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Request for Comment - Proposed Repeal and Replacement of National Policy 58-201 *Corporate Governance Guidelines*, National Instrument 58-101 *Disclosure of Corporate Governance Practices*, and National Instrument 52-110 *Audit Committees* and Companion Policy 52-110CP *Audit Committees*

RiskMetrics Group would like to thank the Canadian Securities Administrators (CSA) for this opportunity to provide comment on the proposed repeal and replacement of National Policy 58-201 *Corporate Governance Guidelines,* National Instrument 58-101 *Disclosure of Corporate*

Governance Practices, and National Instrument 52-110 *Audit Committees* and Companion Policy 52-110CP *Audit Committees.*

Since its inception in the Canadian market in 1985 RiskMetrics Group (RMG), formerly Institutional Shareholder Services, formerly Fairvest Securities Corporation, formerly Allenvest Group Limited, has been dedicated to furthering principles of fairness to minority shareholders and integrity in capital markets on behalf of its institutional clients.

In 1993, under the name Fairvest, we submitted comments to the Toronto Stock Exchange (TSE) Committee on Corporate Governance in Canada on proposed corporate governance principles for the Canadian market. Fairvest supported the TSE's belief that "there is a direct relationship between corporate governance and investor confidence in capital markets" at that time and wishes to reiterate that under current economic and market conditions, that belief is stronger than ever. Many of the issues addressed in our submission at that time are still factors that influence our view of corporate governance best practice in the Canadian market today.

To preface our comments on the proposed amendments to the aforementioned governance instruments and policies, RMG would like to point out that Canadian corporate governance had been recognized as among the best in the world.[1] We credit the standards adopted by the Toronto Stock Exchange following the Dey Report –"*Where Were the Directors?*", along with the work of the Joint Committee on Corporate Governance that served to enhance Canadian corporate governance standards by 2001, and the current versions of NP 58-201, NI 58-101, NI 52-110 and CP 52-110CP with setting appropriate parameters for the structure and disclosure of best practice corporate governance in Canada based on a "comply or explain" regime. The Pension Investment Association of Canada adopted a simplified set of corporate governance standards in 1993 that served as the foundation for the corporate governance guidelines of many Canadian institutional investors. We humbly submit that the concurrent efforts of our predecessor companies Fairvest Securities Corp. in Canada and Institutional Shareholder Services in the U.S. played a key role in evolving corporate governance practice in both Canada and the U.S. over the past 20+ years by means of our submissions to regulatory and government authorities on various corporate governance and shareholder rights issues, and through the development and implementation of corporate governance guidelines upon which proxy votes are determined on behalf of our institutional clients, and which promote best practice and fair and equal treatment of all public company shareholders. The key takeaway from this opening statement is that Canada currently has one of the best corporate governance regimes in the world based on current best practice guidelines and regulation. RMG questions the need to change the current approach and guidance that has served the Canadian market so well, rather than simply enhance the current guidelines to address those areas not previously covered or where greater direction and clarity is necessary.

[1] Governance Metrics International (2003) launched global governance ratings that rated Canada second place overall.

In response to the CSA's specific requests for comment, we have responded in order of the Request for Comment document, adding further general comments at the end of this section.

Questions #1: Re proposed Principles 6, 7 and 9

RMG believes the guidance provided in the Instrument on these three areas of significant concern for investors is a welcomed addition.

Principle 6 – Recognize and manage conflicts of interest
An issuer should establish a sound system of oversight and management of actual and potential conflicts of interest.

Comment: The description that accompanies the introduction of this principle states, "We think that independence from management of the issuer is required to ensure the adequate supervision of management." RMG wholeheartedly agrees with this statement. We believe that strong independent oversight at the board level is critical to ensure effective management of actual and potential conflicts of interest such as those posed by related party transactions to which an insider, control person or significant shareholder is a party. We therefore recommend that the Principle include reference to *"a sound system of **independent** oversight"* in order to convey the importance of independent investigation, evaluation, recommendation and ongoing monitoring of related parties or entities within the corporate structure or related to specific one-time or multiple transactions.

However, we disagree that the proposed Principle should encourage oversight and management of these conflicts in a manner that does not disqualify a control person or significant shareholder from being considered independent. RMG believes that a control person is not and can not be considered comparable to a significant shareholder, by virtue of the fact that a control person acting alone has the ability to influence and direct the actions of a majority of the board of directors and/or how a majority of the votes needed to pass ordinary resolutions are cast and in very many cases direct a sufficient level of controlling votes needed to pass special resolutions. While we recognize that a significant shareholder may wield considerable influence and in some cases that which is even termed "effective control" where no other significant shareholder exists, the fact remains that a significant shareholder does not have the ability acting alone to direct more than 50% of the board of directors and/or 50% of the voting shares of the company to ensure the passage of even ordinary resolutions, and that the rest of the minority shareholders have the ability if they so choose in a coordinated effort to cast a majority of the votes in opposition to those of the significant shareholder if the interests of the minority shareholders differ from those of the significant shareholder. We believe this is an important distinction and that the likelihood of this scenario playing out increases under the now institutionally dominated market and with the easing in proxy solicitation rules which allows communication among shareholders for purposes of defending the value of their investment. This is not the case where a controlling shareholder exists. This is a very important issue given the number of reporting issuers having a controlling shareholder, including those companies with dual class shares structures in Canada. As of the August 2005 report of the Parliamentary Information and

Research Service, *Dual Class Share Structures and Best Practices in Corporate Governance,* which noted a peak in the creation of dual class share structures, it was estimated that 20% to 25% of the companies listed on the TSX use dual class shares or special voting rights. This is considerably different from the U.S. market where roughly 2% of companies issue a restricted class of shares. This is important to note for those who point to the treatment of controlling shareholders under NYSE corporate governance rules. Effective corporate governance that upholds a system of shareholder democracy should not deem a controlling person or entity to be independent.

RMG cannot comment on whether the guidance provided supplements other corporate law and securities law (including legislation and decisions of the Canadian courts) relating to these areas as we have not conducted an in-depth examination of decisions handed down by the Canadian courts in this respect.

RMG believes that the Commentary appears to provide adequate detail to illustrate the situations where conflicts of interest may arise, however we respectfully submit that a further example might be included to demonstrate that there may exist corporate structures where common directors of more than one reporting entity in the corporate structure may be faced with a conflict of interest in making certain decisions that favour one entity over the other. We also believe that the inclusion of the word "*significant*" in referring to potential conflicts of interest in the Commentary section may lead to uncertainty among issuers and investors as to the definition of "*significant"* for this purpose, and we would recommend that an issuer should have practices in place to identify, assess and resolve **any** actual or potential conflicts of interest.

RMG believes the guidance provided in the Examples of practices is adequate so long as the recommended inclusion of "*independent oversight"* and the recommended change to the effect that controlling persons are not deemed independent are undertaken. We reiterate however that we believe the current best practice guidelines are a better format to which additional guidance related to recognizing and managing conflicts of interest could be added.

Principle 7 – Recognize and manage Risk
An issuer should establish a sound framework of risk oversight and management

Comment:
RMG agrees that risk oversight and management in general is most effective when embedded into an issuer's practices and processes throughout the organization rather than being a stand-alone activity. We also concur that the responsibility for risk oversight ultimately rests with the full board of directors. However, as we have learned from the details of the credit crisis currently choking the entire global economy, policies and procedures that include all of the items listed in the 'Examples of practices' section of the proposed Principle, even when regularly reviewed with reports to the board of directors, will accomplish little if the management and board members charged with oversight responsibility do not have the appropriate education, skills and ongoing training to fully understand the nature and severity of risk, or even to determine if they have complete and relevant information related to current and potential risks.

We note that Principles 3 and 4 include references to director education, ongoing training, and access to sufficient and relevant information; however RMG recommends the inclusion of guidance related to the need to incorporate in the policies and processes developed to oversee and manage risk, provisions that would ensure the officers and directors responsible have the appropriate education, expertise and ongoing training to enable them to effectively carry out their risk specific mandate. Examinations of the causes of the global credit crisis have resulted in findings of inadequate basic understanding at the board and senior management levels of corporate issuers of the complicated investment and hedging instruments responsible for severe and widespread losses. Under the circumstances, we believe this theme of appropriate education and ongoing training is important and should be reinforced under this Principle as well.

Principle 9 – Engage effectively with shareholders
The board should endeavour to stay informed of shareholders' views through the shareholder meeting process as well as through ongoing dialogue.

Comment:
Shareholder engagement continues to increase on a global basis therefore the inclusion of some reference to shareholder communication is both timely and relevant. The two bullets in the Commentary section are broad enough to permit a range of activities that would achieve the goal of the Principle.

RMG recommends that the Examples of practices should include the adoption of a majority vote policy for director elections under Canada's plurality vote system. Promoted by the Canadian Coalition for Good Governance (CCGG) as a more democratic and meaningful method of enabling shareholders to elect their board representatives than directors elected solely by plurality of votes, this corporate governance improvement in director elections merits mentioning.

<u>Question #2 – Re Supporting Commentary and Examples of Practices</u>

Please refer to Question #1 for detailed comment on the Commentary and Example of Practices included for Principles 6, 7 and 9.

Principle #1 – Create a Framework for oversight and accountability
An issuer should establish the respective roles and responsibilities of the board and executive officers.

The supporting commentary for this Principle refers to "Usual responsibilities of the board" and lists various activities following the wording "The board is usually responsible for:" RMG would argue that the responsibilities listed are those for which the board is "ultimately" responsible either directly or indirectly through delegation. In our experience there would not be any circumstance involving the responsibilities listed that would absolve the board of this ultimate oversight obligation. The commentary as proposed seems to suggest there may be an alternate

oversight structure that would be acceptable from a corporate governance viewpoint. We submit that even the smallest venture issuer must have a board of directors with whom this ultimate oversight resides. We therefore propose the removal of the word "usual" from both lines quoted herein to eliminate any uncertainty in interpretation.

We note that Principle #1 does not address the appropriate division of responsibilities of the Chair of the Board of Directors and the Chief Executive Officer. Best practice standards and recommendations for effective corporate governance in Canada call for the separation of the roles of Chairman and CEO.[2] Where the two roles are not separate, it is recommended that an independent lead director be appointed with clearly delineated duties and authority that would equate to that of an independent Chairman. RMG believes this continues to be a basic fundamental tenet of acceptable corporate governance practice and recommends that the Principle include this as a minimum expectation in board structure to create a framework for oversight and accountability. We also recommend that the disclosure required under this Principle should include an explanation, in the event that the two roles are not separated, of why the company believes this is not necessary, what alternative structure such as an independent lead director has been implemented, the specific duties formalized, if any, for any person appointed with lead director responsibilities, and a sufficient explanation as to why the company chose not to give the position of chairman to the person with lead director responsibilities and maintain a combined chairman and CEO position.

Principle #2 – Structure the board to add value
The board should be comprised of directors that will contribute to its effectiveness.

The guidance provided under Principle #2 covers the main board structure considerations from a corporate governance perspective.

Principle #3 – Attract and retain effective directors
A board should have processes to examine its membership to ensure that directors, individually and collectively, have the necessary competencies and other attributes.

The commentary supporting this Principle states that a board nomination committee could facilitate the selection and appointment of director nominees but that the responsibility rests with the full board. This is true in as much as the responsibility for overseeing appropriate compensation practices and the integrity of the audit rests with the full board of directors. However just as separate and independent audit and compensation committees are deemed necessary to provide objective and effective oversight and accountability, corporate governance experts have for some time advocated for, at a minimum, a majority independent nominating committee charged with the responsibility of identifying candidates for board membership, particularly where the entire board of directors is less than majority independent. Years of

[2] Examples include recommendations of the Joint Committee on Corporate Governance, Beyond Compliance: Building a Governance Culture (2001), Corporate Governance Standards of the Pension Investment Association of Canada (2007), Canadian Coalition for Good Governance Corporate Governance Guidelines for Building High Performance Boards (2005).

upholding the "old boys' network" along with examples of nepotism in "awarding" director seats to favoured compatriots and family members of senior management and entrenched directors have resulted in weak, ineffective and conflicted directors at some public companies. The board selection and nomination process is critical to the overall makeup of the board and its ability to exercise independent judgment that may at times run counter to the interests of management.

RMG has received comments from seasoned directors to the effect that corporate governance improvements that have led to greater independence on the board have been accompanied by a noticeable shift in attitude among directors that has enabled them to exercise control of key areas of their oversight mandate, such as pressing for greater transparency and reining in executive compensation. These directors relate that higher corporate governance expectations have given boards more authority to challenge management when appropriate on issues that were previously presided over by powerful CEOs and other management insiders. Effective corporate governance, they say, has liberated independent directors to more effectively represent shareholder interests.

RMG believes that any principle related to board structure should reinforce the need for an independent nominating process, preferably carried out by a majority independent nominating committee or in the case of venture issuers with limited resources, a majority independent board.

Principle #4 Continuously strive to improve the board's performance
A board should have processes to improve its performance and that of its committees, if any, and individual directors.

This Principle appropriately reinforces the need for ongoing board and director assessment and continuing education and training opportunities for directors, and provides valuable guidance for implementation.

Principle #5 – Promote Integrity
An issuer should actively promote ethical and responsible behaviour and decision-making.

RMG applauds the CSA for drawing attention to ethics and integrity as a governance principle. RMG agrees that investor confidence can be enhanced if the board clearly articulates the ethical practices that will govern an issuer's activities. And while we agree that executive officers have a responsibility to implement and enforce the articulated ethical standards, we believe the board of directors is ultimately responsible for monitoring the effectiveness of these efforts and that this should be reinforced in the commentary section.

Principle #8 – Compensate appropriately
An issuer should ensure that compensation policies align with the best interests of the issuer.

Executive compensation issues continue to be the most contentious area of corporate governance practice. Not surprisingly, executive compensation has been a focus of criticism in the wake of the global credit crisis and in particular the role of short-term rewards encouraging the design of

and investments in the types of complicated and unsustainable risky investment vehicles that have resulted in widespread losses for investors and issuers. This short-term market focus has been blamed for many compensation related concerns from options backdating practices to excessive golden parachutes and extraordinarily high senior executive turnover.

Given the very contentious nature of executive compensation concerns, equally important is the independent oversight of the compensation setting process. Therefore RMG recommends that the commentary highlight the expectation that a compensation committee structure should make independent oversight and advice a priority and that, *Smaller boards might not need a formal compensation committee to achieve the same objective* ***if a majority of the board of directors is independent from management.*** Examples of practices should include procedure ***(vi) ensure the independence of external expert advice.*** Practices related to compensation committees should also reflect the need for independent external advice by perhaps indicating (e) have procedures to ensure that no individual is directly involved in deciding his or her own compensation ***and to eliminate conflicts of interest in any part of the compensation setting process.***

Question #3 – Re Relative Merits of Principles-Based Approach vs. Comply-Or-Explain

The sole merit, if any, of a principles-based versus the current comply-or-explain approach to corporate governance is perception as opposed to reality. The proposed principles highlight increased flexibility for reporting issuers in adopting as many or as few of the best practice standards and supporting processes for monitoring implementation of a particular corporate governance structure tailored to suit the particular circumstances of each issuer. RMG concedes that this may be true when compared to a rules-based approach like that governing the U.S. market. However, when compared to the current comply-or-explain best practice standards currently in effect in Canada, we believe that the need for flexibility was taken into account in formulating these well thought out standards and that the very nature of comply or explain affords reporting issuers the ability to tailor a corporate governance structure that best reflects investor expectations and each issuer's particular circumstances, as long as accompanied by the required explanation for any deviation from best practice guidelines.

RMG believes that the current corporate governance regime serves a dual purpose, that of educating issuers regarding best practice standards and the expectations of investors while stressing the importance of each area of compliance, as well as that of ensuring a minimum level of disclosure where compliance is met and encouraging increased disclosure and rationale where practices deviate from expectation. We do not believe that the proposed principles-based approach improves on the current corporate governance guidelines and disclosure requirements. In fact, we believe that the proposed changes may create substantial uncertainty and confusion for reporting issuers, perhaps resulting in a lower bar for corporate governance best practice in the Canadian market generally and certainly among mid-cap and small-cap issuers. It has been our experience that in the absence of strong guidance related to best practice standards for corporate governance and disclosure, reporting issuers, particularly mid-sized to smaller issuers that are not widely institutionally held, tend to move to the lowest regulated requirements. RMG

is of the opinion that all issuers who raise funds through the issuance of equity to public investors should be held to the same standard of basic corporate governance expectations that ensure ethical conduct, independent oversight and accountability, and complete and consistent disclosure.

Question #4 – Re Appropriate Level of Disclosure

From an investor's point of view, we are not convinced that the proposed principles-based approach will ensure the level of disclosure necessary to make informed proxy voting decisions. We are concerned also that in the absence of a structured format such as the one provided under the current comply or explain regime, shareholders will not receive consistent and comparable disclosure with which to evaluate a company's corporate governance and disclosure practices against those of other peer companies.

The loss of investor trust stemming from what has been described as a lack of transparency and regulatory oversight of complicated high risk alternative investments and the ensuing lapses in ethical conduct that have permeated public markets, including instances of self-dealing and outright fraud have drawn much needed attention to the subject of ethics once again. RMG commends the CSA for the inclusion of integrity and ethical and responsible behaviour and decision-making as one of the nine principles. The Commentary clearly states that, "*Investor confidence can be enhanced if the board clearly articulates ethical practices which are acceptable to the issuer.*" At a time when probing questions should be asked about ethical conduct and oversight, we note that the proposed disclosure related to Principle #5 only requires a summary of any standards of ethical and responsible behaviour and decision-making or code of business conduct and ethics adopted by an issuer. We believe this is inadequate and inappropriate given present market circumstances and that investor confidence is only enhanced with complete transparency and disclosure of the expected standards of ethical conduct, and the process and structure for monitoring ethical conduct at a reporting issuer.

Disclosure requirements related to Principle #7 Recognize and manage risk, ask for a summary of any policies on risk oversight and management that have been adopted by the issuer. Again, given recent market events surrounding the credit crisis and loss of investor confidence, RMG recommends that required disclosure should include identification of the process and structure for board and management level oversight of risk management activities in order to promote accountability for this responsibility.

Finally RMG notes that the proposed amendments do not include any guidance related to disclosure of extra-financial risks such as those associated with climate change, environmental risk, or other social risks that can affect an issuer's reputation, license to operate, cost of capital, listing ability, and so on. RMG would like to point out that disclosure of extra-financial risks has been recognized as an important element of investor risk assessment and is necessary to the investment mandates of certain investors. Assessment of extra-financial drivers and risks is also seen to be an indicator of management quality and future company performance. Investor coalitions in several markets are pressing for better disclosure of extra-financial risks and in

particular the Investor Network on Climate Risk representing $7 trillion in assets promotes the disclosure and understanding of financial risks and opportunities posed by climate change. Canadian reporting issuers competing for capital from investors both in and outside of Canada stand to be disadvantaged by a lack of transparency in this regard. RMG recommends that guidance related to consideration and disclosure of extra-financial risks be included in the proposed amendments for these reasons.

Question #5 – Requirements for venture issuers

RMG recognizes that venture issuers are, by their very nature, higher risk investment vehicles and while they should be subject to the same disclosure requirements concerning their corporate governance practices, we believe that they should not be subject to the same corporate governance practice expectations. For example, some venture issuers do not have ongoing operations or production capabilities, and some are barely able to maintain going concern status. Venture issuers have limited resources in many cases, have a board of directors comprised of three members most of whom are insiders or somehow affiliated to management, generally do not have corporate governance or nominating committees, often rely on part-time management which typically consists of a core group of principles having an investment in the venture enterprise, and are not institutionally held.

RMG does however recommend that all issuers including venture issuers be subject to at least minimum standards of corporate governance best practice. More appropriately, it is recommended that venture issuers be subject to very clear and frequent disclosure related to the elevated risk to shareholders of investing in these companies with clear disclosure of any differences in regulatory compliance, corporate governance practices, and disclosure.

Question #6 – Definition of Independence

RMG has concerns regarding basing the determination of independence on perception and believes the proposed change will not adequately promote independent oversight and the protection of minority shareholders. There are certain Canadian issuers who may take this approach to further entrench controlling shareholders by deeming representatives of controlling shareholders as independent. This is more unpalatable when control is maintained by means of a dual class capital structure rather than outright ownership of more than 50% of the outstanding common equity. The replacement of bright line tests with indicia is not sufficient to ensure independent oversight and will, we believe, create considerable confusion in the issuer community.

Question #7 and #8 – Appropriate Guidance

Reality should be the basis for assessment of independence rather than perception under either the current or proposed instruments; however human nature being what it is, it is necessary, in our opinion, to provide bright line tests where board accountability and shareholder protections are concerned.

Question #9 – Control Person vs. Significant Shareholder

As already noted in our comment to Principle #6, RMG believes that a control person is not and can not be considered comparable to a significant shareholder, by virtue of the fact that a control person acting alone has the ability to influence and direct the actions of a majority of the board of directors and/or how a majority of the votes needed to pass ordinary resolutions are cast and in very many cases direct a sufficient level of controlling votes needed to pass special resolutions. While we recognize that a significant shareholder may wield considerable influence and in some cases that which is even termed "effective control" where no other significant shareholder exists, the fact remains that a significant shareholder does not have the ability acting alone to direct more than 50% of the board of directors and/or 50% of the voting shares of the company to ensure the passage of even ordinary resolutions. Again, we wish to reiterate that we believe that effective corporate governance that upholds a system of shareholder democracy should not deem a controlling person or entity to be independent.
RMG therefore believes the current definition of independence containing a bright line test is necessary for purposes of MI 52-110.

Question #10 – Disclosure on Director Independence

As stated previously, we believe the current definition of independence set out in MI 52-110 is preferable and therefore the disclosure required under the current instrument is preferable.

Question #11 – Proposed Effective Date

It is hoped that the CSA will reconsider its approach to these amendments and retain the current instruments in substantially similar form with additions to the three new areas included in the proposed amendments under Principles 6, 7 and 9. If this is the case, a six month lead time should be adequate. If the CSA pursues the broader approach outlined in the currently proposed amendments, it is likely that issuers and investors may require a longer period of time to adapt prior to implementation of the new regime.

Conclusion

The CSA states that maintaining the status quo was considered and rejected due to concerns raised by issuers and investors related to the current governance regime, and because corporate governance has evolved both domestically and internationally.

RMG suggests that there is an attractive middle ground available whereby the status quo is updated to include those areas of governance and accountability that now require attention primarily as a result of recent market events, for the purpose of rebuilding investor trust and enhancing the attractiveness and viability of Canadian public companies to investors all around the world. We agree that corporate governance has evolved in many markets and we believe that the current corporate governance regime in Canada continues to place us in the top markets

globally for governance structure and accountability. With the improvements to executive compensation disclosure recently implemented by the CSA, and the likelihood of majority voting and advisory votes on pay becoming the expected corporate governance norms in this market, we believe shareholder engagement will increase improving transparency and understanding between issuers and investors in Canada.

The current comply or explain approach is in fact a principles-based approach to corporate governance but with the added benefit of substantial guidance for issuers regarding the best practice expectations of their shareholders. We would point out that issuers in Canada have gone to considerable expense to understand and comply with the current instruments which in our opinion have helped elevate their corporate governance practices and thus insulate them from the shareholder ire now being expressed in several other markets and from the level of confrontational shareholder activity such as the number of shareholder proposals filed in the U.S. market, or the formation of several large and powerful shareholder coalitions as seen in the U.K. and Europe. We strongly recommend that the CSA maintain an updated and enhanced version of the current comply or explain regime that was developed through a lengthy, informed, and inclusive process that benefited from the considerable expertise of many of Canada's leading and well-respected business, regulatory and legal experts as well as input from a varied market constituency, and that provides substantial relevant guidance on corporate governance expectations and best practices in Canada as a valuable reference for not only Canadian market players but those outside of Canada who see attractive investment opportunities in a market with a well-defined and established corporate governance regime.

Sincerely,

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