe it is important that as we move forward in the area of corporate governance, we increase our investment in research that will, over time, confirm, refine or refute the basic empirical assumptions that inform your report."

J. Robert S. Prichard,
President,
University of Toronto,
September 7, 1994.

"We also believe there is a direct relationship between corporate governance and investor confidence in capital markets."

Northern Telecom Limited, September 30, 1993.

"Individuals who might otherwise decline a directorship on account of concerns of personal liability may be more willing to serve if there is a prescribed process and structure of governance."

Tass G. Grivakes, Q.C.,
August 4, 1993.

Guidelines Should not be Legislated

2.12 We have received some inquiries for our views on the desirability of legislating our guidelines. We would regret embarking on this exercise if our guidelines ended up being legislated. Guidelines by their nature are not appropriate for legislation. Guidelines accommodate the flexibility of approach to governance which we think is critical for our proposals to have the desired impact.

Issues Not Addressed

"[L]et me close by stating my strong agreement that these guidelines not be legislated or enforced by a regulatory decree. A voluntary, consciousness-raising process is appropriate and adequate."

David R. Stevens, President and Chief Executive Officer, Deprenyl Animal Health Inc. June 13, 1994.

"In general, we do not believe in the need for the enactment of new laws or regulations to set new and higher minimum standards for corporate governance. The world is changing rapidly and change affects corporations in different ways at different times."

Canadian Imperial Bank of Commerce, October 15, 1993.

2.13 We have chosen to focus on board performance and decided not to deal directly with certain specific aspects of our corporate system. These include the use of subordinate or restricted voting shares, the adoption of shareholder rights plans, the use of confidential voting procedures, the format for annual shareholders meetings, the procedures for electing directors, the content of a corporation's annual disclosures to shareholders and the system for corporations communicating with their shareholders. These are important issues relating primarily to shareholder involvement in corporate governance which raise broad questions of policy which are not capable of an easy or instant answer in the Canadian environment. We note however that increasing involvement of shareholders in the governance process should mean that certain of these structural features of governance systems will only be adopted in circumstances where there is a stronger consensus amongst shareholders, directors and management as to the appropriateness of the measure for the particular corporation.

2.14 In addition, to deal with some of these issues would have greatly extended the work of the Committee without producing crisp answers, to the detriment of the utility of our Report. To the extent these issues relate to barriers to shareholder participation in the governance process, we commend them for further review and examination but note that their answers may involve working out difficult issues over an extended period of time.

2.15 Although this may be of limited solace to those who have invited us to address these issues, we do believe that the concerns about how these structures impact, in particular on shareholders, are reduced significantly if the board of directors of a company which has adopted one of these structures is strengthened and made more effective – the principal objective of our recommendations.

2.16 It also perhaps goes without saying that, apart from two recommendations concerning changes to corporate legislation affecting directors, we have accepted the basic provisions of our business corporations legislation.

III. BACKGROUND

Financial Stress

3.1 The Canadian economy, as with many others, is in a period of transition. It is adjusting to such developments as the increased globalization of business, the removal of trade barriers, rapid changes in technology, the shock of the dramatic decline in real estate values, and the other stresses created by the recent economic recession. These developments have contributed to the failure of some significant companies, particularly in the financial industry. These failures have given rise to public concerns and have raised questions about the roles of directors and management. The question has often been asked: "Where were the directors?" These public concerns were in part responsible for the formation of this Committee.

3.2 We are in an era of openness and accountability. A current example is the enactment of the Ontario rules requiring disclosure of executive compensation. These rules are intended to enable shareholders to better relate executive and corporate performance to compensation. The amount of executive compensation and the process for determining the amount are high profile aspects of corporate governance studied with interest by many who have no direct stake in the subject.

3.3 We have also observed the plight of the corporation under severe financial stress, and in desperate need of the leadership of a qualified board of directors, but instead having to sustain the resignation of members of the board because of concerns about personal exposure to liabilities imposed upon directors.

3.4 These developments have led to increased media coverage and public focus on how corporations function and contribute to a perception that the performance of businesses generally is not as good as it could be. This, in turn, leads to the conclusion that one way of improving performance would be to improve governance of the corporations or, at the very least, to establish standards for governance against which companies can measure themselves and be measured.

Private Sector Initiative

3.5 The TSE, being acutely aware of the importance of investor perception and confidence to efficient capital markets, supported the undertaking of this project to, in part, address this issue of perception.

3.6 The project was also inspired in part by a desire for the private sector to initiate and to lead a review and to establish any reforms of standards of corporate governance. There has been some recent public sector involvement in the development of certain aspects of corporate governance. The securities regulators have been active in developing these standards with the adoption of such policies as the comprehensive and detailed Ontario Securities Commission Policy 9.1 dealing with transactions between related parties and the judgment of the OSC in the Standard Trustco case in which the Commission examines and comments upon board practices concerning board reliance upon management and the publication of information on a timely basis. The administrators of some of our Canadian federal and provincial corporate statutes are also aware of many of the weaknesses in our system and have undertaken reviews of their respective statutes to determine whether statutory amendments are necessary.

"When insolvency threatens, the traditional protections for directors vanish...It is little wonder that directors' reaction is often to abandon ship, even recognizing that, by doing so, they may not escape liability entirely. It is safe to assume that the legislators who created such a vast array of directors' liability did not intend to create the "board overboard" phenomena. It clearly serves no one's interests: shareholders, creditors, employees or governments."

The Board of Trade of Metropolitan Toronto, September 28, 1993.

"In short, the question to ask is not just "Where were the directors?" As important are questions such as:

- **Are the sanctions and enforcement procedures relating to the failure of directors to act in a proper manner effective and appropriate?**
- **Where were (or are) the shareholders?**
- **Where were the regulators?**
- **Are the rules of behavior and legal standards for directors clear enough?**
- **Was the law enforced, and if not, why not?"**

R.J. Wright, October 5, 1994.

3.7 This is not to say that the securities and corporate regulators and courts do not have an important role in developing corporate governance standards. However, many submissions advocated, and the Committee agreed, that self-regulation is preferable and that standards developed by those involved may be more acceptable to the private sector and therefore more enduring. In addition, the sense of the Committee is that a private sector examination of corporate governance practices and development of guidelines can produce a more constructive and flexible corporate response than the more black and white response engendered by statute or regulation. Many of the submissions to the Committee expressed dismay at the current level of regulation of business in Canada and advocated measures to enhance our corporate governance only if the measures did not involve more regulation.

"While we support the Committee in its review of corporate governance, it is our view that the existing laws and regulations are adequate and that the focus should be on encouraging corporations, perhaps by voluntary guidelines, to adopt more effective internal procedures, where required."

Josef J. Fridman, Senior Vice-President, Law, BCE Inc., October 6, 1993.

Recruiting Directors and Personal Liability of Directors

3.8 The central role of the board of directors underlines the importance of there being a pool of qualified individuals available to serve as corporate directors. The Committee heard anecdotal evidence as to the increasing unwillingness of individuals to sit as directors because of the potential exposure to personal liability for corporate conduct. The laws exposing individual directors to liability for corporate conduct have developed incrementally. This is not surprising in view of the extent of regulation and the multiplicity of jurisdictions in which corporations conduct business. While the Committee accepts that imposing personal liability on directors can be an effective tool for influencing corporate conduct, the Committee is nevertheless concerned with the impact of excessive personal liability on the constitution of effective boards of directors and, ultimately, with the impact upon effective corporate governance.

"Institutional investors now hold a very high proportion of the shares in Canadian public companies and with the relative liquidity of the Canadian equity markets that means that such institutional investors are, in fact, long-term holders of those shares. Given that development, it is their responsibility to begin thinking like an owner rather than a trader of shares and attempt to bring about positive change at a company when deemed appropriate rather than merely selling shares."

Dale E. Richmond, President & C.E.O., Ontario Municipal Employees Retirement Board, September 30, 1993.

Responsive Shareholder Community

3.9 An effective system of corporate governance depends upon an informed and responsive shareholder community. The information provided to shareholders must be timely and must be reliable. Our sense is that the investor community wants to be more responsive to corporate initiatives. Large shareholders in particular recognize that liquidating a stock position comes at a price which they are often not willing to incur. Shareholders increasingly want to behave more like owners and to influence corporate performance by having a larger say in the governance of the corporation. Institutional shareholders, because of, amongst other things, their substantial resources and influence, are in a particularly good position to contribute to the corporate governance process. A more active shareholder community is essential to an enhanced level of corporate governance.

3.10 The relationship between the board of directors and the corporation's owners is an important aspect of corporate governance addressed in our Report. Notwithstanding the spate of fairly recent secondary offerings by significant shareholders, a distinguishing feature of the Canadian corporate landscape is the number of public companies which have a significant shareholder – a shareholder whose holdings are such that it can exercise or influence the control of the company. Control is ultimately exercised by electing or influencing the election of the board of directors. Many Canadian companies are members of groups of companies under the common influence of one shareholder or group of shareholders. A frequent result is "related-party transactions" within these groups of companies. We detect a healthy degree of scepticism within the shareholder community about the ability of directors to represent the interests of all shareholders in the context of a related-party transaction. We also detect an extension of this scepticism to the ability of boards to effectively represent the interests of all shareholders in other circumstances. One of the objectives of this exercise is to address the perceptions that give rise to this skepticism and to improve the contribution of directors to the governance of corporations.

Responses to the Committee

3.11 These were some of the concerns which provided the basis for the original formation of the Committee. With the benefit of the experience gained in the course of this exercise, we note two further reasons which might have been used to support the establishment of the Committee. First, it is apparent from the excellent response to the Committee's initial invitation for comments and the comments on the Draft Report, that our project provided an opportunity for those concerned with corporate governance to pause and reflect upon their particular approach to the issue. This process of self-analysis in itself has increased awareness of the issue, raised the level of the debate and has already produced improvements in approaches to governance.

3.12 Second, the pause and reflection has produced some very thoughtful submissions to the Committee which are on public file at The Toronto Stock Exchange and available to students of corporate governance. With the benefit of these views, we have had the opportunity to consider and develop guidelines for effective corporate governance. These guidelines can be used as standards against which companies, their shareholders and other stakeholders can judge the adequacy of their particular approach to corporate governance.

Further Comment on the State of Corporate Governance

3.13 Our views on the current state of corporate governance in Canada are set out in Part I, the Summary. We have identified some serious concerns raised by thoughtful participants in our capital markets which deserve an answer. In some instances we found corporate governance practices in a very advanced and enlightened form. On the other hand, we believe there have been several notable failures and these failures have shaken public faith in our system.

3.14 We have described above some of the strains to which our corporate governance system has been exposed. It is also apparent to us that there is a fairly broad range of corporate governance practices – not surprising, in view of the diversity in the nature of the businesses, the size and ownership of companies, and the range of maturity of companies. In our recommendations we hope to provide guidance for improving governance, whether the company is large and widely-held or small and emerging.

3.15 We note with interest the strong response of CEOs to a survey conducted by the Business Council on National Issues. The result of this survey would give corporate governance in Canada a mere passing grade. We think this reflects a mutual assessment by management and boards that management can make better use of directors and directors should provide more direction to management. We also have the impression that the "sacking" of some high-profile CEOs has made CEOs acutely aware of the need for management to be completely in touch with the board, to understand board concerns and to

"It has been estimated that over 75 per cent of the corporations whose securities are listed and traded on the TSE are legally or effectively controlled by a majority shareholder…The same principles of corporate governance should apply to boards of directors of such corporations…Although a majority shareholder has an incentive to monitor the performance of management of a corporation that it controls, this incentive is not sufficient to remove the need for the measures outlined above with respect to the composition and structure of a board of directors."

Fairvest Securities Corporation, September 28, 1993.

"It must be acknowledged that the holdings of large institutional investors are long term, and cannot be sold easily. Therefore investment criteria should include long term suitability, rather than quick share price appreciation. In other words, this means altering the criteria traditionally used to assess investments. In addition, the long term nature of holdings requires that institutional investors reassess the way they measure their own investment performance."

Dr. John T. Por
Cortex Applied Research Inc.
June, 1993.

respond constructively to these concerns. These events also reflect an improved awareness by directors of their responsibilities.

Committee Process

3.16 The process undertaken by the Committee to obtain input and to inform itself on the issues of corporate governance in Canada was quite informal. A more detailed discussion of the process is included in Appendix 3.16 which also contains a list of submissions made to the Committee, a list of the presenters at the public meetings and a list of the submissions on the Draft Report.

Relationship to The TSE

"Governance practices and effectiveness vary considerably throughout the corporate sector, even among identifiable segments such as publicly traded companies, privately held companies and non-profit corporations. Canada lacks clear rules and, more importantly, clearly defined expectations of corporate directors and officers. This lack of clarity and the consequent conflicts in accountability of corporate leaders to widely divergent interest groups is creating a growing reluctance on the part of many of our best qualified leaders to serve as corporate directors. This impedes our corporate sector's ability to compete effectively in the global marketplace."

The Guarantee Company of North America, September 30, 1993.

3.17 By way of background, we should also clarify our relationship to The Toronto Stock Exchange. The Exchange has been a supportive sponsor for the project and has requested the Committee to express its views on corporate governance in Canada and make recommendations for improvement. The Exchange has not participated in the Committee process or deliberations and any action it takes in respect of the Committee recommendations will result from a process independent of the Committee process.

The Cadbury Report

3.18 An important introductory note relates to the value we derived from The Report of the Cadbury Committee, the Report on the Financial Aspects of Corporate Governance in the United Kingdom. The reader may find it useful to compare the exercise which we undertook and our recommendations with the process and recommendations of the Cadbury Committee. The comparison will assist in the understanding of our recommendations.

3.19 However, it should be understood that the Cadbury Committee was convened to study the financial aspects of corporate governance of U.K. public companies. It should also be borne in mind that the central recommendation of the Cadbury Committee was that public companies have at least three independent directors and that the boards of these companies appoint an audit committee comprised of independent directors. These recommendations reflect the tradition that boards of U.K. public companies have a majority of management, or executive directors and the absence of a statutory requirement for the appointment of an audit committee with responsibility to review financial statements.

3.20 The Canadian tradition reflects the North American approach which is for public companies to have a majority of non-executive directors. In addition, Canadian corporate legislation generally requires the appointment of an audit committee of the board of directors, the majority of whom must not be officers or employees of the company. Notwithstanding these different traditions, there are a number of useful parallels which can be drawn between U.K. and Canadian public companies in the constitution and functioning of their respective boards of directors. One, in particular, is the need in both jurisdictions for truly independent directors.

The Treadway Report

3.21 Another report considered by us was the Report of the National Commission on Fraudulent Financial Reporting dated October 1987 (sometimes referred to as the Treadway Report), which focused on factors associated with fraudulent financial reporting in the United States and made recommendations to reduce incidents of that type of reporting by U.S. public companies.

3.22 The Treadway Commission made recommendations for both public companies and independent public accountants. The central recommendation for public companies was the requirement that they have audit committees composed entirely of independent directors whose duties and responsibilities are set forth in a written charter. One of the audit committee's responsibilities should be an annual review of management's ability to monitor the company's compliance with a written code of corporate conduct.

3.23 The written code would relate to the company's internal accounting controls and policies designed to avoid fraudulent financial reporting. The Treadway Report also emphasized the need for top management to "set the right tone" in the company to encourage employees to avoid fraudulent financial reporting.

"Corporate governance in Canada is at best mediocre. While this must in the final analysis be a subjective evaluation, the landscape is littered with companies who evidence no real strategic direction, little sensitivity to emerging opportunities, and real myopia when it comes to management competence and succession planning."

Stan M. Stewart,
Managing Director,
Strategic Associates Incorporated,
July 22, 1993.

The MacDonald Report

3.24 In Canada, the MacDonald Commission reported in 1988 to The Canadian Institute of Chartered Accountants with recommendations for improving the role of auditors and the flow of financial information to directors and shareholders of Canadian public companies. The impetus for creating the MacDonald Commission was the failure of several Canadian financial institutions. Flowing from its mandate, the MacDonald Committee recognized the need for Canadian public companies to improve the quality of financial disclosure made available to their directors and shareholders.

3.25 The Report of the Commission to Study the Public's Expectations of Audits prepared by the MacDonald Commission agreed with the Treadway Report that all public companies should be required by law to have an audit committee composed entirely of independent directors. The MacDonald Commission added that it would be useful for an inside director to be designated as an advisor to the audit committee for consulting on management's financial practices. Again, while the objectives of the MacDonald Report and the Treadway Report are different from our focus, the reader may find it useful to review them in light of the corporate governance issues associated with financial reporting.

IV. BOARD RESPONSIBILITIES

4.1 Our analysis of the role of the board of directors involves a discussion of the responsibilities of the board, the process for constituting the board and some suggestions as to the functioning of the board. Parts IV, V and VI of the Report address these issues.

Stewardship of the Corporation and Other Principal Responsibilities

4.2 Before discussing the technical legal obligations of the board, we want to identify the principal responsibilities of the board. *We propose as our first guideline to improved corporate governance the explicit assumption by the board of these responsibilities.*

4.3 *In our view the board has five specific responsibilities which facilitate the discharge of the board's stewardship responsibilities.* By stewardship we mean the responsibility of the board to oversee the conduct of the business and to supervise management which is responsible for the day-to-day conduct of the business. In addition, as stewards of the business, the directors function as the catchall to ensure no issue affecting the business and affairs of the company "falls between the cracks".

4.4 In supervising the conduct of the business, the board, through the CEO, sets standards of conduct for the enterprise. These standards include the general moral and ethical tone for the conduct of the business, the corporation's compliance with applicable laws, standards for financial practices and reporting, qualitative standards for products of the business and so on. These standards should reflect the view of the board of directors as to conduct in the best interests of the corporation.

4.5 Stewardship also requires the board to assess and manage the risks of the corporation's business with the objective of preserving the corporation's assets. While the creation of shareholder value is the fundamental objective of the board, equally important is the protection of the value of the enterprise against significant erosion.

4.6 Five specific responsibilities which we regard as the principal responsibilities to be discharged as part of the board's overall stewardship responsibility, are as follows:

(1) Adoption of a Strategic Planning Process – The CEO, with the active involvement of the board, is responsible for leading the company into the future and therefore must ensure that there are long term goals and a strategic planning process in place. The leadership for this process must come from management. The board should bring an objectivity and a breadth of judgement to the strategic planning process because the board is not involved in the day-to-day management of the business. The board must ultimately approve the strategy as it evolves.

The board is also responsible for monitoring management's success in implementing the strategy.

(2) Managing Risk – The board must understand the principal risks of all aspects of the business in which the corporation is engaged and,

"The focus of the Centre's submission is the concept of the dual nature of the modern business corporation, as both an economic institution and a social institution. As an economic institution, it is a basic premise that the objective of a business corporation is to conduct its activities with a view to enhancing profit for the benefit of its shareholders. This premise is well understood and widely accepted. However, it should be equally fundamental that, as a social institution, a corporation in the conduct of its business activities take into account those ethical principles and considerations that are reasonably regarded as appropriate to the responsible conduct of business."

Canadian Centre for Ethics & Corporate Policy, October 29, 1993.

"Most companies, particularly those that are diversified, do not adopt a single corporate strategy. They are more likely to have a variety of strategies based on evaluations of the competitiveness and positioning of the company's business or businesses. Furthermore, through the use of the term "planning", emphasis would be placed on the development of strategies as an ongoing, not periodic, process. This gives proper recognition to the importance of keeping strategic plans current and of constantly reviewing important issues."

Imasco Limited, October 3, 1994

"Canadian corporate law assigns to directors the primary responsibility for both the financial reporting process and the product. In practice, the board of directors delegates day-to-day responsibility to management. It is vitally important that both groups - the board and management - understand the extent of their responsibilities. Responsibility for the product is generally well accepted and understood; in our judgment, there is less recognition of the direct responsibility for the process."

Price Waterhouse, September 30, 1993.

" 'Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.' "

"...In Canada, the need to define best practice with respect to corporate governance has become a pressing issue, especially since the economic recession has exposed certain shortcomings in Canadian businesses and financial reporting practices, particularly in the financial institutions section. The need or demand for management reporting on internal control has not been a significant issue in Canada up until now, largely we believe due to complacency among the various institutional groups, i.e. regulators, shareholders, investors, auditors and lenders."

Coopers & Lybrand, October 19, 1993, quoted from the Report of the Treadway Commission and from submission.

recognizing that business decisions require the incurrence of risk, achieve a proper balance between the risks incurred and the potential returns to shareholders. This requires the board to ensure that there are in place systems which effectively monitor and manage these risks with a view to the long term viability of the corporation.

(3) APPOINTING, TRAINING AND MONITORING SENIOR MANAGEMENT – The third principal responsibility of the board reflects the fact that the board functions through delegation to management. The board must ensure management of the highest calibre in appointing, training, assessing and providing for succession. The key to the effective discharge of this responsibility is to appoint the best CEO for the job. The CEO will be the corporation's business leader. The board will assess the CEO's performance against objectives established by the board in cooperation with the CEO and will assess his or her contribution to the achievement of the corporate strategy. The process for determining the CEO's remuneration should be a formal process using established criteria including the assessment referred to above.

The board must ensure that objectives are in place against which management's performance can be measured. Not only is this a sensible management approach but the relationship between management performance and compensation must be reasonable. This relationship is being closely monitored by the investment community as a result of the fairly recent executive compensation disclosure requirements.

The board must also be satisfied that the corporation has in place programs to train and develop management and must also provide for the orderly succession of management.

(4) COMMUNICATION POLICY – The fourth principal responsibility of the board is to ensure the corporation has in place a policy to enable the corporation to communicate effectively with its shareholders, other stakeholders and the public generally. This policy must effectively interpret the operations of the corporation to shareholders and must accommodate feedback from shareholders, which should be factored into the corporation's business decisions.

We also note the critical role of the media in publishing and interpreting corporate information.

(5) THE INTEGRITY OF CORPORATE INTERNAL CONTROL AND MANAGEMENT INFORMATION SYSTEMS – Implicit in the effective discharge of the responsibilities we have identified is the implementation of control and information systems which ensure the effective discharge of these responsibilities. For example, in approving a corporate strategy, the board will identify various criteria for measuring the strategy. The board will have to ensure that there are effective systems in place for tracking these criteria so that it can monitor the implementation of the strategy. Similarly, in reviewing and approving financial information, the board will want to ensure the corporation has an audit system which can inform the board on the integrity of the data and the compliance of the financial information with appropriate accounting principles. The board's management of other important areas of corporate conduct, such as the

commitment of the corporation's assets to different businesses or action affecting the environment, should also be supported by effective control and information systems.

Even though the existence of such systems is implicit in the discharge of the board's responsibilities, we believe it is important that the board be required to focus on the machinery upon which the board must rely to discharge its other responsibilities.

4.7 We agree with the position taken in both the Cadbury Report and the Report of the Treadway Commission that all public companies should be required to report on the adequacy of internal controls on financial reporting and regulatory compliance as part of their annual report. However, before this proposal can be implemented a satisfactory framework of reporting on internal financial control and regulatory compliance has to be developed. The definition and the form of management reporting and the nature of the auditor's involvement in the reporting will have to be developed by appropriate management, investor, accountant and regulatory representatives. We support the process which is being led by the Canadian Institute of Chartered Accountants to address these reporting requirements.

4.8 It is apparent from this list that today's board of directors should be less concerned with transactions and more concerned with the systems which support the board's direction of the corporation's business. This may be less true for smaller companies where individual transactions still loom large in relative importance.

4.9 We also want to emphasize the desirability for the board to take a forward-looking approach to decision-making rather than focussing on past results. The board needs to be less dependent upon historic financial information and instead should demand information which provides a broader base for measuring the performance and assessing the future prospects of the business.

Legal Definition of Board Duties

4.10 The definition of the responsibilities of the board of directors in modern business corporations statutes requires the board to "manage the business and affairs of a corporation". Many have suggested that this description is out of date. Today a board may supervise, direct or oversee but it cannot manage, at least not in the day-to-day sense. Day-to-day management must be delegated to others. Some statutes, recognizing the inability of the board to literally manage the business and affairs of the corporation, have been revised to define the general duty of the board to "manage or supervise the management of the business and affairs of a corporation" *(Ontario Business Corporations Act,* section 115(1)). We think the revised language accommodates a more realistic definition of the duties of today's board of directors. We received other interesting expressions of the board's responsibility, e.g. "development of the overall strategic direction, and policy framework for the enterprise". Some commentators, on the other hand, have said that directors ultimately do manage the business and that day-to-day management is simply delegated by the board to the officers. *To eliminate this confusion, we recommend that governing corporate statutes be revised to eliminate any possible interpretation of the directors' responsibility as being to manage the business day-to-day and to describe the responsibility as being to supervise the management of the business.*

"The traditional definition [of board duties] is, in our view, inappropriate because it is inconsistent with reality and creates for the uninstructed a misunderstanding as to how boards can be reasonably expected to function."

Ogilvy Renault, October 26, 1993.

"The duties of directors should be redefined. The general thrust should be along the lines of a duty "to supervise the management of the business and affairs of the corporation and to establish such policies and guidelines to govern the corporation as the directors consider appropriate to the business of the corporation."

John R. Moffat, September 30, 1993.

"The Committee has indicated that one aspect of corporate governance requires a board to ensure the financial viability of the business. We agree that, in reviewing critical strategic and other decisions, a board must take into account the potential impact such decisions will have on a company's financial viability as part of its stewardship role. However, we do not believe that a board can or should be required to "ensure" financial viability given the fact that competition and many other external factors outside the control of the board can and usually do have major impacts on any business. Accordingly, we would propose that financial viability be "taken into account," rather than ensured, as part of the long-term goal of enhancing shareholder value..."

Scott M. Hand,
Inco Limited,
October 11, 1994.

The Interests Represented by the Board

4.11 We want to clarify the definition of the interests which the board must represent. The business corporations statutes require directors to act "with a view to the best interests of the corporation". The expression of the interests which must be reflected in a board's decisions is often extended from the interests of the corporation to the interests of the shareholders generally on the theory that the ultimate responsibility of the board is to create value for the shareholders and therefore what is in the best interests of the corporation should generally also be in the best interests of the owners. The obligations of a board do not change whether the duty is expressed in terms of acting in the best interests of the corporation or in terms of acting in the best interests of shareholders generally. We note that officers of the corporation are, in addition to the directors, also obligated to act with a view to the best interests of the corporation.

"Governance is not advanced by having directors who reflect views of particular interest groups. Every director must act at all times in the best interests of a corporation including all its shareholders."

H.G. Schaefer, Chairman, TransAlta Corporation, September 24, 1993.

4.12 We wish to emphasize that if the extension is made from the "corporation" to "shareholders generally", the board cannot use this extension to define its obligations in terms of the best interests of any single shareholder or any shareholder group. It is not unheard of for some directors to reflect the best interests of a significant shareholder rather than the best interests of the corporation in a corporate decision. Directors must be scrupulous in identifying what they regard as the best interests of the corporation or of shareholders generally, whether this interest conflicts with or coincides with the best interests of a particular shareholder. A board of directors is not a parliament where elected members represent the best interests of their constituency. Directors have only one constituency and that is the corporation and its shareholders generally. Although this should not have to be said, there are some directors who erroneously believe that if a particular shareholder is responsible for their election, the director should represent the best interests of that shareholder in his or her corporate decision-making.

"Although we recognize that stakeholders other than shareholders may have interests which may be affected by board decisions, we take issue with the notion that a board has duties to such stakeholders other than as may be mandated by contract or by existing legislation. Directors have a clear duty to manage the business and affairs of the corporation. While directors may, if deemed appropriate, consider the interests of other stakeholders in making decisions, the Report should emphasize that the overriding duties are nevertheless owed to the corporation and its shareholders and that these duties must at all times prevail."

R.D. Southern, Chairman ATCO LTD. October 4, 1994.

4.13 In some circumstances, the interests of shareholders may not coincide with the interests of the corporation. For example, suppose the shareholders of a corporation receive an offer to purchase their shares at a very attractive price from a bidder who intends to sell parts of the corporation's business and to integrate other parts with the business of the bidder. The consequences of the proposed disposition by the shareholders may be negative for the long term viability and growth of the corporation although it could represent a very attractive opportunity for the shareholders to realize on their personal investments. In these circumstances, if a disposition is reasonably certain, the board's responsibilities may be construed by the courts to place specific emphasis on the best interests of the shareholders.

4.14 The obligation of directors and officers of a corporation to act with a view to the best interests of the corporation is included in what is generally referred to as the "statutory duty of care" of directors and officers which reads as follows:

> "Every director and officer of a corporation in exercising his powers and discharging his duties shall
>
> (a) act honestly and in good faith *with a view to the best interests of the corporation;* and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."

(Canada Business Corporations Act, s.122(1) emphasis added.)

Our discussion has focussed on the interests which must be reflected in decisions of the board because it appears to be an area of confusion in the definition of directors' responsibilities. The other aspects of directors' duties, i.e. the duties to act honestly and in good faith and to exercise due care and diligence, are not so confused and are therefore addressed only peripherally in our recommendations. Effective governance facilitates the discharge of these duties of care and good faith.

4.15 We should note a distinct feature of Canadian business corporations statutes and that is the existence of the oppression remedy. Under corporate law directors can be sued by disgruntled shareholders if they have exercised their powers in a manner "...that unfairly disregards the interests of any securityholder...". While a director cannot act in the best interests of a particular shareholder, in order to avoid an oppression action, the board should be sensitive to the adverse impact of a corporate action on particular groups of shareholders.

4.16 The policy considerations underlying the definition of the board's responsibility to act with a view to the best interests of shareholders generally, rather than with a view to the best interests of other stakeholders, is fundamental to capital formation and the financing of business corporations. Investors will only commit funds to the corporation if they know that the board will make decisions reflecting the best interests of the corporation and its owners. Other stakeholders, of course, also make significant commitments. Their interests are generally protected in the terms of the contract establishing their relationship with the corporation and, in many instances, by "stakeholder statutes", such as environmental laws, which impose specific duties upon boards of directors in relation to the interests of the particular stakeholder. We have already noted that the board will consider the position of other stakeholders in determining the best interests of the corporation. But we also noted that a definition of board responsibilities to act in the best interests of a broader group than the corporation's shareholders would confuse the board's responsibilities and significantly undermine the accountability of the board of directors.

4.17 Having said that directors have no corporate law duty to act in the best interests of any particular stakeholder group, it is obvious that a board cannot make a decision without understanding the implications of its decision for this broader group of stakeholders. In making decisions to enhance shareholder value the board must take into account the interests of other stakeholders. In today's environment it is difficult for a corporation to prosper if it is not "on side" with all of its stakeholders.

"When moving from analysis and description to recommendations and guidelines it is these normative assumptions which become critical. The conflict we perceive in the draft report arises just here. The report relies on the model of stockholder theory for much of its analysis, but reflects a dissatisfaction with the normative assumptions of that model and attempts to incorporate the values of stakeholder theory. The predominant economic theory and ideology in a particular society or culture have a profound influence on legal, economic and market systems. In Canada and the U.S. stockholder theory and ideology have resulted in what can be called "stockholder capitalism". We maintain that this is being replaced by "stakeholder capitalism", and that successful corporations are in fact managed in order to satisfy, and retain the participation of, their primary stakeholder groups."

Max B.E. Clarkson, Michael C. Deck University of Toronto, Faculty of Management, July 1994.

"We think it confusing, in any event, to equate these 'stakeholders' with the shareholders, who own the corporation to which the directors owe a fiduciary duty. We do not believe that such a duty should be imposed in favour of these other groups. To the extent that specific obligations in favour of any of these groups should, in the view of government, be imposed on the corporation, this should not be a fiduciary obligation imposed on the directors as a matter of corporate law. It is difficult enough in the fiduciary context to adequately serve one master."

Fasken Campbell Godfrey, October 5, 1993.

V. CONSTITUTING THE BOARD

5.1 Part V of the Report proposes guidelines concerning the constitution of the board and the corporate process for constituting the board. The so-called nomination process together with certain governance-related processes or functions of the board identified in Part VI are also central to an effective governance system.

Establishing Criteria for Board Directors

5.2 There are many criteria which are applied by those responsible for recruiting new directors. For example, Texaco Inc. spells out ten criteria which it uses in considering a candidate for election to its board. These criteria relate to ethics, education, experience, personality, time availability, involvement in activities which don't conflict with the company's business and so on. Each board should have its own set of criteria for identifying board candidates. These criteria will change from time to time and will vary somewhat from board to board and do not need to be spelled out in a corporate governance guideline.

5.3 There is, however, one feature of the board composition, a constitutional feature, which we think is important and should be spelled out in our governance guidelines. This feature relates to the constitution of a board which is both capable of exercising independent judgment and which is perceived as being capable of exercising independent judgment.

Application of Guidelines

5.4 Below, we have proposed as a governance guideline that a majority of each board of directors should be unrelated directors. In examining this proposal, it should be remembered that the proposal is expressed as a guideline because we do not believe it is appropriate for all corporations. For example, the entrepreneurially-driven emerging corporation may not comply with the guideline in many instances and likely for good reasons. The entrepreneur, who may also be the controlling shareholder, will want to constitute a board which may include a number of the individuals who have contributed to his or her success and with whom he or she, and the investment community, may be comfortable. The entrepreneur may also be concerned that complying with governance guidelines will result in less risk-taking which may translate into less wealth creation.

5.5 We nevertheless believe the guideline should represent an objective which all corporations should ultimately seek to satisfy. Even those corporations which do not currently satisfy the guideline should have a group of unrelated directors to ensure there exists within the board a point of view independent of management.

The Law Requires Independent Judgment Regardless of Relationships

5.6 In Part IV we discussed the obligation of the directors to act with a view to the best interests of the corporation. In the context of the discussion in this Part, relating to the constitution of the board, we refer to this obligation as the obligation to exercise independent judgment. The law requires directors to exercise independent judgment, regardless of the existence of relationships or interests which could interfere with the exercise of independent judgment. Accordingly, by recommending that each board have a majority of unrelated

"It has to be acknowledged that public perceptions are important and that a board of directors with a majority of independent directors is viewed as a stronger/better board than one without an independent majority. Credibility can best be enhanced by defining "independent" in a way which excludes any involvements which would generally be construed as impairing objectivity. A definition of independence that reflects the public's general understanding of independence is necessary to enhance the credibility of boards of directors."

Deloitte & Touche, October 20, 1993.

"The proposition that all corporations should develop and report to shareholders their approach to corporate governance is reasonable. However, each corporation should have the room to develop an approach that is in its, and thereby its shareholders', best interests.

Smaller companies and/or companies with a controlling shareholder are not intrinsically suited to the guidelines in the draft report. The guidelines contemplate a board of directors capable of running a company without senior management and implicitly postulates that such a board is preferred. For smaller especially closely held companies... it is appropriate that management be well represented on the board. It also is appropriate that the controlling shareholder, which may be synonymous with management be represented on the board and on committees of the board. By being represented on the board a controlling shareholder is protecting shareholders' interests so that a proper balance between management and shareholder interests can be maintained."

Martin Goldfarb, Chairman, Goldfarb Consultants, July 18, 1994.

"It is a question of their [directors'] values, strength of character and willingness to challenge management and fellow directors when this is appropriate. Technical requirements do not ensure effective independence of views."

Canadian Imperial Bank of Commerce, October 15, 1993.

"All directors are subject to the same duty of care to the corporation. At issue is not whether a director is related or unrelated. The real issue is whether the director is performing his or her corporate governance role effectively. Non-relatedness, in our view, is not a good proxy for the existence of independent judgement. Rather, attracting individuals with integrity, good judgement, and significant business experience to a Board is the best way to ensure that a company's directors will exercise independent judgement and provide effective corporate governance on the issues facing the company."

Canadian Bankers Association, September 13, 1994.

"We believe that lawyers are in a position to make a valuable contribution as directors, given the nature of their training and professional practice. Indeed, a lawyer who is counsel to the company may be especially well positioned to be an effective and independent voice, given the deeper understanding of the company's affairs that is developed by advising on a continuing basis. We do not believe that the lawyer/director's effectiveness in this regard should be undermined by an inference that the lawyer is a puppet of management. While one might say that this exaggerates the potential effects of the Report, we believe it is the inevitable result of any suggestion that a director is personally beholden to management."

Arthur R. A. Scace, McCarthy Tétrault, September 12, 1994.

directors, we are not suggesting that those directors who do have a relationship can allow that relationship to influence their judgment.

Majority of Unrelated Directors – No Guarantee of Independent Judgment

5.7 We recognize that the existence of a relationship which would characterize a director as a related director does not mean that the director will not exercise independent judgment. Indeed, we are aware of many circumstances where individuals who do have a relationship with the company, other than as a director, are more committed to the corporation because of the relationship and therefore discharge their director obligations more effectively. Similarly, we recognize that the absence of any such relationship is no guarantee of independent judgment. *Nevertheless, we propose as a guideline that every board should be constituted with a majority of individuals who qualify as unrelated.*

Definition of Unrelated Director

5.8 *We define an unrelated director as "a director who is independant 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."* The Cadbury Report defines independent directors as directors who are "free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding".

Independence

5.9 What do we mean by independent? Independent of what? Independent of management? Independent of a major shareholder? Independent of a major stakeholder? Independence is based upon the absence of relationships and interests which could compromise, or could be perceived to compromise, the ability of a director to exercise judgment with a view to the best interests of the corporation. In this guideline we are responding to a concern that the board be able to bring objective judgment to the assessment of management and to the assessment of the merits of management initiatives. Therefore, when we ask: "Independent of what?", we mean independent of management. The board should be constituted so that it can bring, and be perceived to bring, judgment independent of the particular interest at issue – in all circumstances. Simply because the particular interest of a director is not apparently at issue in a specified circumstance does not mean the director is not related. The characterization of the director as related or unrelated is a general characterization which exists for all purposes.

5.10 An easy example is the director who provides services to the company, for example legal or financial services. He or she would generally not be regarded as an unrelated director because the dependence of the advisor/director upon management of the company as a client could, or could be perceived to, interfere with the director's ability to objectively assess, for example, the performance of management. Similarly, an officer of one of the company's lenders who sits on the board might not be regarded as an unrelated director. The officer would be perceived to have a prior duty to protect his or her employer's loan to the company. It is common for a former CEO to remain as a director. The former CEO might not be regarded as an unrelated director, although it is possible he or she could acquire this status after the expiration of an appropriate period of time.

Shareholding Does Not Make A Director Related

5.11 In the Draft Report we proposed that a shareholder in a position to control or influence the control of the company be treated as a related director because he or she is different from an ordinary shareholder. For example the substantial shareholder often sits on the board. We were concerned that this relationship could give rise to the perception that the shareholder/director might exercise judgment that would not reflect the interests of shareholders generally but would reflect his or her interests as a significant shareholder. We were also concerned that in addition to sitting at the board table and participating in board decisions, the significant shareholder/director can potentially have an intimidating influence on other directors who realize that their election to the board is dependent upon the vote support of the significant shareholder/director.

5.12 We have reconsidered this position and concluded that a director who is a significant shareholder or a director with interests in or relationships with the significant shareholder should not be considered a related director for our purposes. We received a number of persuasive comments on the Draft Report to the effect that treating such a director as a related director would compromise the ability of the significant shareholder to exercise control and that the ability to control through the election to the board of individuals related to the significant shareholder is the right of the significant shareholder. It was also argued that investors acquire shares in corporations with a significant shareholder generally aware of the shareholding, and relying in many cases on the significant shareholder to exercise control and execute his or her strategy for the corporation. It was further argued that there are well established procedures to enable the board to address issues where the interests of the corporation conflict with the interest of the significant shareholder. We concluded that these considerations should outweigh our concerns about directors who are significant shareholders or are interested in or otherwise related to significant shareholders acting in the best interests of the significant shareholder in priority to the corporation. In doing so we again emphasize the obligation of all directors to act only in the best interest of the corporation. Accordingly, subject to the constraint in paragraph 5.13, the significant shareholder should be able to elect individuals "related" to the significant shareholder, as directors of the corporation and have such individuals count in the majority of unrelated directors.

Reflection of Minority Shareholders in Board Composition

5.13 *For purposes of this guideline we define a significant shareholder as a shareholder with the ability to exercise a majority of the votes for the election of directors attached to the outstanding shares of the corporation. In the circumstances where 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.*

5.14 The purpose of this constraint on the significant shareholder's ability to elect the board is to ensure in general terms that there is a component of the board, at

"...there is a gap in the governance structure. While the directors clearly owe a duty to all shareholders, the controlling shareholder, as shareholder, owes no duty to minority shareholders. Directors may be faced with a shareholder that will not accede to board requests considered to be in the interests of all shareholders, leaving directors with the option of resigning or dissenting."

Richard S. Sutin, Meighen Demers, September 30, 1993.

"The rules however aren't appropriate where a majority shareholder is still active in the business and has the largest vested interest in the welfare of the company. ...No outside board of directors could possibly care more about the welfare of the company than the majority shareholder who is also a director or who has appointed nominees to the board. Practically speaking, we all know how busy people are and it is foolish to think that outside directors, no matter how well compensated, spend anywhere near the amount of time thinking and dreaming about the future of the company as would such a majority shareholder. I, as a shareholder, would be much more comfortable entrusting the fortunes of the company to those whose interests are the same as mine."

Gail Asper, Corporate Secretary, Canwest Global Communications Corp., October 25,1994.

"Current or former directors or officers of a publicly-held majority shareholder of a TSE company, which is engaged in lines of business that are the same as or complementary to the business of the majority shareholder, have a "relationship" to the TSE company through its majority shareholder. It is precisely because of this relationship that their interests are aligned with the objective of creating shareholder value and exercising judgement in the best interests of the TSE company."

Seymour B. Trachimovsky, General Counsel and Corporate Secretary, Dupont Canada Inc. October 14, 1994.

"I have, then, some difficulty with the blanket proposal that a majority of directors be unrelated to management or any controlling shareholder. The argument can be made that no one has a greater interest in furthering the objectives of the shareholders than the representatives of the largest stakeholders. Why then should they be regarded as second-class directors?

As a practical matter, the directors, "unrelated" or otherwise, must take into account the objectives – if not the views – of the controlling shareholders; if they do not do so there can be no assurance of continuity of board membership which is necessary for the development and oversight of long-term strategies."

N. B. Keevil,
Chairman and President,
Teck Corporation, July 14, 1994.

"The Board should act independently whenever it questions the ability or integrity of management, and whenever there is a conflict of interest between management on an issue facing it. The Board's biggest job is knowing when to replace a CEO. In that role, it can and should use outside advisors, probably executive recruiters, to find a new CEO. If there's an integrity issue, then a Board should use special counsel and the outside auditors (or a second set of outside auditors) to determine the facts."

Robert F. Calman,
Chairman and Chief Executive Officer,
Echo Bay Mines, August 31, 1993.

"We are especially encouraged by the report's emphasis on board independence. We believe a board which operates independently of management is crucial so that management is always mindful that the maximization of long term shareholder value is a paramount objective. The integrity of the market system is preserved when shareholders know that their representatives are clearly giving direction and guidance to management, rather than being controlled by it. The report's recommendations with respect to numbers of outside directors and their duties also clearly support this independence objective."

Canadian Council of Financial Analysts,
October 11, 1994.

least in numbers, generally reflecting the investment of the public or minority shareholders in the corporation which is not related to either the significant shareholder or the corporation. Satisfying this guideline should not be difficult. For example, if the significant shareholder holds shares representing 2/3 of the equity and 2/3 of the votes for the election of directors of a corporation which has a board of 9 directors and which wishes to satisfy this guideline, the holder can elect up to 6 directors who have interests in or relationships with the significant shareholder provided that no more than 4 of the 6 are related to the corporation. The remaining 3 directors would not have any such interests or relationships. In Canada, it is not unusual to have a significant shareholder, i.e. a holder of more than 50% of the votes, which has an equity interest which is less than the voting interest. In these circumstances, judgement will have to be exercised as to what is the appropriate number of directors which fairly reflects the investment in the corporation by the remaining holders of shares. Ultimately the market will judge the composition and effectiveness of the board.

5.15 A holder of shares may hold less than a majority of shares and still elect the board. However, in these circumstances, because of the way we have defined significant shareholder, the requirement for proportionate representation discussed in the previous paragraph does not apply. To apply the proportionate representation requirement in this circumstance would not address the concerns discussed in paragraph 5.12 about compromising the ability of the holder of the large block of shares to control the corporation. For example, if the proportionate representation requirement applied, the holder of 1/3 of the voting shares of a corporation with a 9 director board could elect only 3 directors not related to the holder or the corporation. Although we do not propose a guideline, we do expect corporations in these circumstances to have a meaningful number of directors on the board not related to either the corporation or the holder, i.e. a sufficient number to establish a balance with the directors related to the corporation or the holder.

Inside/Outside Directors

5.16 The definition of a director as unrelated or related should not be confused with the informal definition of a director as an inside director or an outside director. An inside director is a director who is an officer or employee of the corporation or of any of its affiliates. The inside/outside director definition is often used in defining the composition of board committees. The corporate law, for example, generally requires the audit committee to have a majority of members who are not officers or employees of the corporation, i.e. a majority of outside directors.

Conflict of Interest

5.17 The issue of the director with a conflict of interest should not be confused with the related/unrelated director issue. As noted above, corporate and securities law prescribes a code of conduct to be followed when a director is asked to approve a transaction in which he or she has an interest, e.g. the director must disclose the interest and refrain from participating in the board discussion and voting on the matter. A director may be related and never encounter a situation where he or she has to declare a conflict of interest as contemplated by these laws. For example, an advisor to the corporation who sits on the board may be related but may never enter into a transaction requiring board approval. Therefore the advisor/director, although a related director, will never have to declare a conflict of interest. Similarly, a director may be unrelated but have an interest in a specific transaction which obligates him or her to refrain from participating in the board's discussion of the transaction. For example, the director may also be a director of a company which is engaging in a one-time transaction with the first company. The existence of a conflict of interest on a specific matter will not necessarily define whether a director is related or unrelated.

Board Determines Who is Unrelated

5.18 We have proposed a definition of who should qualify as an unrelated director. The definition is very general. *The principles underlying the definition will have to be applied to the circumstances of each individual director. In our view, this exercise should be the responsibility of the board, which should be required to disclose on an annual basis whether the board has a majority of unrelated directors, and in the circumstances of a corporation with a significant shareholder, whether the corporation satisfies the requirement to fairly reflect the investment of minority shareholders in the corporation. Management directors are related directors. The board should also be required to disclose its analysis of the application of the principles to the circumstances of the board.*

5.19 We expect most boards would state that virtually all members, regardless of the existence of relationships to the corporation, exercise judgment with a view to the best interests of the corporation. The exercise we are proposing is not designed to elicit such a statement but is designed to require each board to understand the relationship which exists between each director and the corporation, and to make a determination whether the director is related.

"We also find unnecessarily intrusive (both to the individual director and to the board) the guideline that requires the board to disclose annually not only its "unrelated" directors but also the "analysis" that led to such a characterization. How, for example, is the board to characterize someone who is quite independent in his or her views and who is not afraid to challenge management, if such person might be perceived by outsiders as "related" due to some business or other relationship?"

Sun Life Assurance Company of Canada, October 17, 1994.

"Affiliated" Directors – The Bank Act Definition

5.20 The issue of a board's ability to exercise independent judgment has also concerned those responsible for regulating banks. The *Bank Act* uses the concept of directors "affiliated with the bank". As of the 1995 annual meeting of a bank, no more than two thirds of the directors of a bank may be persons affiliated with the bank. The Regulations to the *Bank Act* contain an extensive definition of the circumstances in which a director is affiliated with a bank. These provisions address, amongst other circumstances, the practice of banks to recruit individuals to be directors of a bank who are in a position to direct business to the bank. For example, CEOs of corporations which borrow from banks constitute an important source of bank directors. Whether the CEO is affiliated with the bank, for purposes of the *Bank Act*, depends upon the amount of the indebtedness of the corporation to the bank.

"Accepting as we do that it is beneficial for the board to have "independent" directors, and given precedents for boards to be comprised of a majority of such "independent" directors, we believe that a modified guideline (to be reflected in a revised definition of "unrelated") for selecting such individuals should:

- **permit greater flexibility in choosing the directors best suited to the post, including representatives of a controlling shareholder; and**
- **avoid possible disincentives to investments in shares arising due to the prohibition on significant representation on the Board by Controlling Shareholders"**

G.C. Wilkins, President, The Horsham Corporation, October 12, 1994.

5.21 Compliance with our guidelines will not put the banks in conflict with the *Bank Act*. It is possible for a director of a bank to be a related director, for example a recently retired CEO of the bank, and yet not be an affiliated director for purposes of the *Bank Act*. On the other hand, it is also quite possible that an affiliated director for purposes of the *Bank Act* could be an unrelated director for purposes of our governance guidelines. For example, the CEO of a corporation which has significant indebtedness to the bank might nevertheless be judged as unrelated for purposes of our guidelines because the corporation may be able to demonstrate the absence of reliance on the particular bank for its borrowings.

5.22 Those responsible for regulating the banks no doubt factored the public interest into their rules for the composition of bank boards. Our guidelines are based upon an assessment of the public interest in good governance. If our guidelines are adhered to by the banks, the number of affiliated directors would probably

"We are also concerned about the narrow view the TSE committee has adopted on board representation by majority or significant shareholders.... Anyone who owns 51% or more of the shares of a company has every right to attempt to dominate a board through the normal shareholder election process. Furthermore, such a shareholder has the right to representation on any board committee, with the exception of the audit committee.... Our system of capitalism, which the TSE should surely support vigorously, recognizes that those who own the shares own the votes -- and the exercise of those votes determines board representation."

Marvin G. Marshall, President & Chief Executive Officer, Bramalea Limited, July 21, 1994.

"Individual director assessment is an intellectually elegant concept but politically impractical."

Matthew Barrett, Chairman and Chief Executive Officer, Bank of Montreal, September 1993.

"We feel that independent directors are even more important to closely-held public corporations effectively controlled by one or very few individuals or corporations acting in concert. If corporations are allowed to go to the equity markets in order to raise capital, then they have a responsibility to ensure that the interests of their minority shareholders are protected. They therefore should be required to provide a board of directors made up of a majority of directors who are not only independent of management, but also independent of the majority shareholders."

Bruce S. MacGowan, Chairman Templeton Management Limited, September 14, 1993.

be reduced to less than the number permitted by the *Bank Act*. The banks should consider compliance with our guideline concerning related directors – of course, only in addition to compliance with their statutory obligations.

The Nominating Committee

5.23 Having established a board constituted with a majority of unrelated directors as the desired objective for board composition, we now turn to a governance function which is at least as important as board composition – the director nominating function.

5.24 We have expressed our belief that corporate performance should be improved by an enhanced approach to governance, and that the improvement occurs as a result, not only of the enhanced approach to governance, but also as a result of the public's perception of this enhanced approach. The board's process for assessing existing directors and identifying, recruiting, nominating, appointing and orienting new directors is central to enhanced governance. This function can be performed by the board as a whole, absent inside directors, but most boards will prefer this responsibility to be delegated to a committee, a committee which we refer to as the nominating committee.

5.25 In Part VI we discuss certain aspects of the functioning of the board, including the composition of board committees. We propose as a guideline that board committees should generally be composed of outside directors, a majority of whom are unrelated, although we recognize that some board committees, such as the executive committee, may include one or more inside directors. This guideline will not be achievable by all corporations. But what is achievable by all corporations is the appointment of a nominating committee composed exclusively of outside directors. *We therefore propose as our next governance guideline that the board of every corporation appoint a committee of directors composed exclusively of outside directors, a majority of whom are unrelated directors, with the responsibility for proposing new nominees to the board and for assessing directors on an ongoing basis. The actual decision as to who should be nominated should be the responsibility of the full board after considering the recommendations of the nominating committee.*

5.26 The nominating committee removes from the CEO the general responsibility for constituting the board. The committee seeks to ensure the true independence of those recruited and an appropriate separation from management. A director who is "beholden" to the CEO will have difficulty acting independently, at least in assessing management. The nominating committee is designed to apply criteria, recommend board composition, and establish inter-director relationships which facilitate board decisions. Although inside directors will not sit on the nominating committee, the nominating committee will want to consult fully with the CEO in its process of recruiting new directors. The nominating committee should not have the delegated power from the board to implement its recommendations but should be obliged to report its recommendations back to the full board for its consideration and implementation.

Assessing Board Performance

5.27 Every board of directors will have in place some mechanism for, at least annually, assessing the performance of the CEO. Good governance requires the board to also have in place a mechanism for assessing its own effectiveness as a board and for assessing the contribution of individual directors. In a survey conducted by the Business Council on National Issues, almost 90% of CEOs supported the assessment process, but also said virtually no board is doing so, at least on any formal basis. The assessment of the board should relate generally to the ongoing governance and operation of the board and more specifically its effectiveness in discharging the responsibilities of the board set out in Part IV of this Report. Assessing the contribution of individual directors is not an assessment related to the performance of the company nor is it an assessment designed to relate director compensation to company performance. The assessment of directors is an examination of each individual director's ability to contribute to the effective decision-making of a board. *Accordingly, our next governance guideline is that each board 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 for assessing the contribution of each individual director.* Each board will have its own approach to assessing its effectiveness and the contribution of its members. In the latter respect corporations should identify criteria for individual contributions and should be willing to provide feedback to directors in respect of their individual performance.

5.28 The assessment exercise should be undertaken periodically by the board, probably most effectively by the nominating committee. How the committee actually implements the process will vary from board to board. It might simply take the form of a retreat during which the board addresses its effectiveness with input from management. In addition, it might take the form of an interview of each director by the nominating committee and the application by the committee of standard criteria such as meeting attendance, understanding of issues, contribution to discussion, etc.

5.29 The assessment process can be more elaborate. Some large corporations require each director to complete a comprehensive questionnaire. The process is time-consuming but can generate many useful ideas for the governance of the corporation. The exercise of completing the questionnaire can also function as a process of self-assessment, which assists the individual director in reaching his or her own conclusion as to the adequacy of his or her contribution as a director.

5.30 The assessment of the effectiveness of the board as a whole will likely involve a discussion by the full board and should include a review with management.

5.31 The Canadian Institute of Chartered Accountants in its submission to the Committee makes the following useful suggestion as to the questions which should be asked by directors as part of a process of self-assessment:

- "Am I meeting the expectations of the shareholders? Am I satisfied with the steps management is taking to discharge the company's responsibilities to other stakeholders such as investors and lenders, customers, suppliers, employees, competitors, regulators, government and the community generally?

- What suggestions can I make to improve the way the board and management communicates and demonstrates values related to integrity and the importance of open communications?

- What suggestions can I make to improve the quality and timeliness of the information which I receive? Is management forthright in providing information and answering questions?

"A board should preferably be congenial, based on mutual respect; working in unison is better than working at loggerheads. All directors should feel that they can be candid and voice concerns in a direct manner."

Stephen A. Jarislowsky, Jarislowsky, Fraser & Company Ltd., August 17, 1993.

"The guidelines suggest that a committee of directors (comprised exclusively of outside directors) be responsible for proposing new nominees to the board and for assessing directors on an ongoing basis. We do not agree with this recommendation. While it may be desirable in some cases to have new nominees proposed by only outside directors, in many other cases this is totally unrealistic. Nor do we believe it is realistic or practical to expect that a committee of a board can evaluate other members of the board in a constructive manner. We concur that it would be most helpful to corporations if this could be done, and we believe that in many instances corporations will try to address this question more often than in the past. However, each will have to do it in a way that best fits their overall circumstances."

G.J. Maier, Chairman, TransCanada PipeLines, September 21, 1994.

- What suggestions can I make to improve the diligence demonstrated by board committees and the quality of the reports provided to the board? Have I been reluctant to ask pointed questions in relation to such reports?

- What suggestions can I make to improve the way the board is meeting its responsibilities in relation to strategic planning and management of risk?"

This list is not exhaustive. Another question the director should ask himself or herself: "Is my level of understanding of the business such that I can make a useful contribution as a director?".

"...it is Power's view that while boards and managements have separate responsibilities, the former for approving and overseeing, the latter for initiating and executing, in the end they must work together within a system of checks and balances to preserve and enhance shareholder value. It has been our experience that boards of directors function most effectively if they are forthright and collegial, rather than secretive and confrontational, either in their discussions between themselves or in their discussions with management."

James W. Burns, Deputy Chairman, Power Corporation of Canada, October 12, 1994.

5.32 Changes in board composition should be effected in an orderly manner – in the absence of unusual circumstances. The process of assessing performance of directors should not result in frequent terminations and replacements if the board is properly constituted in the first place. We do, however, believe that the process of assessment will make directors aware that their performance is being reviewed by their fellow directors and should enhance each director's contribution. The process may also provide constructive input to each individual director as to how he or she can better contribute to the functioning of the board.

Board Functions as a Unit

5.33 We would like to note the importance of the chemistry within the board. It is important that the board be able to function as a unit. The board should probably be constituted with individuals of diverse background and experience. Nevertheless, personal chemistry matters in the way a board is constituted and in the way it functions. Personal skills of individual directors should be an important criterion applied by the nominating committee.

5.34 We reject the notion of a board comprised of directors representing particular constituencies such as certain shareholders, employees, suppliers, environmentalists, etc. As we stated in Part IV, the board should ensure that the implications of its decisions for various constituencies are factored into its decision-making processes, however, we believe that each director should approach each decision with an open mind and not be accountable to any constituency, other than the shareholders generally. Each director must be confident that each other director brings the same open mind to each issue.

5.35 Although we reject the notion of directors representing constituencies, we do support the constitution of boards of directors with a variety of backgrounds reflective of the functions of the business. Our experience is that diversity has many advantages in the board decision-making process. Board decisions are nevertheless collective decisions; all directors participate in the decisions and all directors should accept responsibility for the decisions.

Orienting New Directors

5.36 *Our next governance guideline is that as an integral element of the process of appointing new directors, each corporation should provide an orientation and education program for new recruits to the board.* The program could be a one or two day event which would involve educating the director as to the nature of the business, current issues within the company and the corporate strategy, the expectations of the company concerning input from directors, and the general responsibilities of directors. Some companies have developed orientation manuals. However, the manual is just a beginning. The program should include the opportunity to discuss with experts the responsibilities of a director and of the board as a whole as well as the opportunity to visit facilities and to meet with corporate officers to discuss and better understand the business which will allow the director to contribute effectively from the outset of the appointment.

External Education Programs

5.37 We also support the development of external courses to educate directors on their responsibilities, on how to function as an effective director, and on issues of corporate governance generally. These courses would also be available to others, such as members of senior management and investment officers and others involved in the corporate governance process, to facilitate their understanding of the roles and responsibilities of the board. Over time we believe that such courses will raise the general knowledge and understanding of governance issues, and individuals who take a course on director responsibilities will be more attractive recruits and should ultimately be more effective contributors in the boardroom. We also support the introduction of such courses in the business schools in order that graduates have a better understanding of corporate governance at the outset of their business careers.

Size of the Board

5.38 We think the number of directors constituting a board is an important factor in determining the effectiveness of the board. Generally, the submissions we received support a board size of between 10 to 16 directors. We do not think there is any one number that suits all circumstances. Each board must be constituted to deal effectively with the circumstances of the corporation.

5.39 The issue of board size is that some boards are too big to facilitate effective decision making. If the board is too big, the individual director risks losing a sense of responsibility, may feel constrained about actively participating in board deliberations and may have little sense of personal accountability for board decisions.

5.40 The largest boards in Canada appear to be the boards of the six major chartered banks and other major financial institutions, many of which have boards numbering in excess of 30 directors. One may wonder why we are concerned about numbers when so few public corporations in Canada have a large number of directors. We are pursuing this issue because these corporations have such a significant role in the community and for many members of the public represent their principal basis for assessing corporate Canada.

5.41 The effectiveness of a board of this size has been debated within the Committee. There is a general view within the Committee (not shared by all members) that as the number of directors on a board increases beyond a particular threshold (approximately 20), the effectiveness of the board decreases. Defenders of large boards point to the diversity of view and experience that is available at the board level, the opportunity for broad geographic representation, and the extensive director resources available for constituting board committees, where, within these smaller groups of directors, much of the real work is done. We think that the public is not convinced. The public wonders how any group of 30 individuals functioning within time constraints can make effective decisions.

5.42 We think more imagination and energy could be expended by corporations with large boards to reduce their numbers. We have no doubt that over time large boards can be pared down, and the corporation will still be able to develop a

"We believe that through public education, company presidents may be persuaded that truly independent directors' advice will assist them and their companies. By public education, directors may become more aware of how they can contribute to their companies. By public education, more prospective directors may feel capable of the task, and by public education, shareholders will become aware of what they can expect from boards."

Vancouver Stock Exchange, October 27, 1993.

"In our case, the board of CT Financial Services Inc. currently consists of 28 members and we have already established plans to reduce that number by approximately 20% over the next few years. We wish to point out that many boards, including ours, are subject to significant committee obligations mandated by legislation governing their activities... Many of these committees benefit from specialized expertise and experience and require a significant time commitment so that board members may be reluctant or unable to serve on more than one committee... We suggest that the Committee acknowledge in its final report the special circumstances of highly regulated companies such as CT that frequently require larger boards in order to act effectively."

Diane E. Walker, Vice President, General Counsel and Secretary, Canada Trust, September 16, 1994.

perspective on all regions in which it carries on business, from directors and from other sources. For example, many corporations operating in a global context have created international advisory committees and other advisory mechanisms, which are designed to integrate a broader perspective into the corporation's decision making. We expect that similar types of committees could operate nationally. We stop short of a guideline capping the number of directors at a specific number but do support the objective of reduced numbers on large boards. *We therefore propose as our next guideline that every board 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.*

"Optimal size represents a balance between two important Board effectiveness considerations. On the one hand there is a clear business need to ensure that a broad range of perspectives, experience, expertise and regional Canadian and international knowledge are represented on the Board. On the other hand, when the size of the Board becomes too large, the ability of, and opportunity for, each Director to contribute tend to be impaired."

Royal Bank of Canada, Report of the Corporate Governance Committee, July 6, 1994.

5.43 Committee member Mingo does not agree with the Committee's views on board size. His views are set out in Appendix 5.43.

5.44 Although we have characterized the issue of board size as relating to boards which are too big, we should also note that some boards may be too small. We discuss in the Report the principal responsibilities of the board of directors and we identify a number of board functions. Each board should ensure that it has enough directors to discharge these responsibilities and perform these functions.

Participation of Management on the Board

5.45 Management will participate on the board. Virtually every chief executive officer is a member of the board of directors. A number of boards also include a second member of management. This practice is criticized, in part, because of the natural restraints upon the second member of the management team which prevent exercising judgment different from that of the chief executive officer. We do not take a hard position pro or con this practice. We prefer a limited number of members of management on the board but recognize the desirability of including at least a second member of management in order to address a variety of matters, including succession.

5.46 We also encourage interaction between other members of senior management and board members, both inside and outside of the board meeting. This access has to be managed by the CEO to ensure that the board is not receiving mixed signals from management. Nevertheless, members of the management team are potential CEOs and will have a lot to contribute to the board's discharge of its responsibilities.

Maximum Term for Directors

5.47 Some commentators to the Committee recommended that each director hold office for a period of not more than a specified number of years. The period these commentators had in mind was approximately six or seven years. The basis for the proposal for a maximum term is that it would ensure an ongoing supply of fresh thinking to the board. Our view is that a guideline to this effect is artificial and unnecessary. We believe that the nominating committee, which will be assessing the performance of the board, can propose changes to the board composition which can result in the injection of a fresh approach to board decisions where appropriate.

Limiting Number of Directorships

5.48 We also received suggestions that a guideline be adopted limiting the number of board appointments an individual can hold. While we agree there must be a limit to the number of appointments, we have concluded that a specific guideline is unnecessary. The nominating committee, in assessing the suitability of an individual to be elected to a board, will take into account the individual's other commitments, resources and time available for input to the board.

Remuneration of Directors

5.49 Board remuneration is an important aspect of effective corporate governance. The remuneration of directors should be appreciable and should reflect the responsibility and commitment which goes with a board membership. If directors are paid a token amount there may be a tendency to think the job is not important. On the other hand, if the remuneration is excessive, the director may lose his or her independence. He or she will be perceived as someone who can't afford to put his or her director's position on the line.

5.50 The risk associated with being a director is much higher today where corporate and director accountability are treated much more seriously by the investing public. In addition, more time is involved and the public's expectations of directors are increasing. *Our next governance guideline is that each board 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.* Changes will be fully disclosed in the corporation's information circular.

5.51 We favour directors owning shares. The ownership of shares will facilitate the directors' identification with the interests of shareholders. Indeed, we think corporations can assist directors in acquiring shares by, for example, remunerating directors wholly or partly in shares. The shares could be made to vest over a specified period of time. The director would have to pay income tax on the value of the shares.

5.52 We do not object to the use of stock options as a form of director compensation. However, the options should be valued and the value of the options plus the amount of other compensation should not exceed the amount of the compensation which the board believes is reasonable in the circumstances. In addition, the conditions attached to the options should discourage short term exercise and holding.

Personal Liability of Directors

5.53 Perhaps the most frequent theme in the submissions received by the Committee is the concern about the impact on corporate governance of the exposure to personal liability of corporate directors. We have already accepted in general terms the principle that imposing personal liability on directors is an acceptable and effective technique for influencing corporate conduct. In view of the role of the board in the corporation, this conclusion is not surprising. The concern, of course, is that there be an appropriate balance between the need to influence corporate conduct to achieve public policy objectives and the need for effective boards of directors.

5.54 The liability of directors is not to be confused with the liability of the corporation. What we are focussing on in this discussion is the personal liability of directors for actions of the corporation in which the director may have had some role – although some statutes impose liability on directors even where the director has had no involvement. The concern for corporate governance is that increasing personal liability of directors compounds the difficulty of recruiting qualified individuals to serve as directors. The prestige

"I do not see how a person can be a director of a corporation without owning a significant number of shares. To own none or only a few indicates lack of interest or confidence in the company. Either reason is cause to be disqualified. It seems to me that directors should own shares whose value should at least equal the gross amount of their annual compensation as directors. Not much to ask, is it?"

James R. McMurrich, July 5, 1993.

"As a starting point, an estimate should be made of the time a director is likely to spend on the corporation's affairs over the course of one year – meetings, preparation and travel. What is the "value" of this time? The same daily rate as a CEO? Rates charged by senior professional advisers? These are reasonable benchmarks. However, market practices cannot be ignored and the intangible value of networking must be recognized... Companies should establish a policy covering the percentage of the total package to be paid in cash and the percentage to be paid in common shares and/or stock options. It may be appropriate to require a director to hold a minimum number of common shares in order to be eligible for future option grants or to exercise previously granted options."

William M. Mercer Limited, July 1994.

"Independence in the context that you describe must always include intellectual, financial and political independence, not just one or two of these categories on their own. Practically the only sanction that a Director has if, in the ultimate, he feels he must register the strongest possible protest, is to resign from the Board. He must be able to do this without worrying about the loss of his Director's fees, or of compromising his integrity in the other ways referred to above."

Brian L.G. Lechem, President, Boardroom Advisory Services, September 29, 1993.

and the modest director's fee may not be enough to entice individuals to expose their personal assets to liability arising from their position as a director.

"Our concern with the trend towards expanded personal liability is that enlarging the circumstances in which directors are personally at risk puts undue emphasis on the process for the purpose of avoiding personal liability, at the expense of the application of the proper managerial function of the board."

Cassels Brock & Blackwell, October 1, 1993.

"While recognizing the policy concerns which have led to the legislative changes increasing personal liability and responsibilities of directors, it is clear that some balance must be struck in order to enable companies to attract competent independent directors. Our firm has recently completed a review of the various legislation applicable in the Province of Quebec imposing statutory liability on directors and the extent of this liability is staggering. Although a complete reversal of this trend is unlikely, and perhaps unwarranted in any general sense, it is evident that it must be tempered with reality if we are to have any hope of attracting and retaining competent independent directors to the boards of our public companies. One method of doing this would be to realign the duties and corresponding liabilities of officers and directors to bring them in line with what actually takes place and, in the case of statutory liabilities, to introduce a due diligence defence where it does not already exist."

C.R. Spector, Byers Casgrain, September 29, 1993.

"Over the long term, this [legislation imposing directors' liability] will inevitably lead to the diminution of qualified business advice and counsel, thereby reducing Boards to legal fora which observe the letter rather than the spirit of the law."

The Molson Companies Limited, October 5, 1993.

5.55 There is also a concern that the exposure of individual directors will mean that risk averse directors will follow conservative strategies in circumstances where bolder strategies might be more appropriate.

5.56 We are also concerned with the manner in which, and the extent to which, the law imposing personal liability on directors has developed. The legislatures responsible for enacting the laws have only focussed on the need to make directors accountable for corporate activity and not on the broader implications. For example, some environmental laws provide that directors may be personally liable for the wrongdoing of the corporation if they directed, authorized, assented to, acquiesced in or participated in the commission of the offence and can face fines of up to $100,000 per day plus terms of imprisonment; the income tax laws provide that directors can be held personally liable for the full amount of certain taxes owing, where the corporation fails to deduct or remit the prescribed amounts from certain payments made by it; the health and safety laws provide that directors may be personally liable if they fail to take all reasonable care to ensure that the corporation complies with applicable legislation and can face fines of up to $25,000 plus possible imprisonment; the securities laws provide that any director who authorized, permitted or acquiesced in the filing of on-going disclosure documents that are not in compliance with legislative requirements commits an offence and may be subject to a fine of $1 million and up to two years in prison; and so on. These statutory liabilities are discussed more fully in Appendix 5.56.

5.57 One aspect of personal director liability, which has resulted in resignations of entire boards of directors, arises when a corporation is in financial distress. In addition to concerns about securityholders scouring the corporation in search of deep pockets, directors have personal liability, on a joint and several basis, for certain corporate obligations, i.e. an individual director can be liable for the entire debt to employees, in an amount up to six months' wages for work performed while they were directors. In these circumstances, the impact of the law is counter-productive. While seeking to protect employee wages in the short term, the law actually has the effect of seriously reducing the prospects for the corporation being led through a restructuring and its financial health being restored. The corporation requires the leadership of a board, particularly in times of financial distress.

5.58 In large corporations with extended operations in a complex environment, it is virtually impossible for any director to obtain direct, continuing confirmation of the observance by the corporation of a host of regulatory requirements. We believe it is appropriate to require the director to take reasonable steps to fulfil statutory obligations, but it is inappropriate to face directors with personal liabilities in respect of circumstances which the director, of necessity, cannot absolutely control. The imprecision, ambiguity and difficulty of interpreting certain regulatory requirements add to the problem and the unfairness.

5.59 The legislatures no doubt felt that the public interest demanded that, in addition to corporate liability, directors must be exposed to personal liability as an additional means of ensuring compliance by the corporation with the relevant law. In a particular context there may have been a need; the difficulty is the collective impact.

5.60 The construction of this corporate regulatory scheme has been achieved on an incremental basis. No single body has taken a global view of the exposure of individual directors to personal liability and attempted to consider whether there should be some limitation upon the extent of the exposure. It is a corporate fact of life that corporations and their directors will be exposed to liability under numerous statutes and that the number will increase with the number of jurisdictions in which the corporation carries on business. *We do, however, believe that the departments responsible for the administration of the corporate law in each of the federal and provincial jurisdictions should undertake a review of all legislation enacted in their jurisdiction imposing personal liability upon directors.* This review should be undertaken with the following objectives:

(1) In respect of each piece of legislation imposing liability upon directors, a judgment should be made as to whether or not the imposition of this liability is effective in influencing the corporate conduct in question; obviously if the concern underlying the legislation is not materially advanced by the provision, at least insofar as it relates to directors, the provision should be modified or repealed.

(2) Each piece of legislation should be examined to determine what defences, if any, are available to the directors to defend against allegations of liability. Legislation which does not provide any defence imposes absolute liability on directors. Other legislation may provide a safe harbour for directors enabling them to defend against allegations of liability if the director is able to demonstrate that he or she has acted carefully and with due diligence.

The Draft Report was forwarded to the appropriate ministries in the Federal and Provincial Governments, drawing their attention to the recommended review of legislation. A list of responses is set out in Appendix 5.60

5.61 The Committee had the benefit of a Report of a Federal Government Interdepartmental Working Group on the issue of directors' liability, a federal project which anticipated our recommendation relating to directors' liability at approximately the time our Committee was being established. We quote extensively from the conclusions:

> "Statutory liability faced by directors has expanded during the last 20 years, particularly with respect to source deductions, taxes, unpaid wages, severance and termination pay, and environmental and corporate law. Stronger enforcement and broader court interpretations have increased the exposure of directors to liability. Also, there is significant uncertainty present surrounding the potential interpretation of certain statutes. This has raised concerns in the business community. Those concerns have been exacerbated by the financial difficulty that many companies have found themselves in during the recent recession.
>
> Despite these concerns, the working group did not find sufficient evidence to conclude that directors' liability has become so severe that it could not be handled by the market. A review of statute-based liability and the enforcement record of federal regulators indicates that the practical exposure of outside directors to liability is limited. Some members of the working group remain

"Directors are a convenient target these days. They are the subject of attention and analysis by an increasingly demanding cadre of shareholders, institutions investors, regulators and governance advocates. Litigation lawyers seem to lurk around every high rise office tower in Canada. It is seldom easy to do an effective job when one is simultaneously under a spotlight and a microscope... We believe it would be helpful to directors in adapting to this new reality if they understood more about what is being expected of them and the kind of changes in board structure and process that have been shown to be beneficial in sustaining public and investor confidence."

J. Richard Finlay and Partners, September 1994.

"There is too much legislation in Canada, federally and provincially, which seeks to regulate the same kind of conduct, and much of it is sufficiently inconsistent that it is counterproductive. We recommend that efforts be taken to significantly reduce regulatory constraints and the resulting costs of compliance particularly where there are overlaps and inconsistencies."

Canadian Imperial Bank of Commerce, October 15, 1993.

"I agree that corporate law should be amended to remove personal liability from attaching to Directors for operating issues. A Board is responsible for the broad policy concerns of the corporation and should be sanctioned if they fail in their duties to stakeholders in these broad areas. It serves no purpose at all to attach these Directors with individual liability for day-to-day operating matters."

Albert D. Cohen, Chairman and Chief Executive Officer, GENDIS Inc., June 14, 1994.

> concerned that directors of small businesses might have difficulty meeting the liabilities that have been placed on them. However, the working group did not find sufficient evidence to conclude that directors are resigning in significant numbers to avoid the liabilities that they face. The resignations of directors that received publicity have been isolated to a handful of companies that were in severe financial difficulty and that did not carry enough insurance to adequately protect their directors."

"In British Columbia, the concern over "liability chill" was brought to the fore with the resignation of the outside directors of Westar Mining in the midst of its final financial problems, in order to avoid potential personal liability for employee claims. It is hard to see how it is in the public interest to construct a legal framework which encourages directors to resign, rather than to apply their business judgment and experience in resolving the problems facing the corporation."

BC TEL, October 18, 1993.

This analysis is disappointing. The view that director resignations in corporations in financial difficulty can be avoided through insurance is not justified. In addition, our concerns extend beyond resignations to "liability chill", i.e. the difficulties in recruiting and the conservatism in corporate decision-making induced by extensive liability – director dynamics which are more difficult to measure.

5.62 We are aware of only one circumstance where federal and provincial statutes impose absolute liability on directors, i.e. the directors have no defence to liability, regardless of fault. We are referring to liability for unpaid employee wages. We believe that the imposition of liability upon directors without providing directors with a due diligence defence is unfair and counter-productive to good corporate governance. The existence of a due diligence defence will motivate a board to establish a system within a corporation to ensure that the corporate conduct which is the concern of the relevant law does not occur. The existence of the system is no guarantee that the conduct will not occur but the system should substantially reduce the risk. We also believe that the possibility of establishing a successful due diligence defence in a claim against directors is a stronger incentive to implement an appropriate risk management system than the prospect of the all or nothing scenario created by an absolute liability offence. *We recommend that following the review described above all legislatures should repeal legislation imposing personal liability on directors which no longer serves the purpose for which it was enacted and that legislation not so repealed be amended, if necessary, to ensure directors are provided an effective due diligence defence.* The Committee has written to the appropriate officials within each of the federal and provincial governments to draw this recommendation to their attention with the hope of achieving a fairer and more constructive system of personal director liability in respect of corporate conduct.

"With respect to liability, the current exposure by directors to a myriad of responsibilities has reached the point where it is absurd and dysfunctional. My understanding [is] that legislation holding directors personally liable for wages was originally developed to [protect] employees of private companies from unscrupulous owners/directors. It has virtually no applicability to public companies where independent directors representing the interests of shareholders can no longer accept the risk, especially given the restructuring that our economy is under-going and the plethora of new environmental legislation. In this regard, my particular experience as a director of PWA Corp. [was that] a potential wage liability forced all directors to resign from the subsidiary airline board. Had there not been the good fortune of a holding company which could become the sole director of the operating sub, we could have had a disastrous situation. Directors resigning, together with the additional uncertainty, would not have been in the interest of the corporation, its shareholders, employees, or any other stakeholders."

Herb Pinder, Jr., September 1993.

5.63 We did receive a suggestion that a cap be imposed upon the personal liability of a director. We do not think a cap could be effectively implemented simply through amendments to a corporation's governing statute. A cap would require coordination amongst the jurisdictions imposing personal liability on directors of a particular corporation – a practical impossibility. In any event, we do not think a cap is necessary if the system is subject to examination and reform as suggested above.

Indemnification of Directors

5.64 All directors should have a lively interest in enhancing the functioning of the board. A board made up of committed individuals making judgments in the corporation's best interests will, in addition to giving directors a better sense of well-being, reduce the risk of personal liability.

5.65 To help minimize risk associated with potential personal liabilities of corporate directors, Canadian companies often provide their directors with indemnities and purchase insurance for their directors (typically called directors' & officers' insurance, or "D&O insurance"). Canadian corporate statutes provide that companies may indemnify their directors against all costs, charges and expenses reasonably incurred in respect of any civil, criminal or administrative action. Unfortunately for Canadian directors, corporate indemnities and directors' and officers' insurance will not shelter them from all personal risk associated with their directorship. The cost of D&O insurance is rising, many risks are excluded from the insurance coverage and the maximum amount of coverage is limited. However, we note that the view was expressed to us by one company which arranges D&O insurance that the effectiveness of a corporation's system of governance will significantly influence the availability and cost of insurance.

5.66 Corporations cannot indemnify, and typically insurance companies will not cover, corporate directors against costs incurred as a result of the director not acting honestly and in good faith with a view to the best interests of the company and, in the case of criminal or administrative action that is enforced by a monetary penalty, costs incurred as a result of the director not having reasonable grounds for believing that his or her conduct was lawful. Also, it is typical for directors' and officers' insurance to exclude coverage when costs are associated with fines, imprisonment, dishonest behaviour by the director, willful breach of faith, derivative actions or insolvency of the company.

5.67 It is also critical to point out that an indemnity from a company is only as good as the financial solvency of that company. While corporate indemnities and directors' and officers' insurance help to reduce the increasing risk of directors incurring personal liability, they are not complete solutions to the problem.

"It is time to revisit the concept of the professional director and a professional standard of care raised in the Lawrence Report in 1967. It is a concept which is consistent with the calls for active, informed, independent directors devoting their efforts to no more than 2 or 3 corporations at a time... Taking the securities laws as a model, a higher professional standard of care (and consequently a lower threshold of general liability) could be combined with a due diligence defence. In this way it would perhaps be possible to eliminate disparate other statutory liabilities which may very well have arisen in the vacuum created by the extremely low common law standard of care."

Professor Cally Jordan, Faculty of Law, McGill University, June 22, 1994.

VI. CERTAIN GOVERNANCE RELATED ASPECTS OF THE FUNCTIONING OF THE BOARD

6.1 In this part we identify two additional functions of the board of directors which contribute to effective governance. These functions are in addition to the nominating function, described in Part V.

6.2 The two additional board functions which we think contribute to effective governance are the board's administration of governance issues within the corporation and the board's administration of its relationship to management. We believe that these functions can effectively be performed by committees of the board, or, in the case of a small board of directors, by the full board, absent members of management.

6.3 *As we indicated earlier, our guideline on the composition of board committees is that they generally be made up of outside directors, a majority of whom are unrelated directors.* Requiring a majority of unrelated directors on board committees simply carries forward the recommendation for a majority of unrelated directors on the board. The inclusion of management on board committees should be the exception rather than the rule reflecting our belief, as discussed below, of the importance of the board being able to function independently of management. Some corporations still have an executive committee, which is a committee of the board which generally includes more management or inside directors.

The Governance Committee

6.4 *We propose as our next governance guideline that each board expressly assume responsibility for, or assign to a committee of directors the general responsibility for, developing the corporation's approach to governance issues.* For example, if a committee is appointed or the responsibility is assigned to an existing committee, the committee would be responsible for the corporation's response to the governance guidelines set out in this Report. This function can be readily assumed by the Nominating Committee whose role is central to good governance.

6.5 This committee would propose changes to the board of directors necessary to respond to the governance guidelines. This committee would also be responsible for the explanation to the investment community of the differences between the corporation's governance system and the guidelines.

6.6 If the chair of the board is separate from the CEO, he or she might be an appropriate person to chair the governance committee or the committee responsible for governance matters.

6.7 The governance committee will not only be responsible for the approach of the corporation to governance issues, but will also function as a forum for concerns of individual directors about matters that are not readily or easily discussed in a full board meeting. These matters could include the performance of management or individual members of management or the performance of the board or individual members of the board. As an example, we are aware of at least one corporation which regularly circulates a questionnaire amongst members of the board seeking comment on the adequacy of the corporation's

"The performance of many public corporations in Canada is already being reviewed not only by boards and management, but by other sophisticated control groups such as bankers, bondholders and other creditors, suppliers, government regulators, unions, organized special interest groups, and shareholders with de facto control. Therefore, we would re-affirm our opinion that additional legislation or regulation is not necessary. We also emphasize the responsibility of the Corporate Secretary to be well trained and informed and to keep directors well versed on corporate governance issues."

The Institute of Chartered Secretaries and Administrators in Canada, September 28, 1993.

"A management director is an important source of input and perspective to every committee. To ensure every committee's independence it should at least be balanced or overweighted by outside directors. There is an implication in the Draft Report that management directors somehow taint a committee when, in fact, they should add to the committee's strength… A management director's input should be viewed as an asset, not a liability. If it is the latter, then the board must question whether it is effectively constituted."

Ronald G. Greene, Chairman, Renaissance Energy Ltd., December 7, 1994.

"The Corporate Governance Committee is not a type of Executive Committee with decision-making authority. It is exclusively a tool of the Board, advising and supporting Directors in the effective application of existing corporate governance principles, in convening special sessions of Directors to review the Board Agenda and such other matters as Directors may deem appropriate, in facilitating arrangements for Directors' information needs, and in benchmarking and adapting best practices, as appropriate to the needs and interests of the Bank and its stakeholders."

Royal Bank of Canada, Report of the Corporate Governance Committee, July 6, 1994.

approach to governance. The questionnaire identifies concerns from lack of timeliness of distribution of board materials to concerns about the composition of the board. Any concerns are fielded by the chair who is responsible for developing the response. We recognize that assessment of management may be the responsibility of the Human Resources Committee and the assessment of individual directors may be the responsibility of the Nominating Committee. The important principle, of course, is that these responsibilities be assumed by one or more committees of the board.

"If they [the directors] believe that the CEO, or his department heads, are suggesting courses of action that are detrimental to the interests of the shareholders, they should protest and, even if the vote goes against the protest, should insist on being recorded in the minutes as a contra vote. Sometimes the prestige and goodies of being a director overcome personal conscience in these matters, sometimes the member does not understand the implications in the figures, sometimes he has been so busy or indifferent that he had not read the minutes and his vote is a nothing in terms of intelligent decision making."

Dorothea B. Smart, August, 1993.

6.8 Any concern that the governance committee or the nominating committee has the real power of the board and therefore creates two classes of directors can be addressed by providing for rotation of membership through the committees.

Relationship of the Board to Management

6.9 Many of the responsibilities of the board are delegated by the board to management. We noted earlier the importance of the key participants in the corporate governance process, i.e. management, the board and the shareholders, not confusing their respective responsibilities. At the board level, it is important that the board not participate in the day-to-day management of the business of the corporation. Involvement in day-to-day management may be required in exceptional circumstances but as a general matter it is inefficient, destructive of good management, and precludes the board from discharging its obligation to take a longer term view of the direction of the corporation.

6.10 On the other hand, the board must not be passive and simply react to management proposals. A board must question, scrutinize and be active in fulfilling its role of monitoring management. One of the problems in the past was that some boards were too accepting of the views of management. There must exist a healthy tension between the board and management that ensures that management views are questioned and tested.

"A good board should function as the CEO's sounding board and counsel, the critical role being to raise the red flag about any unforeseen problem, opportunity, risk or "what if." The essential ability for any excellent director is to have what might be described as a well developed "quarterback complex," the attitude of taking ultimate responsibility for spotting and correcting problems or taking advantage of opportunities that are not picked up by others. To govern means to take responsibility for the big issues and problems and to lead in taking decisions and initiatives."

Donald Thain, Business Quarterly, Autumn 1994.

6.11 A key principle to the effective functioning of a board of directors is that it be able to function independently of management – and feel comfortable doing so. There should be an adequate degree of independence and a process or practice in place to allow directors to meet and actively exchange views. In the absence of this ability, a board cannot effectively assess the direction of the company and the performance of management – one of the board's principal responsibilities.

6.12 *We recommend as our next governance guideline that the board, together with the CEO, 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 with the CEO, the corporate objectives which the CEO is responsible for meeting.* This function could be performed by a committee of the board with subsequent board approval. We believe that it is important for the board and management to undertake the exercise. The allocation should recognize the dynamic nature of the relationship necessary for the corporation to adapt to changing circumstances. There will be no one correct prescription for the allocation of responsibilities; it will depend upon the circumstances of each corporation. The allocation of responsibility can be expressed by defining the limits to management's authority on the assumption that corporate action beyond this authority is the responsibility of the board.

Board Must Be Able To Function Independently of Management

Separate Chair and CEO

6.13 Many believe that the principal measure of the nature of the relationship which exists between the board and management is whether there is a chair of the board who is not a member of management. This issue was widely debated in the submissions made to the Committee. Those arguing for separation identify the inherent conflict of interest in having one person act as chair and CEO. How can a board chaired by the most senior member of management function independently of management and monitor and assess management performance? On the other hand, it is argued that if one person performs both roles, the chair/CEO has, in the words of one chair/CEO, "nowhere to hide". Others argue that vesting the two positions in one person may simply be a condition to recruiting the best CEO.

6.14 In our view, the board should be able to function independently of management. This ability of the board is central to effective governance, which requires the board to appoint and monitor management and which creates the public perception that the board functions independently of management. Perhaps the simplest means for implementing this guideline is for the board to appoint a strong non-executive chair of the board whose principal responsibility is managing the board of directors. Although appointing a non-executive chair is no guarantee of the board being able to function independently of management we want to express a preference for the board appointing a non-executive chair. We recognize that other means are also available to achieve this objective. Therefore, we stop short of mandating a firm guideline that the board appoint a non-executive chair. What is important however, is that some structure be in place to facilitate the board in functioning effectively independent of management.

6.15 Structures And Procedures To Ensure Independent Functioning Of The Board – *We propose as our next guideline that every board 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 that the board discharges its responsibilities or (ii) adopt alternate means such as assigning this responsibility to a committee of the board, such as the governance committee, or to a director, sometimes referred to as the "lead director". The chair, or the committee or other director assigned the responsibility, is responsible for managing the processes of the board and for ensuring that the board discharges the responsibilities we have previously defined for it. 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.* The governance committee, if one has been appointed by the board, would be an appropriate committee to perform this function. Public perception of independence is based both on the absence of relationships between individual directors and the corporation and the ability of the board to function independently of management. One practice, which can improve the effectiveness of board meetings, is for the board to meet with the CEO alone at the conclusion of each meeting at which time views can be exchanged as to what was good and what was bad about the meeting. For example, we have heard the complaint that directors feel constrained in their decision-making on a management

"Directors must see their role as more than a quarterly visit to the company for a polite lunch and update."

William J. Anderson, President and C.E.O., Inverness Petroleum Ltd., September 22, 1993.

"The Alcan Board has taken the view that this matter should be kept under periodic review and should not, therefore, be mandated once and for all. The pros and cons of separation have to be measured in the light of the company's business, the constitution and make-up of the board as well as, most critically, the personality and background of the incumbent CEO. All these matters will vary from time to time and it must be one of the prime duties of any board to decide for itself – and for the company it represents – whether or not separation is advantageous to its shareholders."

P. K. Pal, Vice President, Alcan Aluminium Limited, August 29, 1994.

"This [governance] committee's mandate was very broad and included the authority to make recommendations concerning:

i) Board operations, including frequency of meetings and committee structure;

ii) Board composition, size, selection and tenure of directors;

iii) Board assessment, including an element of individual member assessment; and

iv) evaluation of the performance of the chief executive officer."

Donald J. DeGrandis, Secretary, Northern Telecom Limited, October 6, 1994.

"In our experience, the separation of the responsibilities of Chairman and Chief Executive Officer is more important than the appointment of a chair who is not a member of management. We believe it is more important for the two offices of the Chairman and CEO to operate as a close-working partnership where the Chairman's primary responsibility is for external constituencies, while equipped with a day to day awareness of internal management and its operations, and that these two senior officers work together having regard to their different primary responsibilities. The separation helps reinforce the distinction between the role of the board and that of management, and brings a greater sense of accountability of management to its board and of the board to its shareholders."

J. Trevor Eyton, Chairman, Brascan Limited, September 30, 1994.

"The committee [a governance committee] proposed would go a long way towards solving a major problem in Canadian pubic corporations where there is no format for outside directors to precipitate change on highly sensitive issues without appearing to conspire against management...It is true that the proposed committee would have a very heavy responsibility because it would be expected to head off disaster when the man in charge is either unwilling or unable to do so. But it is also true that investors expect outside directors to accept this responsibility."

Brian P. Drummond, Vice-Chairman, Richardson Greenshields of Canada Limited, September 8, 1993.

"Boards of directors must have the ability to exercise all supervisory responsibilities independent of any undue influence by management and while the Institute agrees with the separation in principle, one has to realize that separation of the two roles is by no means a guarantee of board independence."

The Institute of Corporate Directors, September 1994.

presentation if members of management remain in the boardroom during all of the board deliberations.

6.16 As part of the process of defining board and management responsibilities, a job description should also be prepared for the chair of the board. A director would not, simply by virtue of his or her appointment as non-executive chair, be characterized as a related director.

6.17 The corporation will be required to discuss its manner for handling the board's relationship to management in its annual disclosure concerning corporate governance.

Use of Board Committees

6.18 When the board appoints a committee it has to spell out the authority of the committee, and in particular, whether the committee has the authority to act on behalf of the board or simply has authority to examine a particular issue and report back to the board with a recommendation. Authority to act on behalf of the board should be the exception rather than the rule. Use of a committee does not absolve the board from responsibility for the committee's work or decisions. The Committee will function primarily as a means for examining an issue and for preparing a recommendation for full board action. In circumstances where the board appoints the committee to provide a focussed response to issues raised by activity of the corporation, e.g. the environmental committee, the committee may have authority to make some decisions which bind the board. In circumstances where the committee is constituted with independent directors for a specific reason, e.g. to review a related party transaction, the committee will normally have the power to make the decision whether the transaction is in the corporation's best interests, and will simply report its decision to the full board.

6.19 This Report has identified particular functions to be performed by the board rather than proposing specific committees of the board. Most boards will delegate many of these functions to committees of the board. In addition to the audit committee which is required to be established by law, typical issues to be delegated to committees of larger public companies will include:

(i) nominating directors, assessing the effectiveness of the board and the contribution of individual directors – nominating committee;

(ii) corporate objectives, assessment of management, compensation of management – human resources and compensation committee;

(iii) governance of the corporation – corporate governance committee or nominating committee; and

(iv) internal control and management information systems – audit committee.

A number of corporations have achieved efficiencies in the application of board resources by renaming the nomination committee, the governance committee which retains the responsibilities of the nomination committee, assumes the responsibilities of the governance committee and the responsibility described in paragraph 6.15 of ensuring that the board is functioning effectively. The board may also appoint other committees depending upon the nature of its business, e.g. environmental committee, occupational health and safety committee, executive committee, etc. The board will also appoint ad hoc committees as circumstances require, e.g. independent committee to assess a related party transaction or a financing committee to settle the final terms of a proposed financing.

The number of board committees will be a function of the size of the corporation and the board. Smaller corporations will have fewer committees with some of them having responsibility for more than one area of the corporation's activities.

THE AUDIT COMMITTEE

6.20 We will add our support for the widely-held view that the audit committee should be composed of exclusively outside directors. *We therefore propose as our next guideline that the audit committee of every corporation should be composed only of outside directors.*

6.21 We also endorse the Coopers & Lybrand recommendations concerning the audit committee:

> *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 communication 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 would be the responsibility of the audit committee to ensure that management has done so.*

THE EXECUTIVE COMMITTEE

6.22 Boards of directors have become much less reliant upon executive committees. Executive committees are generally delegated all the powers of the board, except for powers which can effect a fundamental change to the corporation. The historical model of the executive committee comprised of the real decision-makers within the board has virtually disappeared. We support this trend. Executive committees tend to create two classes of directors, those on the inside and those on the outside, with the result that those directors on the outside may lose interest and feel little sense of accountability for corporate decisions. In those corporations that do retain the executive committee, it is not uncommon to automatically rotate membership on the committee so that all directors know that they will be involved at some time in the decisions of the executive committee. As noted earlier, the composition of an executive committee should satisfy our guideline concerning a majority of unrelated directors on the committee.

DIRECTOR LIABILITY FOR COMMITTEE ACTIVITIES

6.23 We did hear a comment to the effect that some directors refuse to sit on particular committees, such as the audit or environment committees, because of a fear of heightened personal liability. If the committee has decision-making authority (as opposed to authority to examine and recommend) the members of the committee

"... corporate governance is headed in the direction of the creation and empowerment of a strategic management audit committee of outside directors that would evaluate and report on company results and the performance of the CED and his or her team in the same manner that the audit committee evaluates and reports on the integrity of the financial statements."

Donald Thain, Business Quarterly, Autumn 1994.

"Given the complexity of governing major corporations, the ability of board members to concentrate in one or two areas helps to assure the entire board that adequate monitoring is taking place. This is accomplished through the functioning of board committees composed of outside directors. Periodic rotation of members between committees helps to ensure fresh ideas and objectivity and also helps to broaden the experience of the members."

The Society of Management Accountants of Canada, October 15, 1993.

"What has to be considered is what better information really means. It does not necessarily mean more information...What is needed is clear and pertinent information."

The YorkMont Partners, Limited, September 27, 1993.

"The requirement of ensuring that adequate and proper information is made available to the board is one of the most important processes for effective corporate governance. The reality of the situation for a large, diversified corporation is that it needs a chairman who has intimate knowledge of the company. He or she has to know what information the board needs to make quality decisions and how to get it. This would almost certainly be more difficult for a chairman who is not the CEO. An independent chairman would have to establish and maintain his or her own lines of communication in the company, separate and apart from the CEO. In the real world, this would be exceedingly difficult to do for a person coming into a company from the outside."

Richard M. Thomson, Chairman & Chief Executive Officer, The Toronto-Dominion Bank, October 3, 1994.

"In addition to the responsibilities in relation to corporate governance arising from the Committee report, it is to be expected that the Chair will in some cases assume a limited range of responsibilities to complement the CEO's focus. The increased scope of activities of the Chair flowing form the Committee's recommendations and the further development of the role can be expected to result in compensation and office arrangements that are different from those presently customarily associated with a director or committee chair, and that are commensurate with the commitment which will be required for the Chair position."

Imasco Limited, October 3, 1994.

will have increased exposure to liability under the corporate law for decisions made by the committee. Directors who are not members of the committee may not be directly liable for decisions of the committee although the full board could also be held liable for the decision to appoint the committee and the decision establishing the terms of the relationship between the committee and the full board and for the manner in which they monitor the activities of the committee. Personal liability under particular stakeholder statutes will often depend upon the director's ability to establish his or her due diligence defence. Directors who are members of committees will be measured against a different standard than will directors who are not members of committees in establishing their due diligence defence in respect of corporate action falling within the authority of a board committee.

6.24 In today's environment, it is necessary for many companies to operate through committees. While there may, as a practical matter, be some heightened exposure, it should be offset by procedures and systems which establish a due diligence defence. A refusal by a director to sit on a committee because of fear of increased personal liability should be viewed negatively in the assessment of the contribution of the director to a board.

Board Dependence Upon Information

6.25 Nowhere is it truer than in the context of a board of directors that "information is power". Individual directors do not have the time or resources to obtain information from the corporation relevant to proposed board decisions. Further, they cannot be certain of the information they do need or should ask for. The directors are totally dependent upon others for information.

Qualitative and Quantitative Information

6.26 We also want to underline the importance of boards receiving information that is not just historical or bottom line and financial oriented. The effective board of directors will seek information that goes beyond assessing the quantitative performance of the enterprise and looks at other performance factors such as customer satisfaction, product and service quality, market share, market reaction, environmental performance and so on.

6.27 The responsibility for meeting this need will generally fall to the chair of the board. The chair will also have responsibility for setting the agenda for directors' meetings. The chair will have primary responsibility for organizing the information necessary for the board to deal with the agenda and for providing this information to the directors on a timely basis. If the chair is also the CEO, the board should have in place a procedure to ensure that its agenda items are placed on the agenda. For example, the chair may be required to review the agenda of each meeting with the chair of the governance committee prior to settling the agenda.

6.28 We recommend that all boards specifically allocate the responsibility for setting the board agenda and for organizing and circulating the information relevant to the agenda on a timely basis. Although this responsibility appears obvious, we were continually impressed by the anecdotal evidence of either too little or too much information being provided to directors too late in the decision-making process. A board which is foreclosed from making constructive input into a corporate decision because the board is involved too late should be expected to deal with management quite harshly.

Individual Directors Engaging Outside Advisors

6.29 Boards of directors do not necessarily act collectively and do not always achieve a consensus on corporate decisions. The individual director who wishes to dissent from a board decision, believes that the direction the board is taking is wrong, or is otherwise concerned about his or her personal liability for corporate actions may want to better understand the proposed board action and understand the implications of his or her dissent, and in some circumstances may want to consider other courses of action such as resigning from the board or making a public statement. There are any number of circumstances in which an individual director will want to obtain outside advice. A director, we believe, will function more effectively if the director knows that he or she has reasonable access to his or her own experts. *We support the right of individual directors to engage outside advisors, at the expense of the corporation, in appropriate circumstances. To impose some discipline upon the engagement of outside experts, we recommend that the engagement by an individual director of an outside expert be subject to the approval of an appropriate committee of the board.*

6.30 To alleviate any management concerns that this right could be abused, the engagement of outside advisors should be done with the full knowledge of management. The engagement of outside advisors should be for the purpose of assisting the director in overseeing management of the corporation and should not be for the purpose of enabling the director to participate in day-to-day management of the business.

6.31 Outside advisors would include lawyers, public accountants, financial advisors and so on. Public accountants, as one of the potential outside advisors, have particular responsibilities in that, when they serve as auditors, they are required to report directly to the shareholders. Accordingly, they have extended potential liability in respect of such reporting which goes beyond that normally applicable to other advisors. The concerns that we have expressed above relating to the expansion of personal liability of directors also apply to the civil liability of advisors. It is ultimately counterproductive to ask advisors to carry unduly onerous liabilities because ultimately these will imperil the ability of the corporation to obtain timely and effective advice.

6.32 We note the increasing concern being expressed by some outside advisors, particularly public accountants, about the liability issue, and we also note that the incidence of lawsuits and claims against such advisors is escalating. In some cases, the institution or the threat of institution of a lawsuit can be damaging to such persons even if the lawsuit ultimately is not successful. The danger of liability chill in these circumstances would be counterproductive to the effective discharge by directors of their responsibilities. The establishment of appropriate limits to this liability is beyond this Committee but it is an issue which should receive further consideration. We note that the problem of professional liability is one that is being addressed in other jurisdictions; for example in Australia, the United Kingdom and the United States, where governments and government agencies are reviewing possible solutions.

"There has recently been a trend towards boards of directors obtaining independent financial and legal advice under appropriate circumstances, such as those contemplated by Ontario Policy Statement 9.1. I encourage this trend. I believe that directors should have the ability to retain advice independent of management whenever they consider it appropriate, including, but not limited to, the circumstances contemplated by Ontario Policy Statement 9.1. These circumstances could include related party transactions, questions of the adequacy of due diligence examinations in public issues and the relations between the chief executive officer and the company. However, once again the board should limit its role to the review of management activities where that is necessary and should not duplicate the advice received by management unless it is strictly necessary."

William R. Miles, Ladner Downs, September 16, 1993.

VII. SHAREHOLDERS IN THE GOVERNANCE PROCESS

THE RELATIONSHIP BETWEEN THE BOARD AND SHAREHOLDERS

7.1 The intimacy of the relationship between the board and management generally does not exist between the board and shareholders even though the directors are elected by and are accountable to the shareholders. The important exception is the significant shareholder who sits on the board. Apart from this circumstance, the allocation of decision-making authority between the board and shareholders is generally not an issue. Decisions made by shareholders relate to the election of directors, the election of auditors, and generally to fundamental changes to the corporation's constitution or business. Good governance also requires shareholder votes in circumstances where the board of directors may be interested in the transaction. Shareholder votes may be mandated by the governing corporate law, securities commission policy statements, etc. Periodically, a shareholder advisory vote will be conducted by a board in respect of a matter on which the board seeks shareholder views, although the results of the vote do not technically bind the board and are simply for the board's guidance.

"OMERS believes that corporate governance in Canadian public companies is not very effective primarily because there are too many instances where the board of directors is not demonstrating that it is, in fact, directing the corporation and providing adequate accountability to all shareholders equally. OMERS further feels very strongly that shareholders themselves have a duty to make their feelings known to the Boards of companies in which they are shareholders and not simply to senior management."

Dale E. Richmond, President & C.E.O., Ontario Municipal Employees Retirement Board, September 30, 1993.

7.2 The effectiveness of the proxy solicitation process and the shareholder meeting as a forum for shareholders to express their views is open to question but is an issue which the Committee does not propose to address in any detail. We note that shareholders and corporations recognize the limitations of the shareholders meeting and are becoming more creative in exchanging views. We do, however, want to discuss the importance of shareholder involvement in corporate governance and the importance of the information upon which shareholders rely in making investment decisions.

"Confidence in corporate governance will likely require that governance become more transparent to shareholders and other important stakeholders such as employees, regulatory bodies, consumers, creditors, etc."

Canadian Comprehensive Auditing Foundation, September 1993.

7.3 We note that shareholders are becoming more effective in influencing corporate decisions, not so much the decisions relating to the business, but the decisions relating to the structure of the corporation, such as the share structure and the response strategy to unsolicited take-over bids. We also detect a concern of shareholders relating to board composition and the willingness of boards to monitor and independently assess management. Effective governance depends heavily on the willingness of the owners to behave like owners and to exercise their rights of ownership, to express their views to boards of directors, and to organize and exercise their shareholder franchise if they do not receive a satisfactory response.

"...we are more and more witnessing an increase in institutional investors presence. This has led to increased activism on their part for purposes of protecting their long-term interests. These investors have become specialists and analysts who can overpower smaller isolated shareholders ultimately leading to the indirect management of the corporation. However, this has the advantage of encouraging management to better perform due to a higher degree of sophistication on the part of these shareholders. The coming to the forefront of these investors has shifted the focus of corporate accountability from stock market discipline to the existing governance structure."

Hollis Harris, Chairman, President and CEO, Air Canada, September 2, 1993.

SHAREHOLDER – CORPORATION LINES OF COMMUNICATION

7.4 Effective corporate governance also depends upon a vital shareholder community. The vitality is usually reflected in the shareholder's interest in the affairs of the corporation and in many circumstances, the shareholder's willingness to make its views concerning corporate activities known to the corporation. As the holdings of the larger shareholders have grown, they recognize the limitations in disposing of their holdings or reducing their holdings as a response to poor corporate performance. Instead, these shareholders are opening lines of communication with corporations and are seeking to establish a dialogue which can be used as a basis for expressing views on a broad range of corporate activities.

"...we have noticed an increase in the significance of the institutional investor as a shareholder in our organization. The implications of having serious long term "owners" involved who may express views and exert influence on corporate direction can be beneficial. Long term investors can be more consistent than the influence of a multitude of short term investors who seldom express their views or offer advice only through the formal proxy solicitation process. The long term owner has a greater potential to be an effective monitor of corporate performance which could be conducive to greater efficiency and competitiveness in our organization."

Brian F. MacNeill,
President and Chief Executive Officer,
Interprovincial Pipe Line System Inc.,
September 30, 1993.

"Institutional shareholders already own a large portion of the outstanding shares of Canadian corporations, especially what are considered "large cap" stocks... these holdings will increase significantly in the future, as well. Given the relatively small size of the Canadian equity market and the constant cash flow into pension funds, it is unavoidable that these institutions will become long term investors, i.e. owners in these corporations. If there is a party that can effectively influence the shape of corporate governance in Canada in general and a specific corporation in particular, it is these investors themselves... [T]he Task Force would indicate its conviction that shaping the governance of a given corporation and holding the Board accountable are tasks that cannot be accomplished without the active participation of the institutional shareholders."

Dr. John T. Por, President,
Cortex Applied Research Inc.
August 10, 1994.

7.5 In addition to information required to be published by corporations through annual reports, information circulars, timely disclosure releases, etc., corporations can also disseminate information through meetings with analysts. Larger shareholders who employ analysts will seek periodic meetings with corporations to obtain more detailed knowledge of information than is already on the public record. Analysts employed by market intermediaries will have the same access to the corporation and will reflect these discussions in commentaries available to investors.

7.6 We heard from many institutional shareholders of their desire to better understand the business of the corporations in which they have invested in order to improve the quality of their investment decision-making. We also heard from a number of CEOs that they also want to be able to treat significant shareholders more like "partners". In other words, they want their shareholders to better understand the business of the corporation. Their purpose is to create a more stable shareholder base. They believe that shareholders will be willing to maintain their shareholding and take a longer term view of their investment if they have a better understanding of the corporate strategy. The objectives of the investors and CEOs appear to be quite compatible. We encourage this relationship provided two issues are properly addressed.

7.7 The information which a corporation typically provides to an investor should not qualify as undisclosed material information about the corporation. The information should generally provide background to a previously disclosed corporate initiative or may simply be more comprehensive information about the business of the corporation. Nevertheless, the first issue which has to be addressed is to ensure that the information does not qualify as undisclosed material information. On the rare occasion when an investor is provided material undisclosed information "in the necessary course of business", the issuer has to be satisfied that the investor will not use the information to trade securities of the issuer until the information is generally disclosed or is no longer material. The investor has to agree to abide by these terms.

7.8 Second, the same opportunity should be available to all shareholders, although, as a practical matter, the opportunity for shareholders generally to obtain material information may have to await more general disclosure. How corporations accommodate small shareholders may require some creativity but at the very least corporations should be as accessible to analysts of brokerage houses as they are to the analysts of the large institutional investors.

7.9 In support of two-way communication between corporations and their shareholders, each corporation should have in place a corporate policy for dealing with communications from investors. For example, inquiries received by directors from shareholders may be referred to particular officers of the corporation depending upon the nature of the inquiry. We believe it is important that corporations facilitate shareholder feedback rather than, as is the case in the eyes of some corporations, regarding it as a nuisance. In times of corporate stress, however, the conventional policy for dealing with shareholder inquires may not be appropriate, because direct relationships between directors and significant shareholders may open lines of communication which may be useful in the circumstances.

7.10 The board will want to ensure that it receives an ongoing report from the responsible officer or director of comments or concerns expressed by shareholders to the corporation. The system for responding to shareholder communications should ensure that information is not provided to any particular shareholder that is not generally available to all other shareholders.

7.11 Part of the success realized by investors in increasing their degree of influence on corporations is as a result of initiatives taken by these investors to have a more organized, coherent and broadly-based approach to corporate issues through institutional shareholder bodies organized by the shareholders. One of the areas of particular focus of investors in the last several years has been the manner in which corporations are governed. An important objective of our recommendations is to require corporations to provide investors with more information concerning the governance of the corporation.

Reliability of Corporate Information

7.12 For the investor community to be vital, it must be confident of the accuracy and currency of the information base upon which it must rely. We have the distinct sense that concerns exist about the ongoing disclosures of public companies. The concerns focus both on the timeliness of the release of information and upon the content of the releases. We observed in Part IV that one of the principal responsibilities of the board of directors is communicating with shareholders. The decision as to when information should be released is one of the most difficult decisions facing a board coping with an evolving transaction or changing set of circumstances within the corporation. However, we regard the decision as to the timing of release of the information as of paramount importance in building shareholder confidence in corporate management.

7.13 Our provincial securities laws spell out the rules concerning the timing and content of disclosure concerning the affairs of a public company. In general terms, there are two types of disclosure, i.e. prospectus disclosure and continuous disclosure. The prospectus is the most comprehensive disclosure document and its accuracy is certified by the corporation and the board of directors. The directors, in addition to the corporation, are liable for any misrepresentations contained in the prospectus although the directors have available a due diligence defence.

7.14 Our continuous disclosure system includes timely disclosure releases regarding material changes, as well as quarterly and annual reports. There is no statutory civil liability attaching to the decision as to the timing of the publication of a timely disclosure release. In addition, no statutory civil liability attaches to the content of the timely disclosure or quarterly or annual reports, with two exceptions, i.e. issuers undertaking securities offerings in the short form system and issuers who are registered in the United States. The short form system, which is most often used to market securities subject to a "bought deal", depends upon the use of a short-form prospectus which incorporates by reference previously released continuous disclosure reports. The short-form prospectus and the material incorporated by reference are required to be certified as constituting full, true and plain disclosure of all material facts concerning the issuer. In circumstances where materials from the continuous disclosure file are incorporated by reference in a short-form prospectus, statutory civil liability attaches not only to the short-form prospectus but to

"Effective shareholders will keep themselves informed about corporate governance issues, not shrink from any activist role and manage their proxy votes in order to protect stock ownership rights from erosion."

Pension Investment Association of Canada, September 27, 1993, PIAC Corporate Governance Standard.

"We believe it is management's responsibility to establish good communications with the company's shareholders and would expect most shareholders to contact management with their questions or concerns, at least in the first instance. If a shareholder found management unresponsive, the shareholder would still be free to communicate with the directors."

John Labatt Limited, September 30, 1993.

"Institutions may want one thing, the majority shareholder another. These two groups have a great deal of power but the board must still consider and protect the interests of its other constituents – individual shareholders, debt holders, customers, government, the community. In too many situations today this balancing of interests does not exist. We are strongly against providing or allowing to exist any special rights or privileges for significant shareholders, whether they be institutional shareholders or majority owners of closely-held public companies. In this situation directors have the difficult task of forcing an open and candid discussion of their role and responsibility in the presence of both management and the major shareholder so that management is given a clear understanding and explicit direction on its relationship with the directors."

J.S. Mustoe, Senior Vice-President, General Counsel, NOVA Corporation of Alberta, September 30, 1993.

the material incorporated by reference. The civil liability does not relate to the timing of any timely disclosure releases. In addition, a Canadian issuer which has offered securities to the public or is listed in the United States will be exposed to potential civil liability under U.S. laws.

7.15 We also note the difference between personal director liability for financial statements included in a prospectus, on the one hand, and liability for quarterly unaudited financial statements as they are released, on the other. In the former case there is a well established process, including the involvement of the outside auditors for verifying the accuracy of the statements. In the latter case, the external auditors are not necessarily or fully involved and the question arises as to why should directors assume personal liability for the content of the statements. We are sympathetic to the position of the directors in these circumstances and are concerned about the impact of an extension of liability for quarterly financials to individual directors.

7.16 We stop short of actually recommending legislating civil liability for the timing and content of releases concerning material changes. *We agree with the proposal of the Chair of the Ontario Securities Commission in his January 25, 1994 remarks to the 1994 Corporate Secretaries Congress, entitled "Making Continuous Disclosure Work Better", that the issue of legislated civil liability in respect of timely and continuous disclosure should be put back on the policy agenda.* We applaud the appointment by the TSE of a committee to explore disclosure issues relating to listed companies The timeliness and quality of information is not only critical to efficient capital markets but also to effective corporate governance.

7.17 We expressed our concerns in Part V about the extent of the use of personal liability of directors as a means of influencing corporate conduct and recommended a review of the legislation imposing personal liability and amendments to this legislation in some circumstances. *In light of these concerns we would not support any recommendation to legislate civil liability of directors for timely and continuous disclosure, unless our general recommendation concerning civil liability of directors is also accepted and implemented.*

7.18 In addition, any statutory measure to impose civil liability on directors must be fair to the board and take into account the concerns we expressed in Part V concerning personal liability of directors for corporate conduct. While we might support a statutory provision imposing civil liability on directors for the content of continuous and timely releases, we have difficulty supporting civil liability of directors for the timing of releases. One of the most difficult decisions corporations face is the timing of releases concerning material changes in the affairs of a corporation. The market can be harmed both by premature and late disclosure. The corporation is liable for the timing of releases. We believe that requiring boards to approve all timely disclosure releases would be counterproductive. Mobilizing a board on a timely basis to approve the content and timing of a release will not be possible for many corporations. Any extension of liability to the board will have to be carefully considered in the context of the larger objective of timely and accurate disclosure.

"In recent years, with the recession, many public companies in Canada have experienced financial difficulties. In some cases, information on the extent of problems has been slow to come. In other cases, companies have been premature in reporting that problems have been overcome. Several have presented their circumstances in too positive a light. Ultimately, when the reality becomes apparent, shareholders feel they have been misled."

The Board of Trade of Metropolitan Toronto, September 28, 1993.

"Generally management reacts negatively to a proposal. Perhaps they see it as confrontational. Perhaps they dislike public discussion.... It seems to us that a role exists for the Board as shareholder representatives in examining shareholder proposals.... It is important to keep in mind that the majority of small shareholders do not attend annual meetings and are unlikely to do the things you suggest in 7.3. The proposal for them provides opportunity to consider a question with salient arguments and then "behave like owners". Hopefully then in a future redrafting a reference to the board's responsibility to facilitate communication among shareholders through advice on proposals could be addressed."

W.R. Davis, Coordinator, Taskforce on the Churches & Corporate Responsibility, July 14, 1994.

VIII. IMPLEMENTING THE GUIDELINES

8.1 *We recommend that every company incorporated in Canada or a province of Canada whose shares are traded publicly in Canada be required to disclose on an annual basis its approach to corporate governance. The disclosure – a "Statement of Corporate Governance Practices" – should be made in the corporation's annual report or information circular.* When we say disclose its approach to corporate governance, we mean a description of the corporation's system of corporate governance with reference to the guidelines that we have proposed in this Report and, where the company's system is different from the guidelines, an explanation of the differences. We expect the discussion would be relatively brief but would address at least the following points:

- Mandate of the board, which should set forth duties and objectives
- 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
- 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
- Description of the board committees, their mandates and their activities
- Description of decisions requiring prior approval by the board
- Procedures in place for recruiting new directors and other performance-enhancing measures, such as assessment of board performance
- Measures for receiving shareholder feedback and measures for dealing with shareholder concerns
- The board's expectations of management

TSE Listing Requirement

8.2 *Perhaps the most practical way to make the disclosure requirement applicable to the largest number of public companies incorporated in Canada or a province of Canada is to request the TSE to adopt the disclosure obligation as a listing requirement. In delivering this Report to the TSE, we will request consideration by the Exchange of the adoption of such a listing requirement. We will also request the TSE to discuss with other Canadian exchanges the extension of the listing requirement to companies listed on those exchanges.*

"We recommend that the TSE Committee give recognition in its Report to the value of comprehensive corporate governance policies for boards of directors as a means of helping them to meet the challenges of corporate governance and to develop procedures that will protect directors from liability. Every board of directors should be strongly encouraged to adopt a comprehensive and well developed corporate governance policy. The manner of writing and implementing the guide should be left up to each board as it sees fit."

Canadian Bankers Association, December, 1993.

"We believe it is important for a corporation's stakeholders to be able to ascertain and understand a company's corporate governance philosophy. Accordingly, each company, as part of its governance statement, should be required to outline the values, standards and principles that underlie its governance policy. In addition, a statement of director duties , outlining the performance and ethical standards required of individual directors, should be published...

Continuing on the theme of disclosure, we believe it would be helpful if companies disclosed, probably in the annual report, the type and number of board committees, their mandate, and the frequency of meetings held."

J. Richard Finlay and Partners, September 1994.

"...Whether or not the guidelines should be equally applicable to large and small corporations or whether, in fact, initially they should only be applied to the larger TSE companies. This issue, again, would seem to turn on whether the guidelines will be used as a compliance standard requiring a basis for explaining why a corporation is not meeting them, or whether they will be backdrop against which a corporation will describe what in fact it is doing."

H.G. Schaefer, Chairman of the Board, TransAlta Corporation, July 20, 1994.

"...we would note that while the idea of voluntary guidelines is a good one, we do not believe that mandatory disclosure on compliance or non-compliance with the guidelines is advisable in the immediate future. Until sufficient experience has been gained in dealing with the proposed guidelines, any comment by an issuer in its proxy materials on compliance with the guidelines ought to be on an optional basis only."

Josef J. Fridman, Senior Vice-President, BCE Inc., August 23, 1994.

The Guidelines Are Points of Reference

8.3 We are not, as we stated at the outset, recommending that public companies be required to comply with the guidelines which we have developed in this Report. We recognize that each company should have the flexibility to develop its own approach to corporate governance. We do think that our guidelines establish the framework for a sound approach to corporate governance but we recognize that corporations will develop alternatives that may be just as sound. What is important, of course, is that each corporation consciously address the governance issue and that the investment community receive an explanation for the corporation's approach to governance so that it is in a position to support the approach or to work to influence change.

8.4 Although we have not proposed mandating compliance with our governance guidelines, we are hopeful that the existence of the guidelines may raise the reasonable standard against which the conduct of boards and individual directors will be judged. The courts, in judging whether a board has acted in good faith or has acted in the best interests of the corporation, will refer to community standards. The guidelines should contribute to the development of these community standards. Consistent with our view that the guidelines should serve as benchmarks against which governance systems can be assessed is our view that adopting a system different from the guidelines should not in itself give rise to liability.

8.5 We are also hopeful that individual directors and full boards will be able to use our thoughts about effective corporate governance to implement improvements. Many boards will not require external encouragement but will recognize the value to the corporation of enhanced governance. The shareholders, the owners of the corporation, will have the opportunity to, and if we are to improve the quality of corporate governance in Canada must, use their influence as shareholders to challenge the approach of the other boards and to force change.

APPENDIX A

PRINCIPAL AMENDMENTS TO THE DRAFT REPORT

Application of Disclosure Obligation – The listing requirement on which the proposals in the Final Report are based will apply only to companies incorporated in Canada or a province of Canada (and listed on a stock exchange which accepts the proposals) rather than to all companies wherever incorporated.

Disclosure Obligation – The obligation of the listed companies will be to describe in their annual report or information circular their system of corporate governance with reference to the guidelines proposed in the Final Report rather than to disclose annually in their information circulars whether they comply with the guidelines.

Principal Responsibilities of the Board – The corporation should adopt a strategic planning process from which a corporate strategy evolves rather than simply adopting a corporate strategy. The process is more dynamic than suggested in the Draft Report.

A fifth board responsibility has been added – the understanding of the principal risks of the business. The board must ensure there are in place systems which effectively monitor and manage these risks.

The board responsibility in respect of communications is expressed as ensuring the corporation has in place a communications policy rather than a communications program to eliminate any suggestion that the board has a responsibility for day-to-day communications.

The reporting obligation of public companies on internal controls is limited to internal controls on financial reporting and regulatory compliance.

Unrelated Directors – The definition has been amended to eliminate any interest or any business or other relationship arising from shareholding. Accordingly, directors with interests in or other relationships to a significant shareholder are unrelated directors.

A significant shareholder is a shareholder with the ability to exercise a majority of the votes for the election of the board of directors.

If a 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.

Disclosure Obligation Concerning the Board – The obligation will be to disclose whether the board has a majority of unrelated directors rather than which directors qualify as unrelated directors.

If the corporation has a significant shareholder, the corporation will be obligated to disclose whether the board is constituted with the appropriate number of directors who are not related to either the corporation or the significant shareholder.

Consolidation of Guidelines – Guidelines (11) and (13) in the Draft Report concerning structures and procedures to ensure the board can function independently of management have been consolidated.

The Final Report, like the Draft Report, stops short of proposing a guideline that the board appoint a non-executive chair of the board, but does express a preference for the appointment of a non-executive chair.

APPENDIX B

COMMITTEE STAFF

The following persons assisted the Committee at various times during its process as members of the Chair's former law firm, Osler Hoskin & Harcourt:

Frank R. Allen
Michael A. Burns
John Claydon
David W. Drinkwater
Christian B.L. Erickson
Martin T. Guest
Carol A. Hansell
Clay Horner
Allyson C. Landy
Richard Lococo
Andrew J. MacDougall
Stanley Magidson
Paul R. McKeown
Richard J. Nathan
Karin Schwarz
Frank J. Turner
David H. Zemans

APPENDIX 3.16

COMMITTEE PROCESS

The Committee's consultation and information gathering process was made up of three components: (a) written submissions; (b) oral submissions; and (c) other activities and forms of consultation.

WRITTEN SUBMISSIONS

Starting in June of 1993, the Committee invited interested parties to make written submissions on corporate governance issues. The invitation requesting submissions was published in the Globe and Mail, Financial Post, and La Presse newspapers, the regular bulletins or newsletters of the provincial securities commissions, and was sent directly to more than 500 interested parties, including securities regulators, public companies, lawyers, accountants, investors and investment managers, as well as various professional, academic, and other organizations, associations, and groups. The form of the notice that was published is included as Appendix 3.16A.

The solicitation for submissions resulted in the Committee receiving more than 80 written submissions from a wide variety of sources, ranging from concerned individuals to some of Canada's largest corporations. The list of those who provided written submissions is included as Appendix 3.16B. The majority of the submissions received by the Committee are available for public review at the Information Resources Centre of The Toronto Stock Exchange and may be viewed by appointment.

ORAL SUBMISSIONS

In September 1993, the Committee held a series of public meetings in Vancouver, Calgary, Toronto, Montreal, and Halifax, at which any interested parties were invited to attend and make presentations on topics of their choice. Information relating to these hearings was disseminated in the same fashion as the invitations to make written submissions.

In all, the Committee heard presentations from some 37 different people. As with the written submissions, the oral submissions came from a broad range of interested parties. The complete list of those who made presentations at the public meetings is included as Appendix 3.16C.

The Draft Report of the Committee was released in May, 1994. The Committee received approximately 70 submissions on the Draft Report. The list of those who provided written submissions on the Draft Report is included as Appendix 3.16D. The majority of the submissions on the Draft Report received by the Committee are available for public review at the Information Resources Centre of The Toronto Stock Exchange and may be reviewed by appointment.

OTHER ACTIVITIES

In addition to the more formal activities described above, the Committee undertook several other less formal activities to gather information and gain the benefit of public opinion on corporate governance matters. By their nature, these activities are difficult to catalogue or summarize, but they included the development of a fairly extensive library of written materials, one-on-one meetings with interested individuals, cooperation with other groups studying corporate governance topics, consultation with certain government representatives, and numerous speaking engagements and similar activities which allowed Committee members the opportunity to engage in unstructured debate and hear some of the concerns prevalent in the broader community.

The Committee also benefitted from the input of a number of other parties involved in corporate governance including Matthew Barrett and Dereck Jones, respectively the Chairman and CEO and the Senior Vice President, General Counsel and Secretary of the Bank of Montreal; Michael A. MacKenzie, Superintendent of Financial Institutions Canada; W.A. Macdonald, Chair of the Commission to Study the Public's Expectations of Audits; and the Business Council on National Issues. The BCNI conducted a comprehensive survey of CEOs which was of great assistance to the Committee. In addition the Chair of the Committee had the benefit of separate interviews with Sir Adrian Cadbury, Chair of the Cadbury Committee, officers of the London Stock Exchange, R. D. Regan of the Association of British Insurers and with members of a number of City of London law firms.

APPENDIX 3.16A

ISSUES FOR COMMENT

The Toronto Stock Exchange Committee on Corporate Governance in Canada

The Toronto Stock Exchange has established the Committee on Corporate Governance in Canada with a mandate to conduct a comprehensive study of corporate governance in Canada and to make recommendations to improve the manner in which Canadian corporations are governed.

The Toronto Stock Exchange has stated that it believes there is a direct relationship between corporate governance and investor confidence in capital markets.

For the purposes of the Committee's study, "corporate governance" could be defined as follows:

> "Corporate governance" means the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing long-term value for shareholders and the financial viability of the business. The process and structure define the division of power and accountability among shareholders, the board of directors and management and can have an impact on other stakeholders such as employees, customers, suppliers and communities.

The Committee will seek to make recommendations designed to improve corporate governance in Canada and thereby increase confidence in and improve the efficiency of Canadian capital markets in order to ultimately enhance the competitiveness of the Canadian economy.

As part of its research, the Committee is inviting interested parties to make written submissions on matters relating to the Committee's work. It is expected that the Committee's review will cover a diverse range of issues. In particular, the Committee is soliciting comments on the following issues:

1. State of Corporate Governance in Canada
- How effective is corporate governance in Canadian public companies?
- Are the various corporate governance rules and practices followed in Canada working effectively or are these rules and practices, or some of them, in need of reform?

2. Duties of Directors
- How should the duties of directors be defined in relation to the other parties responsible for or participating in corporate governance?
- Is the traditional definition of the directors' responsibility "to manage the business and affairs of the corporation" appropriate?
- What are the implications for good corporate governance of the trend, both by changes in legislation and practice, to increase the personal liability and responsibilities of directors?

3. Directors and Management
- Does the appropriate balance of power exist between the board and management? What is the appropriate role of the board in acting independently of management?
- What are the various means for achieving this balance, structural and otherwise, such as separating the chair from the CEO?
- Is the concept of "independence", for purposes of board selection and operation, understood?

4. Directors and Shareholders
- What is the appropriate relationship between the board and shareholders?
- What are the implications for corporate governance in Canada of the increasing significance of institutional shareholders in Canadian capital markets?
- What unique issues are faced by directors of closely-held public companies in Canada?

5. Enhancing Board Effectiveness
- Can the effectiveness of the board of directors be increased by improving the type and form of information available to the board?
- Is it desirable to review certain constitutional features of the board, such as the manner in which it is appointed, the use of committees and the frequency and types of meetings?
- What access should the board have to, what use should be made by the board of, and what reliance should the board have on, external advisers, including the corporation's auditors?

All submissions should be sent to:

The Toronto Stock Exchange
Committee on Corporate Governance
c/o Peter J. Dey, Q.C., Chair
Suite 6600
1 First Canadian Place
P.O. Box 50
Toronto, Ontario
M5X 1B8

The deadline for making submissions is September 30, 1993.

The Committee is also contemplating public hearings, further details of which will be made available at a later date.

If you require further information on the Committee, its mandate and procedures, or the submission process, please call (416) 862-6708.

The Exchange

APPENDIX 3.16B

LIST OF SUBMISSIONS ON ISSUES FOR COMMENT

AFC Management Services Limited
Air Canada

BAA plc
BC TEL
BCE Inc.
BioChem Pharma Inc.
Boardroom Advisory Services
Byers Casgrain

Canadian Bankers Association
Canadian Centre for Ethics and Corporate Policy
Canadian Comprehensive Auditing Foundation
Canadian Imperial Bank of Commerce
Canadian Institute of Chartered Accountants
Cassels Brock & Blackwell
CN Investment Division
Consumer and Corporate Affairs Canada
Conference Board of Canada
Coopers & Lybrand
Cortex Applied Research Inc.
Coward, W. S.

Daniels, Ron and Morgan, Ed
Department of Finance Canada
Deloitte & Touche
di Norcia, Prof. Vincent
Drummond, Brian
D. S. Rudd Associates Ltd.

Echo Bay Mines
EthicScan Canada

Fairvest Securities Corporation
Fasken Campbell Godfrey
Financial Executives Institute Canada
Finlay, J. Richard & Partners
Franco-Nevada Mining Corporation Ltd.

Grivakes, Tass

Hammerson Canada Inc.
Hanna Heppell Bell & Visosky

Inverness Petroleum Ltd.
Industry and Science Canada
Interprovincial Pipe Line System Inc.

Jarislowsky, Fraser & Company Ltd.
John Labatt Limited

Lafferty, Harwood & Partners Ltd.
Lewis, Donald, Bergman, Paul and Park, Yun
Litchfield, Randall

Mawani, Amin
McMurrich, James
Meighen Demers
Miles, William
Ministry of Industry and Science
Moffat, John
Montgomery, K.E. and Leighton, D.S.R.

National Centre for Management Research and Development
Newell, John
Northern Telecom Limited
Nova Scotia Securities Commission
NOVA Corporation of Alberta

Ogilvy Renault
Ontario Municipal Employees Retirement Board
Ontario Teachers' Pension Plan Board

Pension Investment Association of Canada
Pinder, Herb
Price Waterhouse

Rayrock Yellowknife Resources Inc.
Rees, Donald

Shell Canada Limited
Sibson & Company
Smart, Dorothen
Sobey, David F.
Strategic Associates Incorporated

Templeton Management Limited
The Board of Trade of Metropolitan Toronto
The Guarantee Company of North America
The Hogan Group
The Institute of Chartered Secretaries and Administrators in Canada
The Molson Companies Limited
The Society of Management Accountants of Canada
Tovell, David
TransAlta Corporation

Vancouver Stock Exchange

Waterloo Insurance Brokers
Wells Fargo Nikko Investment Advisors Canada Limited
Wharf Resources Ltd.
William M. Mercer Limited
World Access Canada Inc.

YorkMont Partners Limited

One Confidential Submission

APPENDIX 3.16C

LIST OF PRESENTERS AT PUBLIC MEETINGS

CALGARY - SEPTEMBER 20, 1993

Jim Coleman, MacLeod Dixon

Rhondda Grant, NOVA Corporation

Andrew Love, MacLeod, Dixon

Jim Millard, MacKimmie Matthews

VANCOUVER - SEPTEMBER 21, 1993

Larry Bell, Shato Holdings and Westar Mining

Nicholas Geer, The Jim Pattison Group of Companies

John Howard, MacMillan Bloedel

Bruce MacDonald, Certified General Accountants' Association of Canada

David Mercier, American West Capital Corporation

William Miles, Ladner Downs

Geoffrey Mynett, MacMillan Bloedel

Anthony Toth, Certified General Accountants' Association of Canada

HALIFAX - SEPTEMBER 23, 1993

Patrick Brennan, President, Atlantic Canada Chapter of Financial Analysts

Jody W. Forsyth, Dalhousie Law School

Edwin Harris, Daley, Black & Moreira

Robert MacLellan, Chair, Nova Scotia Securities Commission

Robert Mellish, Daley, Black & Moreira

MONTREAL - SEPTEMBER 27, 1993

Tass Grivakes, MacKenzie Gervais

Stephen Jarislowsky, Jarislowsky, Fraser

David Morton, Alcan Aluminium Limited

Patricia Pitcher, Ecole des Hautes Etudes Commerciale

TORONTO - SEPTEMBER 28, 1993

Bob Bertram, on behalf of Pension Investment Association of Canada

John Chippindale, Marsh & McLennan

Richard Finlay, J. Richard Finlay & Partners

Doug Greaves, OMERS, on behalf of the Toronto Society of Financial Analysts

Peter Held, Canadian Institute of Chartered Accountants

Peter Hellier, on behalf of Pension Investment Association of Canada

Brian Lechem, Boardroom Advisory Services

Donald Lewis, Sibson & Company

Jim Maunder, on behalf of Pension Investment Association of Canada

Jeff McIntosh, Faculty of Law, University of Toronto

Kathryn Montgomery, Researcher

William Riedl, Fairvest Securities

Lawrence Schwartz, Lawrence P. Schwartz Ph.D., Consulting Economist

Stan Stewart, Strategic Associates Incorporated

Joseph Tontini, Wyatt Company

John Turner, Miller, Thomson

Appendix 3.16D

List of Submissions Received on Draft Report

AFC Management Services Limited
AIT Advanced Technologies Corporation
Air Canada
Alcan Aluminium Limited
ATCO Ltd.

Baker & McKenzie
BCE Inc.
Blake, Cassels & Graydon
Boardroom Advisory Services
Bramalea Limited
Brascan Limited
Business Council on National Issues
Bugyra, William J.

CAE Inc.
Caisse de Depot et Placement du Quebec
Canada Trust
Canadian Bankers Association
Canadian Council of Financial Analysts
Canadian Institute of Chartered Accountants
Canwest Global Communications Corp.
Caribbean Utilities Company Ltd.
CARENA Development Limited
CCL Industries Inc.
Clarkson, Max B.E. and Deck. Michael C., University of Toronto Faculty of Management
COGECO Inc.
Cortex Applied Research, Inc.
Corporate Governance International Pty. Limited

Deprenyl Animal Health Inc.
Dimma, William A.
DuPont Canada Inc.

Fairvest Securities Corporation
Federal Minister of Industry
Finlay, J. Richard and Partners
Future Shop Ltd.

Gendis Inc.
Glyko
Goldfarb Consultants
Goran Capital Inc.

The Horsham Corporation

Imasco Limited
Inco Limited
The Institute of Corporate Directors
IFL Investment Foundation (Canada) Limited

Jordan, Cally, McGill University Faculty of Law

Maax Inc.
Mackay-Smith, Sandy
The Management Corporation of North America
McCarthy Tétrault
Mobil Corporation
MVC Associates International

National Association of Corporate Directors
Northern Telecom Limited

Ocelot Energy
Ogilvy Renault

Peters & Co. Limited
Phoenix Canada Oil Company Limited
Power Corporation of Canada
Price Waterhouse
Prichard, J. Robert S., University of Toronto

Renaissance Energy Ltd.
Royal Bank of Canada

Silver Standard Resources Inc.
Sun Life Assurance Company of Canada

Tombill Mines Limited
Taskforce on the Churches and Corporate Responsibility
Teck Corporation
Thain, Donald H.
The Toronto-Dominion Bank
TransAlta Corporation
TransCanada Pipelines

William M. Mercer Limited

APPENDIX 5.43

VIEWS OF WILLIAM MINGO CONCERNING THE SIZE OF THE BOARD

The majority of the Committee holds, and has made the theme of a guideline, the view that "as the number of directors on a board beyond a particular threshold (approximately 20) increases, the effectiveness of the board decreases."

While the boards of public corporations in Canada which go beyond this threshold may not exceed more than ten in number, and be limited to the financial services sector – an aberration perhaps insufficient to warrant a guideline (or even this dissent) – as a member of one of them I feel constrained to say that nothing in my experience supports the majority view. A large board can be more effective than a small board if only because it is likely to have more star performers, and a wider latitude of experience.

By "effectiveness" I assume what is meant is effective monitoring of management and quality decision-making.

Effective monitoring of management is very time consuming, and in a large bank with complex, geographically extensive operations may only be practical if the work is divided among different committees (e.g. audit, credit policy, strategic planning, human resources and compensation, etc.). The board has to be large enough for each of these committees to be sufficiently manned that they can operate effectively with one or two members absent.

Quality decision-making depends on the quality of the directors participating in the decision, the quality of their briefing and homework at the time, and the intention and skill of the chairman. The size of the board is not really relevant except that, the larger it is (within a range of, say, 10 to 40), the larger the number of quality or star participants likely to be available when the decision is made.

To date at least, no nominating process seems good enough to screen out the potential non-contributors, with the result that, whether the board is large or small, sometimes perhaps not many more than half contribute on a regular basis, and half a small board is not enough for large, complex, geographically extensive operations like those conducted by Canadian chartered banks.

The obvious solution to this problem – a process which monitors the board's performance over time, identifies the weaker contributors, and keeps replacing them with better prospects – should, of course, be adopted, but it is naive, I think, to assume that it will work so successfully that the problem of the non-contributing director will disappear.

The criteria for good performance by a director is not easy to settle. It cannot be simply meeting attendance and the extent to which he or she intervenes in debate. One can intervene a lot without contributing very much.

A process of monitoring director performance and replacing the weaker contributors will, I suspect, succeed in replacing some of the more blatant non-contributors. However, directors will continue to shy away from disqualifying colleagues whose performance is, for whatever reason, only marginal, if only because they find the exercise distasteful, and are not unanimous on its criteria or proper application. In the result, the problem of non-contributing directors will continue.

Until we have had some successful experience with this process, I am loath to coerce our financial institutions to reduce the size of their boards – a measure calculated to reduce the quality of the talent available to them at the board level without any offsetting advantages.

APPENDIX 5.56

STATUTORY LIABILITIES OF DIRECTORS[1]

1. Impairment of Capital and Corporate Solvency Tests

(A) Types of Payment

The corporate statutes seek to maintain the financial stability of the corporation by prohibiting certain actions by the corporation if it does not meet the solvency tests set out in the statute. These solvency tests are described below. Directors who vote for or consent to a transaction when the corporation does not meet the solvency tests may be liable for amounts paid out by the corporation which it does not otherwise recover. In other words, the directors who cause or allow the corporation to take certain action which lead to its insolvency are required to restore to the corporation the funds which the corporation expended in the course of this action. The list of transactions for which directors could incur this type of liability includes:

- issuing shares for property or past services which have a fair market value less than the money the corporation would have received if it had issued the shares for money (unless the director did not and could not reasonably have known that the corporation would have received more if the shares had been issued for money);

- any of the following actions in contravention of the statutory solvency tests, which are described in greater detail below:

- purchase, redemption, retraction or other acquisition of shares of the corporation;

- payment of a dividend;

- provision of loans, guarantees or other financial assistance to certain related parties;

- payment of an amount to a shareholder who has exercised statutory dissent rights;

- payment to an officer or director of an indemnity prohibited by the corporate statute; and

- paying an unreasonable commission to any person purchasing shares of the corporation.

Since directors only incur liability for these transactions if they vote for or consent to the resolution authorizing the transaction, they should bear in mind that they will be deemed to have consented to a resolution unless their dissent is registered in the manner and within the time prescribed by statute. The procedure for registering a dissent is described in Part II.

An action against a director for authorizing the types of transactions listed above must be commenced within two years of the date of the resolution authorizing the unlawful act.

(B) Corporate Solvency Tests

The corporate statutes prohibit a corporation from taking certain action if the corporation would fail to meet two tests after taking that action. These tests are commonly referred to as solvency tests, although one deals with solvency and the other deals with impairment of capital. The two tests are discussed here in the context of the declaration of dividends, but a version of these solvency tests also applies to the redemption or retraction of shares, financial assistance and the other types of transactions listed above. In the case of dividends, the solvency tests are intended to prevent directors from declaring dividends out of the corporation's capital or otherwise distributing to shareholders, assets of the corporation which should remain in the corporation for the protection of creditors. While lenders do not usually rely exclusively on these statutory provisions to protect them from corporate actions which might jeopardize the corporation's ability to pay the creditors and may well require covenants which impose other or more stringent tests, the solvency tests are intended to provide a measure of protection against the corporate assets being stripped away.

The solvency test prohibits a corporation from declaring or paying a dividend if there are reasonable grounds for believing that the corporation is unable to pay its liabilities as they become due or would be unable to do so after paying the dividend. The inability to pay liabilities as they become due will have different meanings in different circumstances. Generally however, if a corporation could only satisfy its ongoing liabilities by liquidating assets fundamental to running its business, the directors could likely not conclude that the test had been met. If, on the other hand, the directors determine that the corporation would need to sell one significant asset in order to meet a large and unusual liability, they might still conclude in good faith that this

(1) Extracted from "Directors' Duties", Osler, Hoskin & Harcourt, 1993

did not result in the corporation being unable to meet its liabilities as they became due.

The impairment of capital test prohibits the corporation from declaring or paying a dividend where there are reasonable grounds for believing that the "realizable value" of the corporation's assets would, as a result of the dividend, be less than the aggregate of its liabilities and the stated capital of all classes of shares. The manner in which assets are valued will depend on the corporation and its circumstances. It is generally reasonable to value the assets on a going concern basis, unless there is some reason to believe that the corporation will be wound up or put into some form of solvency-related proceeding in the near future or that an urgent and significant disposition of its assets is planned. Because the test refers to the "realizable value" of the corporation's assets, as measured against its liabilities and stated capital, the value of the assets must be established on the basis of some sort of notional sale. While valuation should take into account taxes payable arising from the sale as well as legal and other costs associated with a disposition of assets, the directors are also entitled to assume that the sale will be implemented on a tax efficient basis, so long as that assumption is a reasonable one. Moreover, discounting such costs may be justified if disposition is not imminent.

Under some corporate statutes, the test is less stringent for corporations with wasting assets. These are assets which are necessarily consumed in the operation of the corporation's business. These provisions apply to corporations which have as their principal operations a producing mining or oil and gas property, or which have 75% of their assets of a wasting character. They also apply to corporations incorporated to acquire assets, liquidate them and distribute cash to shareholders. Such corporations are not required to meet the solvency tests imposed on other corporations. Rather, they are entitled to pay dividends out of funds derived from their operations even if the payment reduces the value of their assets to less than their stated capital, so long as they can still meet their liabilities.

The tests are prospective, requiring directors to determine whether the corporation would be able to meet its obligations as they become due. No time frame is given and no guidance is provided for the definition of the term "liabilities". The corporate statutes do not indicate, for example, whether contingent liabilities such as guarantees should be included. The tests are also based on values which cannot be determined with certainty at the time the directors must decide whether to declare a dividend. The directors cannot (and are not expected to) determine with certainty the realizable value of the corporation's assets, because this value can only be known when the assets are sold. Nor are they expected to predict future events. For example, after a corporation has paid a dividend, a significant depreciation in the value of a corporation's inventory – as has happened to corporations holding real estate – may call into question the ability of the corporation to satisfy its liabilities and may with hindsight make the payment of the dividend seem imprudent. The directors only need to be satisfied, at the time the resolution is passed to declare and authorize the payment of the dividend, that there are no reasonable grounds for believing that the tests would not be met. If the directors determine in good faith that the corporation meets the tests, based on an estimate of the value of assets which they reasonably believe, in good faith, to be true at the time the dividend is declared and payment is authorized, the courts have indicated that the directors will not be liable if the value of those assets is subsequently lost.

(c) Defence and Penalty

Whether the corporation meets the solvency tests is a question which in most cases must be determined by the board. However, under the corporate statutes, the directors are entitled to rely on the corporation's financial statements, which an officer of the corporation or a written report of the auditor represents to fairly reflect the financial condition of the corporation. In appropriate cases, directors may also rely on outside advisers. As discussed in Part I, such reliance must be in good faith and reasonable.

Directors will not be able to look to the corporation's auditors for opinions on whether the corporation meets the solvency tests. Chartered accountants in Canada were advised in an October 1988 release by The Canadian Institute of Chartered Accountants not to provide opinions (that is, positive or negative assurances) on matters relating to solvency. The rationale for this position is that solvency is a state of affairs which must be determined, at least in part, prospectively under the prescribed test and therefore is not a matter on which accountants are prepared to opine. This position illustrates the challenge faced by directors in seeking to determine whether the tests have been met, particularly in circumstances where the corporation could be said to be near the margins of the test.

Directors who consent to any of the transactions described above when the corporation does not satisfy the solvency tests may be jointly and severally liable to repay to the corporation any amounts distributed or paid by the corporation as a result of that transaction. Any potential for liability ceases two years after the date of the resolution approving the transaction. Directors who are found liable are entitled to look to any other directors who also consented to the resolution for their share of the amount in question. Such directors may also apply to a court for an order requiring the person who received the money to repay that amount to the corporation.

2. Insider Trading

As noted in Part III, regulation of insider trading is intended to promote fairness in the capital markets. Persons who have information about a corporation by virtue of their relationship with that corporation should not be in a position to use that information to trade in securities of the corporation or to assist others to trade in securities of the corporation before that information is publicly disseminated.

(A) Directors as Insiders

Directors are insiders of the corporation on whose board they serve, but they are also deemed to be insiders of any other corporation in which their corporation owns or controls more than 10% of the voting securities.

The insider rules have two aspects. First, as insiders, directors must report to the securities authorities any trade they make in securities of the corporation in which they are insiders. This is discussed in greater detail below under "Insider Trading Reports". In addition, because they are in a "special relationship" for securities law purposes to any corporation in which they are insiders, they may be liable if they trade in securities of that corporation with knowledge of a material fact or material change that has not been generally disclosed. In addition, directors may incur liability if they pass that information to someone else who trades with knowledge of the information (commonly referred to as a "tipee"). This is discussed in greater detail below under "Use of Inside Information".

(B) Insider Trading Reports

Persons who hold securities in a corporation are required to file an insider report when they become insiders. When a person who holds securities of a corporation is appointed to the board of that corporation, for example, or when an existing director acquires securities of the corporation for the first time, that person must file an initial report. The report must be filed within ten days of the date on which the person became an insider or within ten days of the end of the month in which the person became an insider, depending on the jurisdiction. When directors trade in securities of entities in which they are insiders, they must file a report of that trade within ten days of the trade or within ten days of the end of the month in which they make the trade, again depending on the jurisdiction.

The extent of the reporting requirement may also vary from jurisdiction to jurisdiction. In addition, there are various definitions which broaden the term "insider" so that it covers other entities within a corporate group. Given the potential degree of complexity and detail, it is standard practice for most public corporations to have a memorandum prepared for their directors and senior officers to assist them in complying with these requirements. The regulators consider timely and accurate reporting a priority and it is therefore very important for directors to meet these requirements within the time periods prescribed.

Insider reports are filed with the appropriate securities commissions as well as with the federal government if the corporation is federally incorporated. Insider reports are public information and are often tracked and reported by the financial press. As an internal administrative matter, the corporation's legal or administration department is frequently responsible for filing the insider trading reports for the corporation's directors, but directors should bear in mind that they, and not the corporation, will bear the liability for failing to file their insider trading reports as required. In Ontario, failure to file may result in a fine of up to $1,000,000 or two years in prison, or both.

(C) Use of Inside Information

Under both the corporate and securities statutes, directors are liable for using confidential or "inside" information about the corporation to trade in securities of the corporation or for passing such information on to someone else. The provisions and language used to describe these liabilities vary depending on the statute but include "material fact", "material change", "material information" and "confidential information". Many, though not all, of these concepts may apply to directors who are insiders of private corporations as well as those who are insiders of public corporations.

A director who trades with knowledge of such information or who provides that information to someone else may encounter liability on three levels. First, the director may be subject to a fine of not less than the profit made, but not more than triple the profit, up to a maximum of $1 million, and up to two years in prison. If a corporation is convicted of insider trading, every director who authorized or acquiesced in the offence is also guilty and is liable for damages resulting from the trade and for a fine of not more than $1 million and two years in prison. The director may also be liable to the person who traded with the director or with the person the director advised of an undisclosed material change or material fact. Damages may be up to the amount by which the transaction price was affected by the confidential information available to one, but not the other party. Finally, the director will be liable to the corporation for any gain realized by insider trading or tipping.

(D) Defences

There are a number of defences available to a director who has been charged with insider trading. Proof that a director reasonably believed that the information had been generally disclosed may be a defence. Similarly, if the other party to the transaction knew about the undisclosed information or ought reasonably to have known, the director may not be liable. If the trading took place in "innocent" circumstances such as the purchase of shares by a director in an automatic plan such as a dividend reinvestment plan or share purchase plan which was in place before the director became aware of the confidential information, or where it was made to fulfil a legally binding obligation entered into prior to the acquisition of the undisclosed information, the director may not be liable. Chinese wall defences may also relieve directors of liability in situations where a corporation made an investment which constituted insider trading but can show that no director, officer, partner, employee or agent of the firm who was involved in the investment decision had actual knowledge of the confidential information.

Similarly, a number of defences are available to a charge of tipping. For example, if a director informs a third party of an undisclosed material fact or a material change in the necessary course of business, that action does not constitute tipping. However, if a director informs a third party of an undisclosed material fact or material change other than in the necessary course of business, the director will have a defence if the person who bought or sold shares of the corporation knew or ought reasonably have known about the information.

While certain defences to insider trading and tipping may be available, there are only limited situations in which they will be applicable. The potential fines on the other hand are very significant and can be up to triple the profit made or $1 million.

(E) When is Information Disclosed

The securities rules permit trading to commence when information has been "generally disclosed". It is important for directors to note that this is a term that has specific meaning. The issuance of a press release alone is not sufficient; there must be an opportunity for the information to be disseminated and absorbed by the marketplace. As a general rule, insiders should not trade for at least 24 hours after the press release has been issued. This period may be longer, up to a week, if the information is not picked up and disseminated to the public through the news media.

3. Disclosure Documents

Liability for disclosure documents arises in two ways: quasi-criminal liability for failing to comply with requirements such as the requirements to file financial statements in accordance with prescribed rules and civil liability for misrepresentations in certain documents such as prospectuses.

(A) Ongoing Disclosure Documents

Public companies are required to file various ongoing or continuous disclosure documents. Any director of a corporation who "authorized, permitted or acquiesced" in the filing of documents that are not in compliance with those requirements commits an offence. Such liability could occur, for example, as a result of disclosure or lack of disclosure in:

- annual and interim financial statements;
- information or management proxy circulars; or
- material change reports.

On conviction, directors may be subject to a fine of up to $1 million, two years in prison, or both.

(B) Prospectuses

Certain documents are so fundamental to the public disclosure system and the functioning of the capital markets that they also have the potential for exposing directors to personal civil liability. The most commonly used of these documents is the prospectus. A number of persons and entities, including directors, are involved in the creation of a prospectus and liability is imposed on many of them for any "misrepresentation".

The issuer of the securities, or a selling shareholder on whose behalf the distribution is being made, is liable and has no defence where a misrepresentation appears in the prospectus. The underwriters of the offering and any other person who signs the prospectus, such as a promoter, are also liable but may have a due diligence defence. If reference is made in the prospectus to any report, opinion or statement of an expert, that expert will be liable with respect to those references, but is also provided with a due diligence defence. Similar liability applies to misrepresentations contained in take-over bid circulars.

A director will not be liable to a purchaser who purchased securities offered by a prospectus containing a misrepresentation for an amount in excess of the price stated in the prospectus at which the securities were offered to the public or for any damage which the director proves does not represent the depreciation in value of the security as a result of the misrepresentation. A purchaser must bring an action with respect to a misrepresentation in a prospectus within 180 days of becoming aware of the misrepresentation, but, in any event, before the end of three years from the date on which the securities were purchased.

The main defence available to directors to a claim by a purchaser that a prospectus contains a misrepresentation is the due diligence defence. In other words, directors will be liable if they failed to conduct a reasonable investigation. The steps which directors should take in order to show that they conducted an adequate investigation are discussed in greater detail in Part III.

Directors have a number of other defences to a claim by a purchaser that a prospectus contained a misrepresentation:

- the purchaser was aware of the misrepresentation at the time of purchase;
- the prospectus was filed without the director's consent and the director gave reasonable general notice of this fact or the director withdrew consent and gave reasonable general notice of this fact and of the reasons for withdrawing consent; or
- the misrepresentation appeared in an expert's portion (that is, a reference to a report or opinion of an expert) or it was made by an official person or contained in an official statement and the director had reasonable grounds to believe that there was no misrepresentation.

4. Liability for Offences Under the Corporate Statutes

The corporate statutes impose a number of obligations on the corporation. To ensure compliance by the corporation, the corporate statutes also impose personal liability on a director who knowingly authorizes, permits or acquiesces in the corporation failing to comply with certain provisions. The offences for which a director may incur such liability under the Canada Business Corporations Act include the following:

- failure of the corporation to send a proxy to shareholders at the same time as they are given notice of a shareholders' meeting as required by the CBCA;
- failure by the corporation to send a management proxy circular to shareholders and to the Director under the CBCA before soliciting proxies;
- failure by the corporation to comply with take-over bid requirements under the CBCA;
- failure by the corporation to comply with requests for information under the CBCA with respect to insider trading, proxies or take-over bids; and
- the inclusion by the corporation of an untrue statement of a material fact in any document required under the CBCA or the omission by the corporation of a material fact in such a document.

Directors may be liable for fines of up to $5,000 or prison terms of up to six months, or both, whether or not the corporation itself has been prosecuted or convicted for the offences described above. The defences available to directors will vary with the particular offence and the circumstances, but in most cases directors must have knowingly authorized, permitted or acquiesced in the commission of the offence before they will incur liability.

5. Environmental Legislation

Liability for environmental offences vies with liability for employee wages as the highest profile liability facing directors. Anyone may incur liability under any one of a number of statutes for causing or permitting damage to the environment and directors may be subject to this liability if they themselves cause or permit damage. In addition, however, many of the environmental statutes in Canada make directors liable for the environmental offences committed by the corporations they serve. This is the liability which is of particular concern to directors who may have no particular knowledge of or control over corporate activities which may cause environmental problems.

In the last few years there has been a significant increase in the number and severity of Canadian environmental laws. Much of this legislation has developed in a piecemeal fashion in response to particular concerns. As a result, environmental legislation, regulation, policy and guidelines are neither comprehensive nor coherent. In addition to the general environmental protection statutes such as the Canadian Environmental Protection Act and Ontario's Environmental Protection Act, there are a host of statutes dealing with water, air, pesticides, mining, oil and gas and waste management which impose specific environmental protection requirements. These requirements include among their sanctions, the imposition of liability on the directors of a corporate offender. Keeping abreast of legal developments, let alone complying with them, is difficult.

(A) Offences

The Canadian Environmental Protection Act ("CEPA") is typical of most environmental legislation across Canada. Under CEPA, a director may incur liability for offences of the corporation if that director "directed, authorized, assented to, acquiesced in or participated in the commission of the offence". The effect of this wording is that, for the purposes of CEPA and most other most environmental legislation in Canada, directors will be subject to liability as directors only if they had knowledge of the actions which constituted the offence.

Ontario's Environmental Protection Act and certain other environmental statutes go beyond the type of provision found in CEPA. They require directors to take "all reasonable care" to prevent the corporation from unlawfully discharging a contaminant into the environment. Under these statutes, directors have an obligation to act pro-actively to ensure that the corporation is in compliance.

(B) Due Diligence Defence

The liability of directors for the environmental actions of the corporation is not an absolute liability. Directors may avoid liability if they are able to show that they exercised appropriate diligence to ensure that the corporation complied with environmental legislation. The onus is on the directors to establish that such diligence was exercised.

The ability to successfully raise a due diligence defence will depend on the steps taken by directors prior to the commission of the offence. A director's diligence is founded on an understanding of the issues, formulation of appropriate corporate policies, delegation to qualified personnel of the responsibility for implementing the policies and ensuring compliance by establishing a monitoring system which enables the director to confirm that the policies established are being followed and employee concerns addressed. This action should be appropriately documented in board minutes as well as reports from experts and from management. A discussion of the procedures which a board should consider implementing to ensure that it has met the requisite standard of care is set out in Part III.

(C) Penalties

There are several types of liability which a director may face in connection with environmental legislation. Directors may be subject to substantial fines or imprisonment or may be named in orders to implement and pay the costs under preventative, clean-up and remedial orders.

Fines or imprisonment, or both, may be imposed where a court determines that punitive action against a director is appropriate. Fines may range from $10,000 to $100,000 per day for directors ($50,000 to $2,000,000 per day for the corporation). Under CEPA, the individual is subject to the punishment that is provided for the particular offence committed by the corporation. In addition to daily fines, the potential penalties under that statute range up to a fine of $200,000 plus 5 years imprisonment for more serious offences. For certain offences, such as intentional or reckless disregard for an environmental disaster, or for the lives and safety of others, there is no maximum limit to the fine, and there may even be the potential for prosecution under the Criminal Code with a maximum penalty of life imprisonment.

There has been a steady increase in charges relating to environmental offences laid both against individuals and corporations in Canada over the last several years. For example, from 1985 to 1991, the number of charges in Ontario increased from 150 to 2,000. Penalties have also increased. Total fines imposed in Ontario for environmental offences in 1991 were $2,500,000 and in a recent Ontario decision, an executive of a hazardous waste disposal company was sentenced to eight months in prison. The factors which a court will take into account when imposing a sentence include the nature of the offence, the deliberateness of the action, the extent of cooperation with officials, whether commitments have been made to achieve compliance and the speed and efficiency of rectification.

Directors may be named in remedial orders to implement and pay the costs of a clean-up, usually where they can be shown to have been directly responsible for the pollution. Orders of this nature are not intended to be punitive and, if the corporation is financially capable of complying with the orders, it is unlikely that such orders will be issued against the directors.

Statutory civil liability for losses or damages resulting from actions commenced under environmental statutes may arise in the case of a spill of a toxic substance. A director could be liable to a third party if the director had ownership, charge, management or control of a pollutant immediately before it was spilled. To date, there have been no decided cases in which a director's statutory civil liability was considered. Even where a statute does not impose civil liability on a director, liability could arise under the common law.

6. Pension Matters

Under pension benefits legislation, the corporation is frequently the "administrator" of the employee pension plan. In such cases, the task of fulfilling the obligations associated with the administration of the plan and the administration and investment of the pension fund falls to the board of directors. In most cases, the board delegates all or a portion of that authority to a committee of the board or to a committee which may be composed of board members, employees of the corporation and outside advisers, or to individuals employed in the company's finance or human resources departments.

While the board is justified in delegating to others, board members continue to have responsibilities. In addition to their duty as fiduciaries of the corporation, the directors must ensure that the corporation fulfils its obligation with respect to the pension fund to "exercise the care, diligence and skill that a person of ordinary prudence would exercise in dealing with the property of another person". If directors act as administrators of a plan, in some jurisdictions such as Ontario, they must use in the administration of the plan, all relevant knowledge and skill that they possess or, by reason of their profession, business or calling, ought to possess.

The board must determine the degree of delegation of responsibility for the pension plan which is appropriate. The board should ensure that individuals with appropriate skill and experience are designated to deal with pension matters and that there is in place a systematic set of procedures and evaluation measures to track the performance of those responsible for the plan. In Ontario, the board of directors or its delegate must develop a set of investment guidelines and review, confirm or revise those guidelines annually. It is prudent for the board to require periodic reports on the performance of the plan.

Under Ontario regulated plans, where a corporation is convicted of an offence under the pension benefit legislation, any director who participated in the offence is also liable and is subject to a fine. In addition, where a corporation is convicted of an offence for failing to submit payment to a pension fund or insurance company, any director who participated in that offence may be required to pay the outstanding amount in addition to any fine.

7. Employee Related Matters

Liability for amounts not paid to or on behalf of the corporation's employees is among the most significant liabilities that a director may incur. Without a systematic and reliable audit and reporting system, it is also among the most difficult liabilities to avoid if the corporation becomes financially unstable. Because individual directors are only liable for payments which should have been made while they were directors, the prospect of this liability has prompted directors to resign when they recognize the corporation might not be able to make these payments in the future. The nature of directors' liability for employee wages, vacation pay and termination pay, as well as liability for various source deductions, is set out below. Liability for the corporation's obligation to deduct and remit income taxes on behalf of its employees is discussed in the section on the Tax Liabilities in this part.

(a) Wages, Vacation Pay and Termination Pay

Many of the corporate statutes and provincial employment legislation impose liability for employee wages and vacation pay on directors. Under the Canada Business Corporations Act, for example, directors may be liable for all debts up to a maximum of six month's wages payable to each employee for services performed while they were directors. Very few provinces impose liability on directors for termination pay, that is, pay in lieu of notice.

In Canada, the activities of a corporation (and the corporation's relationship with its employees) are subject either to provincial or federal legislation. For example, broadcasting and some financial institutions are under federal jurisdiction, while manufacturing would generally be subject to provincial jurisdiction. In industries under provincial jurisdiction, directors may be liable for employee wages under provincial employment standards legislation as well as under the corporation's governing corporate statute. In those industries, employees may proceed in one of two ways if they are not paid for wages or vacation pay. If they proceed under the provincial employment standards legislation, they may present their claim to the provincial employment standards branch. If that branch believes the claim is valid, it will pursue the matter with the corporation and the directors on behalf of the employees. If the provincial authorities do not support the claim or if the employees do not enlist their help, the employees themselves may institute an action against the corporation or the directors under the relevant corporate statute.

If the business of the corporation is under federal jurisdiction, employee relations are governed by the Canada Labour Code which does not impose liability on directors for wages or vacation pay. Unless the entity's governing statute imposes liability for wages and vacation pay (as does the federal corporate statute and the Bank Act), its directors will not incur liability for these amounts.

The corporate statutes which impose liability for employee wages on directors also impose certain procedural requirements if an employee wishes to sue the directors. Under the CBCA, for example, directors will not be liable for amounts owing to employees unless they are sued while they are still directors or within two years of the date on which they ceased to be directors. In addition, directors may not be sued for these amounts unless:

- the corporation has been sued successfully within six months of the date when the wages were due and the corporation did not satisfy the judgment in full;
- a claim for the wages was proved within six months of the date on which the corporation was dissolved or on which it commenced liquidation and dissolution proceedings (whichever is earlier); or
- a claim for the wages has been proved within six months of the date on which the corporation made an assignment, or a receiving order was made against it, under the Bankruptcy and Insolvency Act.

Directors are jointly and severally liable with all of the other directors for these amounts, meaning liability for the entire amount may be imposed on a single director, on several of the directors, or on all of them. Any director who has paid an employee claim under these provisions is entitled to look to the other directors to contribute their share of the amount paid.

(B) Source Deductions

A corporation is required to deduct certain amounts from its employees' wages or salaries and to remit those amounts to various levels of government. These are payments which the corporation makes on behalf of the employees, and failure to make such payments is treated in much the same way as failure to make payments on account of wages and salaries. Typical source deductions include income taxes and employees' premiums for unemployment insurance and contributions to the Canada Pension Plan. If the corporation fails to deduct and remit these amounts, those individuals who were directors at the time the amount should have been remitted may be jointly and severally liable for that amount as well as for interest and penalties on these amounts.

A due diligence defence may be available to directors who have taken the steps necessary to ensure that source deductions are being made and remitted. Some corporations have adopted a procedure requiring senior management, such as the chief financial officer, to certify to the board on a regular basis that all source deductions have been remitted and paid by the corporation to the appropriate authority. When a company is experiencing no financial difficulty, it may be sufficient to do this on an annual basis, perhaps coincident with the approval of the annual financial statements. When signs of financial instability appear, this certificate or other confirmation should be obtained more frequently. Advice should also be obtained about whether other steps should be taken to establish a due diligence defence, such as those described in the next section on Tax Liabilities.

(C) Occupational Health and Safety Legislation

Provincial occupational health and safety legislation is designed to ensure that employees work in an environment that is safe and free of hazards and liability for a corporation's failure to comply with health and safety legislation in most provinces may extend to the directors of the corporation. In Ontario, for example, directors must take "all reasonable care to ensure that the corporation complies" with the provincial requirements.

While provisions of this nature impose an obligation on directors to take active steps to ensure compliance, they also allow a defence of diligence for any director charged with an offence under the legislation. The test of due diligence is a factual one and the meaning of "reasonable care" may depend on the industry in which the corporation operates. In most cases, the care taken by directors should include ensuring that management has identified areas of operation in which precautions should be taken to protect workers from human error and from other sources of possible harm. Training employees and supervisors will also be critical to the discharge of this responsibility. It is generally accepted that a director will not be held personally liable if employees and supervisors who have received the appropriate training and education and who have been properly instructed and supervised are derelict in their own duties.

If there is a standard practice of care that is recognized for a particular operation or industry, directors should ensure that the corporation at a minimum adheres to that standard. However, this standard of care may not be sufficient if the circumstances warrant increased care. In assessing the level of care that is reasonable, the factors that should be considered include:

- the gravity and the likelihood of the harm that could result; and

- the alternatives available to a corporation to minimize both the possibility of a contravention occurring and the potential harm which could result.

Penalties will vary from province to province. In Ontario, directors who fail to comply with their obligations under the Occupational Health and Safety Act may be subject to fines of up to $25,000 and prison terms of up to one year.

8. Tax Liabilities

(a) Source Deductions and Other Remittances

Under the Income Tax Act, individual directors of a corporation can be held personally liable where the corporation fails to deduct or remit to Revenue Canada the prescribed amounts for certain payments by the corporation including:

- salaries, wages, pension benefits, retiring allowances and certain other amounts paid to employees or former employees; and

- amounts paid or credited to non-residents of Canada that are subject to Canadian withholding tax.

Actions against a director must be commenced within two years after the date on which a person ceased to be a director of the corporation which failed to make the payment and can only be commenced if Revenue Canada has first taken certain specified steps to attempt to collect the liability from the corporation. Furthermore, the courts have generally only imposed liability when the corporation's failure to withhold and remit occurred before the individual ceased to be a director.

Individual directors are not liable for the corporation's failure to withhold and remit the required amounts from employee wages and payments to non-residents if they are able to demonstrate that they exercised the degree of care, diligence and skill to prevent the failure to withhold or remit that reasonably prudent persons would have exercised in comparable circumstances. Revenue Canada has taken the position that this due diligence defence requires directors to take positive steps to ensure that the corporation makes the required remittances. Positive steps may include establishing controls for proper withholding and requiring reports from the chief financial officer on the implementation of those controls, as well as confirming that remittances have been made during all relevant periods. Where the corporation is in financial difficulty, Revenue Canada is of the view that directors should obtain, from the financial institution extending funds for the payment of salaries and wages, an enforceable undertaking to pay all related source deductions when due or, if this is not possible, establish a separate payroll trust account for the deposit of the gross payroll. Payments would be made to both the employees and to Revenue Canada from this account.

There has been considerable litigation surrounding the standard of care required to establish the due diligence defence. Consistent with Revenue Canada's published position, directors have generally been held to a high standard of care by the courts. Therefore, directors must take a "hands-on" approach to seeing that source deductions are made, since a failure on the part of a director to take positive steps will likely make the director liable. Directors who have not played an active role in the affairs of a corporation are generally as much at risk as those who have. Moreover, the responsibility to ensure that source deductions are remitted cannot be delegated to other directors or officers of the corporation.

The courts have stated that while other statutes may permit directors to undertake risks in running a business, the Income Tax Act does not allow for any risk taking in respect of source deduction obligations.

(B) Offences of the Corporation

In addition to the other liabilities discussed in this section, the Income Tax Act imposes liability on a director for any offence committed by the corporation under the Income Tax Act if that director "directed, authorized, assented to, acquiesced in or participated in" the commission of the offence, whether or not the corporation has been prosecuted or convicted.

(C) Clearance Certificates

The Income Tax Act generally requires certain persons, including an assignee, liquidator, administrator or other "like person", to obtain a clearance certificate from Revenue Canada before distributing any property of the corporation under that person's control. Failure to obtain a clearance may result in that person being liable for the unpaid taxes, interest and penalties of the corporation. Whether a director of a corporation is a "like person" will depend on the circumstances of each case and, in particular, upon whether the director, in approving the distribution, is in fact acting in a capacity similar to the specified positions. Accordingly, where the director may be acting in such a capacity, advice should generally be obtained about whether the corporation should apply for a clearance certificate before the directors approve any significant distribution of property.

(D) GST

A director may also be held liable for any net goods and services tax ("GST") payable by the corporation under the Excise Tax Act. This liability is based on similar provisions to those contained in the Income Tax Act. Liability is imposed only on payment obligations which arose during an individual's tenure as a director, and a director may avoid liability by establishing a "due diligence defence". The Excise Tax Act also contains offence provisions which are similar to those in the Income Tax Act outlined above.

(E) Other Tax Statutes

A director may be subject to liability under a number of other federal and provincial tax statutes, depending on the nature of the corporation's business. For example, under Ontario's Retail Sales Tax Act, a director's potential liability is similar to that imposed in the income tax and GST contexts.

APPENDIX 5.60

RESPONSE OF GOVERNMENTS TO COMMITTEE INVITATION TO REVIEW LEGISLATION IMPOSING PERSONAL LIABILITY UPON DIRECTORS

Alberta:	Minister responsible for Municipal Affairs – letter dated August 17, 1994 from Stephen C. West.
British Columbia:	Minister of Finance and Corporate Relations – letter dated October 6, 1994 from Elizabeth Cull and letter dated October 13, 1994 from Kim Thorau, Director.
Canada:	Minister of Industry – letter dated August 23, 1994 from John Manley.
New Brunswick:	Minister of Justice – letter dated October 12, 1994 from Edmond P. Blanchard, Q.C.
Newfoundland and Labrador:	Office of the Minister and Attorney General – letter dated August 4, 1994 from Edward Ross.
Ontario:	Ministry of Consumer and Commercial Relations – letter dated August 4, 1994 from Marilyn Churley.
Saskatchewan:	Minister of Justice and Attorney General – letter dated September 26, 1994 from Robert W. Mitchell, Q.C.