

BACKGROUND

Proposed Amendments to the *Canada Business Corporations Act*

The actions of corporate management, the role and responsibility of boards of directors and auditors, and the integrity and reliability of financial reporting are fundamental to investor confidence. Standards of corporate governance matter to investors, both domestic and foreign, because they can influence corporate performance over time. Over the last couple of years, these corporate governance issues have attracted considerable attention. Indeed, many leading world economies have reviewed, or are in the process of reviewing, their corporate governance standards. As well, a revised *Principles of Corporate Governance* has been issued by the Organisation for Economic Co-operation and Development (OECD) to provide a set of guidelines for the implementation of an effective corporate governance framework.

In Canada, several important actions have been taken by governments, securities regulators and self-regulating bodies to ensure that Canada's legislative and regulatory framework responds to the needs of investors and entrepreneurs, and continues to foster the efficiency of our capital markets. Reforms have touched on a number of areas: enforcement, financial reporting and disclosure, the audit process, management accountability and governance structure.

The 2004 Budget stated that the federal government "is currently preparing proposals for amendments to the *Canada Business Corporations Act* (CBCA), which it expects to release in the near future, that will enhance the transparency and accountability of corporations toward investors and shareholders." The consultation paper, entitled, *Towards an Improved Standard of Corporate Governance for Federally Incorporated Companies: Proposals for Amendments to the Canada Business Corporations Act* represents a first step toward satisfying this commitment. The proposals are briefly outlined below.

Boards of Directors

The composition of boards of directors is fundamental to the corporate governance of the company. Directors are elected by shareholders to represent their interests by managing or supervising the management of the business and affairs of the corporation. Currently, the CBCA does not specify criteria regarding the independence of directors, nor does it provide a definition for what is meant by "independent director".

Proposal 1

Require that a majority of directors of distributing corporations be independent.

Separation of Chair and Chief Executive Officer

There is currently no provision in the CBCA requiring that the functions of chief executive officer (CEO) and chair of the board be separated. It has been argued that the separation of these two functions is a major step in ensuring overall board independence.

Proposal 2

Require that distributing corporations either separate the functions of board chair and CEO or, where the positions remain integrated, that corporations provide for an independent “lead director”.

Audit Committee Independence

Because of its responsibility for the review of the financial statements of the corporation, there is wide recognition that the composition and function of the audit committee is a key component to good corporate governance. The CBCA currently requires distributing corporations to have an audit committee comprised of at least three directors, a majority of whom are not officers or employees of the corporation or any of its affiliates. This requirement is not in line with generally accepted best practices in the marketplace, where a clear trend is developing in favour of an entirely independent audit committee.

Proposal 3

Require that audit committees of distributing corporations be composed only of independent directors.

Audit Committee Responsibilities

Under Canadian corporate law, the appointment of the auditor is the prerogative of the shareholders, and auditors are, in turn, responsible to shareholders. It has been argued, however, that, in practice, shareholders are too widely dispersed to allow them to effectively oversee the auditors and, as a result, management has assumed that role.

Proposal 4

Amend the CBCA to require the audit committee to recommend the auditor to the board of directors prior to the board’s approval of the management proxy circular.

Compensation and Nomination Committees

The issue of executive compensation is one that has received considerable public attention over the past few years. Currently, the CBCA permits the directors to determine the remuneration of officers, directors and employees of the corporation. With respect to nomination committees, an independent committee responsible for nominating potential directors would avoid a nomination process centred, or appearing to be centred, around appointing either persons closely associated with management or representatives from a cadre of “professional” directors who may not be suited for that particular company.

Proposal 5

Require independent nominating and compensation committees for distributing corporations. These committees may be combined into one body.

Definition of “Independent Director”

The issue of how to define “independent director” is critical. There is widespread agreement that any definition chosen must be clear and easy to apply in practice.

Proposal 6

Adopt a definition in the CBCA regulations of “independent director” that provides a standard that is clear, strong and consistent with other legal instruments.

Auditor Oversight and Independence

The decrease in investor confidence came about in large measure as a result of highly publicized irregularities in the financial reports of some corporations. The CBCA already requires that the external auditor be independent. However, the persons otherwise allowed to perform audits are not explicitly defined in the CBCA.

Proposal 7

Amend the definition of “auditor” in the CBCA to require that auditors of distributing corporations be a participating firm in the Canadian Public Accountability Board.

Certification of Financial Statements

As a matter of accountability, senior officers of the corporation should be required to stand behind the financial accounts of the corporation. There is no express requirement in the CBCA for an attestation as to the quality of financial statements.

Proposal 8

Require certification of financial statements of distributing corporations by the CEO and the chief financial officer (CFO).

Offences

In relation to civil penalties, the CBCA is considered to be a self-enforcing statute because shareholders have most of the same remedies as the director. Civil remedies will continue to be the most effective means to enforce the CBCA. However, to ensure that appropriate sanctions are available when there is flagrant violation of the legislation, modifications to the CBCA's offence structure are proposed.

Proposal 9

Amend the penalties in the specific CBCA offence provisions to match securities legislation penalties where corporate and securities legislation overlap.

Proposal 10

Create an offence with respect to CEO/CFO certification of financial statements

Information about Industry Canada's plan to reform the *Canada Business Corporations Act* and a copy of the discussion paper are available online at http://strategis.ic.gc.ca/corporate_governance. Comments on the proposals paper can be sent to Industry Canada at corporate_governance@ic.gc.ca. The deadline for comments is September 30, 2004. If you do not have Internet access, paper copies can be obtained by calling (613) 952-2113.