CA-Queen's Centre for Governance

Technical Report

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Corporate Governance:
Platitudes, Principles or Best Practices

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Executive Summary

- Since 2005 corporate governance disclosure requirements for Canadian public companies are set by the Canadian Securities Administrators. The requirements are essentially a system of *voluntary* compliance with "best practices" but with *mandatory* disclosure of compliance or explanation of how it complied "in principle." A company would be compliant if "best practices" were not followed, as long as compensating disclosure was made about the alternative approach taken.

- In December of 2008 the CSA proposed revisions to their requirements. The proposed new requirements support a so-called "principles approach" to governance, a substantial change from the "best practices" which are used as benchmarks in the 2005 requirements.

- Our study, sponsored in part by the *CA-Queens Centre for Governance*, is based on second-year compliance with CSA standards and had a significantly larger sample size then the first year compliance CSA study. Our study featured 307 TSX registrants and 148 TSX Venture registrants. For the TSX companies we found:
    - Summary statistics of board independence show that 80% of our sample adopted best practices, 10% compensated for non-adoption through disclosure of their alternative arrangements, and 10% *did not comply*, essentially ignoring the regulation. For example, approximately 50 companies (of 307 companies) did not have a board that included a majority of independent directors, yet they did not even discuss the matter.
    - Grouping executive compensation recommendations together show adoption of recommended practices overall at 80%, with another 4% compliant through disclosure leaving 16% not commenting on significant aspects of their board's oversight of this critical governance issue. For example, only 73% use a compensation committee comprised of only independent directors and 7% provide and explanation of their alternative approach to comply with the principle of oversight. Yet an astounding 20% do not comply and do not discuss this noncompliance with disclosure.

- The non-compliance rate for TSX firms ranged from 11% to 20%, using the lenient test of whether the company ignored the requirement to disclose and explain the company's approach alternative approach to governance if they did not comply with best practices suggested in the nine areas we reviewed. We did not judge the appropriateness of the alternative approaches taken by firms that complied by making disclosure of differences with best practices, just as would be done under the new proposed "principles" based policy.

- The TSX Venture companies under current policies are exempted from *any* disclosures except for the most basic. However, they are encouraged to take voluntary action. TSX Venture companies, in general, chose to NOT take such voluntary action through either adoption of best practices or through the compensating disclosure. Non-compliance, in individual non-required areas, ranged from 25% to 84%, are of which are significantly higher than the current TSX rates of non-compliance. Is this a possible harbinger of things to come under the "principles" approach?

- Overall, the non-compliance rate should give the investment community, and therefore the CSA, cause to hesitate. The December 2008 approach of the CSA is to retreat from the specifics of corporate governance. Yet, the system that is now in place requires little in terms of hard action, because it allows compliance through disclosure of other approaches.

- The CSA should be moving to enforce compliance/disclosure within their flexible current system with perhaps making a clear statement on how controlled issuers should be dealt with differently. Instead, the direction seems to be to make system a return to the pre-1995 setting where basically anything goes in corporate Canada. **A curious choice of direction, in today's uncertain economic climate.**

Corporate Governance:
Platitudes, Principles and Best Practices

Introduction

In September 2007, the Canadian Securities Administrators announced plans to carry out a broad scale review of National Instrument 58-101 *Disclosure of Corporate Governance Practices* and its companion policy 58-201 *Corporate Governance Guidelines*. These 2005 regulations had been developed to provide a timely response to governance concerns in the post-Enron environment, and generally consist of "best practices," versions of which were adopted in many financial markets world-wide. The regulations cover a wide spectrum of key governance issues, requiring companies to comply with the then state of the art best practices or provide disclosures if adoption is not appropriate. Disclosure typically involves explanation of the area, and alternate structures or practices adopted to meet the governance principle. These requirements apply to all TSX companies, with less extensive disclosure provisions required for TSX Venture companies.

There has been concern with the policy, however, both in terms of the level of compliance and in terms of whether or not the best practices are appropriate for the minority of Canadian listed companies that are controlled by other entities since the policy was first passed. Accordingly, the policies have been under review by the CSA. On the Friday afternoon of December 19th, 2008, less than a week before Christmas, the CSA did a low-profile announcement of new corporate governance proposals, which would represent a substantial change in the approach to corporate governance disclosure regulation in Canada. There is a considerable weakening of regulatory oversight contained in the new 58-201rfc *Proposed Repeal and Replacement of NP 58-201 Corporate Governance Guidelines, NI 58-101 Disclosure of Corporate Governance Practices,* and *NI 52-110 Audit Committees and Companion Policy 52-110CP Audit Committee.*

The CSA now proposes a "principles approach" to corporate governance such that companies who be required to describe their own mechanisms set up to meet the nine relatively vague "core governance principles" (See Appendix) or as we see them, corporate governance "platitudes" (see similar comments in Shecter, Dec. 22, 2008). If all goes as planned by the CSA, the era of Corporate Governance Guidelines and "best practices" would come to a quiet end and it would be left to marketplace participants to attempt to judge vaguely worded disclosures as to whether the company in question had effective governance mechanisms in place.

The question we attempt to address in this study is whether the current regulations are really unworkable either because of their nature or because they are poorly enforced, and to use disclosures based on the current regulations to project to what disclosures investors might expect under a "platitudes-principles" approach. Clearly, the current regulations have not been put to the test if they have not been rigorously enforced and we can glean from the level of voluntary disclosure by Venture issuers what we might expect under the “platitudes-principles” approach as they have been urged to make voluntary disclosures about the many matters they are not required to disclosure under the current regime.

CSA Study

The CSA performed its own study of existing regulations for the first year of adoption experience of 58-101 in June of 2007. The resulting report, 58-303 *Corporate Governance Disclosure Compliance Review*, used a sample of 100 companies, comprised of 65 TSX issuers and 35 TSX Venture issuers. The CSA reviewed corporate governance disclosure to determine compliance with disclosure requirement, and also evaluated the substance of disclosures, looking for clear and complete disclosure. Compliance rates in eight significant areas ranged from a low of 70% to a high of 94%. Compliance was defined as meaning that either a recommendation was adopted, or compensating disclosure was made. CSA staff expressed concern both with the compliance level and also with the lack of meaningful information contained in “boiler-plate” disclosures. Twenty-seven TSX issuers and eleven TSX Venture companies were required to address deficiencies in some form.

However, despite the seemingly pervasive concerns identified, the CSA report concluded that future compliance would be monitored only through selective review in the ongoing continuous disclosure review, and would not be the subject of a follow-up study of future compliance. Rather, the CSA indicated that they planned to review of the regulations themselves. In December of 2008, this review of the regulations resulted in proposed changes to the very nature of the requirements.

Our Studies

This report is part of an ongoing series that examines second year disclosures of corporate governance matters by Canadian corporations, in a broader and deeper sample than that used by the CSA. The studies are sponsored in part by the *CA-Queen’s Centre for Governance*.

We were concerned that the first-year compliance study undertaken taken by the CSA included only 100 companies - 65 TSX registrants and 35 TSX Venture registrants. This limited sample might not provide reliable data to draw conclusions about corporate governance disclosure practices in Canada. After all, previous CSA samples in the area of internal controls were at the 275-company level (CSA Staff Notice 52-315 *Certification Compliance Review* released September 22, 2006) and over 125 companies on the more limited area of audit committees, in two reports (CSA52-312 and 52-318).

This research series involves a group of approximately 450 Canadian companies, including 307 TSX companies and 148 TSX Venture companies. A sample of this size allows us to have much more confidence in our conclusions about the state of corporate governance disclosures in Canada and about the degree of compliance with current “best practices” in the regulations. Further, the experience of the TSX Venture companies in the sample is illuminating. Such companies are required to follow only a few of the guidelines, but they are encouraged to voluntarily disclose in accordance with all the guidelines. Their level of voluntary disclosure may give a rough insight into how companies would react to the less structured "core principles" approach to disclosure found in the 2008 proposed new CSA approach.

In the first study we produced on this sample of companies, in the summer of 2008, compliance with the CSA regulations in *52-110 Audit Committees* and its companion policy were reviewed. The setting was different for this issue in that the CSA took the unusual step of publicly chastising corporate Canada in 2006 over the lack of compliance with the required post-Sarbanes Oxley audit committee reforms. The CSA participating administrators (with the 'usual' holdout of British Columbia) released a review, on January 13, 2006, of fiscal 2004 disclosures and concluded that "the level of compliance was unacceptable." The CSA promised further follow-up reviews (see CSA 52-312). In a rare burst of timely follow-through, the second review was carried out in the next fiscal year (CAS 52-318). The conclusions in this June 29, 2007 report was positive in tone, despite the finding that some audit committee charters did not reflect mandatory assigned responsibilities at up to rates of 28%.

The *CA-Queen's Centre for Governance* sponsored follow-up study on Audit Committee requirements found that for our selected sample of over 450 Canadian companies, 90% or more complied with the 52-110 regulatory requirements for Audit Committee member independence and financial literacy, assigned responsibilities acknowledged and audit firm fee disclosures. The study concluded "that the overall story is a good news one for Canadian regulators. In one of the rare cases where regulators went public with a strong statement of disapproval of the level of noncompliance at the end of their first study and kept their promise to carry out the follow up study in the next fiscal year, corporate Canada seemed to be convinced that the regulators were serious about enforcement of this regulation." However, that study found that where mandatory compliance was not required, as was in the case for many items for TSX Venture Exchange firms, compliance declined sharply. (The full study, *Audit Committees on Canada's "Big Board" fall into Line; Little Guys Continue to Lag*, is available on the Centre website at http://business.queensu.ca/centres/CA-QCG/centre_reports/index.php.)

The Sample

The data for this study is based on a random sample of 307 Canadian companies traded on the TSX and whose financial data is tracked by Compustat (a financial database provider) plus 148 of the approximately 500 actively-traded companies that are included in the TSX S&P Value Index. In selecting the sample, we excluded all firms cross-listed on US exchanges, because these companies must comply with the requirements of the Sarbanes-Oxley Act and the various US exchange listing requirements. These requirements tend to be more prescriptive than the CSA regulations. Data about our sample companies has been hand-collected from Annual Reports and Proxy Statements (a.k.a. Management Information Circulars) for the first fiscal year-end after June 30, 2006 and has been cross-referenced to corporate directories, corporate websites, "Who's Who"-like publications, and other secondary data sources to enhance data reliability.

The 307 TSX companies reported average (median) total assets of $2 billion ($160 million) and a market capitalization of an average (median) of $918 million ($167 million). The 148 TSX Venture companies were much smaller, with average (median) total assets of $19 million ($7.7 million) and average (median) market capitalization of $65 million ($7.7 million). However, it should be noted that some of the TSX Venture companies were sizeable and that all should not be neatly dismissed as inconsequential to investors. Nearly 20% of the TSX Venture companies were greater in size than the bottom 25% of the TSX based on market capitalization; 11% of our Venture sample was greater in size then the bottom 25% of the TSX when based on total asset size.

Regulation and Companion Policy

The required practices in the area of corporate governance are contained in National Instrument 58-101 *Disclosure of Corporate Governance Practices* and its Companion Policy 58-201 *Corporate Governance Guideline*. The required practices stem from the TSE-sponsored Dey Report of 1994, whose original 14 guidelines reflected "best practices" of the day. The Dey conclusions were modified somewhat as events unfolded in the late 1990's, and significantly influenced by the US Sarbanes-Oxley Act and other US stock exchange listing requirements.

In a relatively unique policy approach, the CSA regulatory regime can be characterized as one of *voluntary adoption* of Corporate Governance Guidelines but *mandatory reporting* of either the adoption of the these guidelines or compensating disclosure. That is, a company may be considered compliant with the policy either through substantively adopting the recommendations or through disclosure of non-compliance, explaining alternative means of achieving the objective, if valid. In some cases, this disclosure might explain alternate measures taken to meet the end objective, and in other cases the disclosure simply justifies the departure.

Our Examination

We examined our sample for compliance in key areas as identified in the Corporate Governance Guidelines. We then distilled these observations into overall measures as listed below cross referenced to the detailed tables provided at the end of this paper.

Table	Topic
1	Board independence
2	Composition of committees (composite index)
3	Compensation
4	Ethics
5	Board mandate
6	Nomination of directors
7	Assessment of board and members
8	Orientation and continuing education
9	Position descriptions
10	Audit committees

For each requirement, a company's disclosure was assigned to one of three categories:

1. The company has not met the requirement or provided disclosure
2. The company has not met the requirement but provides alternative disclosure as permitted by regulation
3. The company has met the requirement in the guideline.

Companies are *compliant* with the CSA rules if they met the requirement in the guideline, or did not meet the guideline's requirements but made alternative disclosures as permitted by regulation (categories 2 and 3, above).

Note that in some cases, a company's disclosures were not adequate to determine compliance. However, we have a large data base of information about Canadian public companies, and their directors, and we are able to independently evaluate some of the items required. Hence, where possible, if we could determine that a company had complied with the substance of a requirement, the company was classified as compliant.

Findings

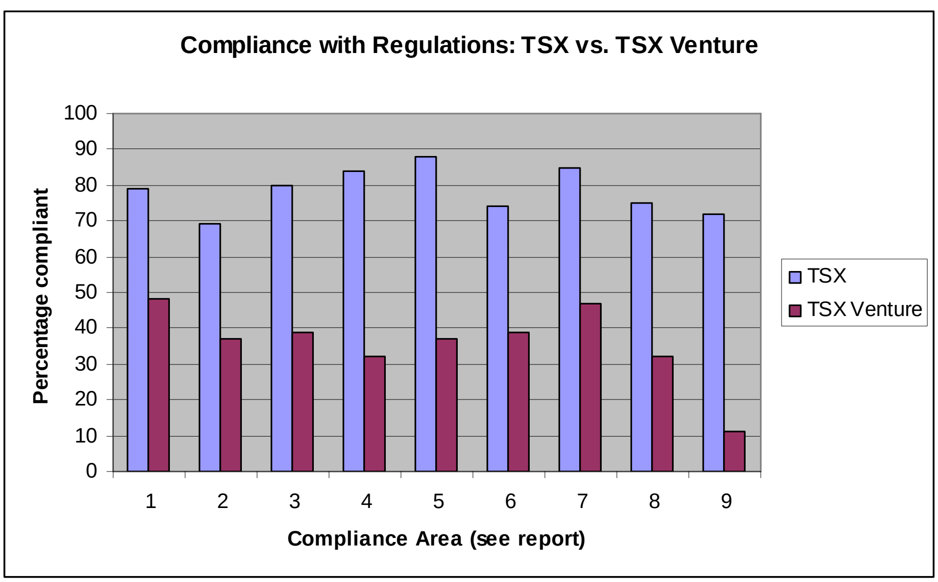
Highlights of our findings:

1. Differences in Adoption of Guidelines' Requirements and Disclosures by TSX Venture versus TSX firms

The compliance rate for TSX Venture firms' was consistently lower that the equivalent disclosures of TSX firms. See Chart 1, below. Also refer to Table 7, where requirements are in place for both TSX companies and TSX Venture companies. TSX firms disclose 87% in accordance with the regulation whereas TSX Venture disclose 54%. TSX Venture companies are not required to meet other requirements, and when a practice or disclosure was not required, the difference was even more radical. Non-compliance and non-disclosure rates are frequently in the 60% + range, and often in excess of 80% . Refer to *any* other Table for examples; in particular, Tables 6 and 9 clearly show low voluntary compliance levels in the TSX Venture companies.

One conclusion is that both practices and disclosures will only be made if specifically required. One then wonders about the quality of practice and/or disclosure for the nine vaguely worded "core principles" CSA-proposed approach (see Appendix). Of course, firms that follow "best practices" tend to be those who make the most extensive disclosures; vague regulations may then lead to exemplary disclosure in Canada by those firms who least need prodding in the area of corporate governance.

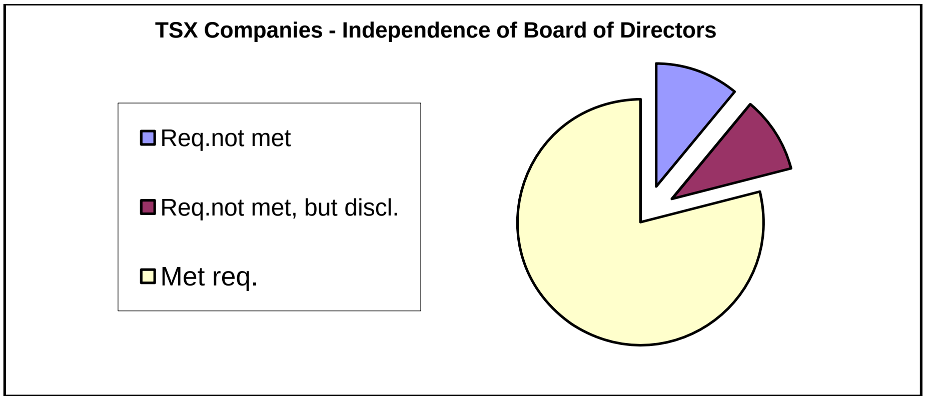
Chart 1



2. Independence of Board

For the TSX companies, approximately 80% adopted the guideline's requirements for board independence. There are close to 50 TSE companies in our sample that do not have a majority of unrelated members on the board of directors. A full 10% did not follow the recommendation but provided disclosure in the area. Thus, while the *compliance rate* with the rules is close to 90%, only approximately 80% have adopted the practices outlined. (See Chart 2)

Chart 2

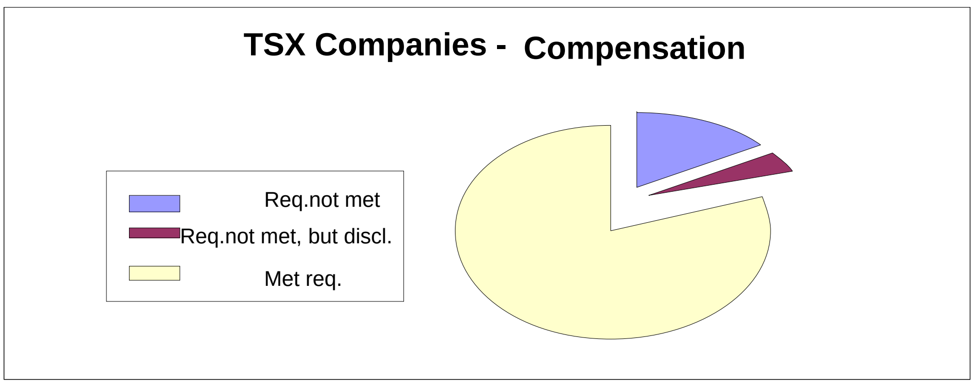


The 2007 CSA study reported a healthy 94% compliance rate for independence, a finding that is not substantiated by our larger study. The TSX Venture companies have no requirement in this area, and only approximately 70% of companies have a majority of independent board members.

3. Compensation

Appropriate determination of the levels of executive and board compensation is a critical task of the board of directors. Since directors can set their own compensation, they are in a conflict of interest and scrutiny is appropriate. Most TSX companies (95%) have a compensation committee. However, they are less likely (73%) to adopt the recommendation that the committee include only independent directors. There are 84 TSE companies in our survey in this situation. Composition of committees is a major concern uncovered by this study, as previously mentioned. Even fewer of the TSE companies (71%) disclose the text of the committee charter. Transparency is lacking. Our overall measure shows that the recommendations were adopted 80% of the time, with another 4% compliant through disclosure. See Chart 3.

Chart 3

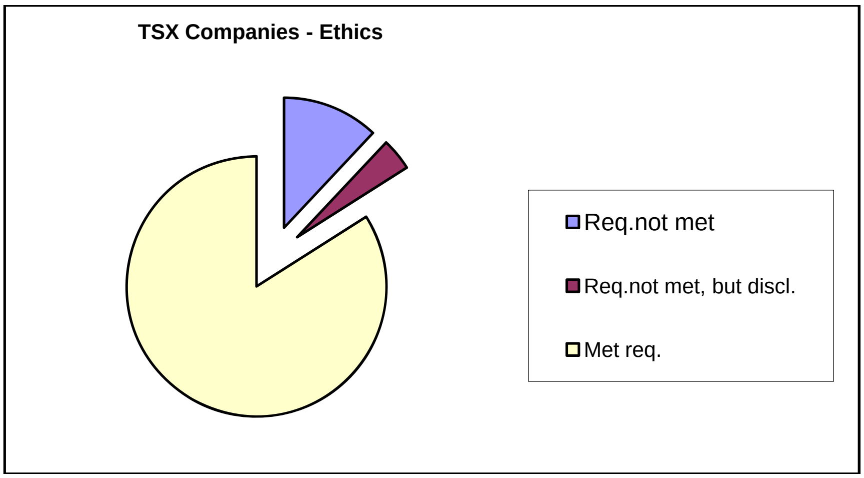


For the TSX Venture companies, where there is no requirement for compliance of any sort, only 73% have a committee, 28% have only independent members on it, and only 16% disclose the text of the committee charter.

4. Ethics

A code of ethics is a basic requirement to set and monitor expectations. Our study reports an 84% adoption rate in this area for TSX companies. However, in general terms this seems low, given the consequences of directors' and employees' actions. There are 47 TSE companies with no code. In addition, there are 54 TSX companies who do not monitor the code of ethics. This calls into question the effectiveness of the code of ethics. See Chart 4

Chart 4



Conclusions and Observations

The CSA Corporate Governance requirements represent a system of *voluntary* compliance and *mandatory* disclosure. Thus, if a mandated practice is not followed, a company would be classified as compliant with the requirements if compensating disclosure is made. This seems to be a very forgiving approach to corporate governance.

For the TSE companies, some of the most basic corporate governance requirements were left unmet. Summary statistics of board independence show that 80% of our sample adopted best practices, 10% compensated for non-adoption through disclosure, and 10% *did not comply*, even with disclosure. Approximately 50 companies in our sample of 307 companies did not have a board that included a majority of independent directors. Compensation issues, a sensitive issue, show adoption of recommended practices in a summary statistic of 80%, with another 4% compliant through disclosure. Only 73% use a compensation committee comprised of only independent directors. In the area of ethics, there are 47 TSX companies in our survey that have not adopted a code of ethics. Overall, the summary statistic shows 84% met the requirements, but this should not be viewed as acceptable in this important area. In other areas, 69% of TSE companies met the practices suggested for committee composition, 88% met the practices covering appropriate board mandates, and 74% were in line with processes and practices governing nomination of new directors. There was 85% compliance with practices over assessment of the board and its members, and 75% compliance with the expectations for orientation and continuing education of board members.

Companies could be compliant with the requirements even in the absence of recommended governance procedures, if they provided compensating disclosure. In the nine areas reviewed, the non-compliance rate was significant, and ranged from 11% to a high of 20% .

The TSX Venture companies in this sample were exempted from *any* requirements in many given areas, and were only *encouraged* to comply in many areas. For the most part, TSX Venture companies did not choose to comply using either adoption of "best practices" or through compensating disclosure. Compliance levels were significantly lower in ALL measured areas. Non-compliance, in individual non-required areas, ranged from 25% to 84%.

Overall, the percentage of TSX companies that were not compliant, even with compensating disclosure, and the percentage of TSX Venture companies that did not provide voluntary adoption of recommendations, should give the investment community, and therefore the CSA, cause to hesitate. The December 2008 approach of the CSA is to back off from specifics of corporate governance. Yet, the system that is now in place requires little in terms of hard action, because it allows compliance through disclosure of other approaches. Why is it necessary to water this approach down by reverting to a "principles approach"? Instead, the CSA should be moving to enforce compliance with their flexible – perhaps too flexible - system. The direction chosen seems to make the system *more* flexible. **A curious choice of direction, in today's uncertain economic climate.**

Appendix

CSA Proposed Core Governance Principles

- **Principle 1 - Create a framework for oversight and accountability**

An issuer should establish the respective roles and responsibilities of the board and executive officers.

- **Principle 2 - Structure the board to add value**

The board should be comprised of directors that will contribute to its effectiveness.

- **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.

- **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.

- **Principle 5 - Promote integrity**

An issuer should actively promote ethical and responsible behavior and decision-making.

- **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.

- **Principle 7 - Recognize and manage risk**

An issuer should establish a sound framework of risk oversight and management.

- **Principle 8 - Compensate appropriately**

An issuer should ensure that compensation policies align with the best interests of the issuer.

- **Principle 9 - Engage effectively with shareholders**

The board should endeavor to stay informed of shareholders' views through the shareholder meeting process as well as through ongoing dialogue.

TABLE 1
Independence of Board

	TSX Companies				TSX Venture Companies		
58-201 GUIDELINES	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**	**58-101 F2 GUIDELINES**	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**
3.1 Majority of directors independent	9% (29)	7% (20)	84% (258)	-	31% (46)	0 (0)	69% (102)
3.2 Chair of board is independent	21% (64)	28% (87)	51% (156)	-	64% (96)	1 (2)	34% (50)
3.3 Independent directors hold separate regularly scheduled meetings	15% (47)	9% (28)	76% (232)	-	84% (124)	3 (5)	13% (19)
3.1. Explicit disclosure for each director re: relationship	2% (6)	0% (1)	98% (300)	1	5% (6)	0 (0)	96% (142)
3.2. Procedures exist to allow board to function with independent judgement	7% (21)	4% (13)	89% (273)	-	70% (103)	4 (6)	26% (39)
Totals	**11% (167)**	**10% (149)**	**79% (1,219)**	**-**	**51% (375)**	**1% (13)**	**48% (352)**

Commentary: For the TSX companies, approximately 80% met the requirements for board independence, which includes meeting such guideline requirements as such having sufficient members that are independent, the practice of having regular meetings of independent members alone apart from management, and procedures in place for the board to act with independent judgement. Another 10% did not follow these guidelines but comply with the regulation by providing alternative disclosures. About half of TSX companies have an independent member as chair of the board, with another 28% providing disclosure as to why not. 21% of TSE companies neither follow the guideline's requirement nor explain why they do not.

Among the TSX Venture firms, with no requirement in the area for board independence, approximately 70% of companies have a majority of independent board members. Matters only get worse when one considers other requirements of this guideline.

The CSA study, carried out a year prior to this study, reported a 94% compliance rate for independence, a finding that is not substantiated by our larger study.

TABLE 2
Composition of committees - Composite Index

The governance guidelines deal with the composition of the board as well as many of its key committees. This combined metric tracks overall response by firms to the guidelines' composition requirements for the Board as a whole, the nomination committee, and the compensation committee.

	TSX Companies				TSX Venture Companies		
58-201 GUIDELINES	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**	**58-101 F2 GUIDELINES**	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**
3.1 Majority of directors independent	9% (29)	7% (20)	84% (258)	-	31% (46)	0 (0)	69% (102)
3.2 Chair of board is independent	21% (64)	28% (87)	51% (156)	-	64% (96)	1 (2)	34% (50)
3.10 Committee to nominate new directors: All members are independent directors	24% (72)	7% (23)	69% (212)	-	81% (120)	0% (0)	19% (28)
3.15. Compensation committee: Entirely independent members	19% (63)	7% (21)	73% (222)	-	70% (104)	1% (2)	28% (42)
Totals	**19% (228)**	**12% (151)**	**69% (848)**		**62% (366)**	**1% (4)**	**37% (222)**

Commentary: Overall, only 69% of the TSX companies adopt all of these composition guidelines, with another 12% compliant with the rules through the alternative of disclosure. Only 37% of the TSX Venture firms, for whom compliance is not required, meet this requirement.

The difference between the two exchanges indicates the critical importance of regulation in this area, if independent director involvement is considered a key safeguard in improving these aspects of corporate governance (i.e. not stacking the boards with friends of management as in the nomination committee, not over-rewarding management as in the compensation committee) then a regulatory response is needed.

Indeed, even among the TSX companies, key committees appear to have non-independent membership with alarming frequency. For example, committees to select new board of directors' members are not independent in 95 TSX companies and the compensation committee is not comprised of only independent members in 84 TSX companies.

TABLE 3
Compensation

58-201 GUIDELINES	TSX Companies REQ. NOT MET	REQ. NOT MET BUT DISCL.	MET REQ.	58-101 F2 GUIDELINES	TSX Venture Companies REQ. NOT MET	REQ. NOT MET BUT DISCL.	MET REQ.
3.15. Compensation committee established	2% (8)	2% (7)	95% (291)	-	25% (36)	3% (4)	73% (108)
3.15. Compensation committee: Entirely independent members	19% (63)	7% (21)	73% (222)	-	70% (104)	1% (2)	28% (42)
3.15. Compensation committee has a written charter	27% (83)	1% (4)	71% (219)	-	83% (123)	1% (2)	16% (23)
Totals	**16% (154)**	**4% (32)**	**80% (732)**		**59% (263)**	**2% (8)**	**39% (173)**

Commentary: Most TSX companies (95%) have a compensation committee. Fewer than 73% adopt the guideline's requirement that the committee include only independent directors. Even fewer TSE companies (71%) disclose the text of the committee charter. For the TSX Venture companies, where there is no requirement for compliance, only 73% have a committee, 28% have only independent members on it, and 16% disclose the text of the committee charter.

TABLE 4
Ethics

	TSX Companies				TSX Venture Companies		
58-201 GUIDELINES	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**	**58-101 F2 GUIDELINES**	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**
3.8 Have a written code for business conduct and ethics for directors, officers and employees	9% (28)	6% (19)	85% (259)	4	9% (51)	6% (42)	85% (55)
3.9 Monitor compliance with code	16% (47)	2% (7)	82% (252)	-	69% (102)	3% (5)	28% (41)
Totals	**12% (75)**	**4% (26)**	**84% (511)**		**52% (153)**	**16% (47)**	**32% (96)**

Commentary: Our study reports an 84% adoption rate for TSX companies. However, this still means there are 54 TSX companies who are non-compliant with the requirement to monitor their code of ethics in a sample of just over 300. While the TSX Venture companies report the presence of a code in 85% of the companies, only 28% indicate that it is monitored (not required for compliance by these companies), and only 3% explain the lack of monitoring. The CSA study reported a compliance rate of 86% in their year earlier study.

TABLE 5
Board Mandate

	TSX Companies				TSX Venture Companies		
58-201 GUIDELINES	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**	**58-101 F2 GUIDELINES**	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**
3.4(b) Accept resp. for strategic planning process	6% (18)	0% (0)	94% (289)	-	61% (90)	0 (0)	39% (58)
3.4(c) Accept resp. for identification of risk and risk management systems	9% (27)	0% (1)	91% (279)	-	57% (84)	0 (0)	43% (64)
3.4(d) Accept resp. for succession planning	11% (36)	1% (2)	88% (269)	-	62% (92)	0 (0)	38% (56)
3.4(e) Adopt communications policy	16% (50)	1% (2)	83% (255)	-	71% (105)	0 (0)	29% (43)
Totals	**12% (131)**	**0% (5)**	**88% (1,092)**		**63% (371)**	**0% (0)**	**37% (221)**

Commentary: There is a highly significant difference for the TSX companies as compared to the TSX Venture companies. Our study showed that the recommendations were adopted in a significantly more companies (88%) in TSX companies but at a far lower rate (37%) in the Venture companies.

It is surprising, though, that board of directors are not anxious to disclose their mandate in areas such as strategic planning and succession planning. Recommendations were adopted for risk management by 91% of the TSE companies, but only 43% of the TSX Venture firms. The CSA study reported compliance of 77% in their year earlier study.

TABLE 6
Nomination of Directors

	TSX Companies				TSX Venture Companies		
FACTOR PER 58-201 GUIDELINES	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**	**FACTOR PER 58-101 F2 GUIDELINES**	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**
3.10 Committee to nominate new directors exists	2% (8)	7% (20)	91% (279)	5	9% (14)	1% (1)	90% (133)
3.10 Committee to nominate new directors: All members are indep. directors	24% (72)	7% (23)	69% (212)	-	81% (120)	0% (0)	19% (28)
3.11 Nomination committee has a written charter	34% (103)	4% (12)	62% (192)	-	92% (136)	1% (1)	7% (11)
Totals	**20% (183)**	**6% (55)**	**74% (683)**		**61% (270)**	**0% (2)**	**39% (172)**

Commentary: Our study shows an overall level of compliance at 80% for TSX companies, with 74% following the guideline's requirements and 6% providing the alternative disclosure. Composition of the committee, as previously highlighted is problematic for TSX firms, and also disclosure of the committee charter is relatively low. Again, there is much lower compliance among the TSX Venture Companies, essentially pulled down in areas where requirements are not in place. Only the requirement to have a committee is in place for TSX Venture companies and here 90% meet the guideline. The CSA reported 82% compliance in their year earlier study.

TABLE 7
Assessment of Board and Members

	TSX Companies				TSX Venture Companies		
58-201 GUIDELINES	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**	**58-101 F2 GUIDELINES**	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**
3.18. Process in place to evaluate effectiveness of board, committees, individual directors	5% (16)	5% (15)	90% (276)	8	38% (56)	15% (22)	47% (70)
3.12b. Discussed appropriate size of board	19% (59)	0% (0)	81% (248)	-	53% (78)	0% (0)	47% (70)
Totals	**13% (75)**	**2% (15)**	**85% (524)**		**46% (134)**	**7% (22)**	**47% (140)**

Commentary: The compliance rate for TSX companies is 87% (85% + 2%), but slips to 54% (47% + 7%) for TSX Venture companies. Processes seem to be in place among TSX companies, at least, to allow evaluation of the board, committees and individual directors (90%). TSX Venture companies lag significantly despite this being a requirement. The CSA study reported a compliance rate of 85% in their year earlier study.

TABLE 8
Orientation and Continuing Education

	TSX Companies				TSX Venture Companies		
58-201 GUIDELINES	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**	**58-101 F2 GUIDELINES**	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**
3.6 Program for orientation and education of new directors	8% (24)	11% (34)	81% (249)	3	31% (46)	26% (39)	43% (63)
3.7 Provide continuing education program for directors	14% (43)	17% (51)	69% (213)	3	60% (89)	18% (26)	22% (33)
Totals	**11% (67)**	**14% (85)**	**75% (462)**		**46% (135)**	**22% (65)**	**32% (96)**

Commentary: Our study shows that TSX companies adopt this requirement with a rate of 75%, slipping to 32% for TSX Venture companies. Many of the TSX Venture companies provided reasons for non-compliance (22% overall) but many provided no disclosure. Among the TSX companies, programs for new members appear to be more pervasive (81%) than programs for continuing education (69% meeting requirement.) The CSA study reported 85% compliance in their year earlier study.

TABLE 9
Position descriptions

58-201 GUIDELINES	TSX Companies REQ. NOT MET	REQ. NOT MET BUT DISCL.	MET REQ.	58-201 F2 GUIDELINES	TSX Venture Companies REQ. NOT MET	REQ. NOT MET BUT DISCL.	MET REQ.
3.5 Written position descriptions for CEO	16% (50)	13% (39)	71% (218)	-	83% (123)	6% (9)	11% (16)
3.5 Board develops/approves corporate. objectives of CEO	15% (45)	5% (16)	80% (246)	-	82% (121)	1% (1)	17% (26)
3.5 Written position descriptions for chair of the board and each board committee chair	19% (57)	16% (50)	65% (200)	-	91% (135)	3% (5)	6% (8)
Totals	**17% (152)**	**11% (105)**	**72% (664)**		**86% (379)**	**3% (15)**	**11% (50)**

Commentary: Our study shows 83% compliance and 17% non-compliance in this area for TSX companies. Of the compliant companies, 72% adopted the recommendation and 11% were compliant through an explanation. However, the TSX Venture companies have no recommendations in this area and few adopt the practices.

It is difficult to understand how committees can operate effectively if position descriptions for committees and chairs do not exist (as is the case for 107 TSX companies) or if the board does not approve and develop the CEO's corporate objectives (61 TSX companies). This latter task is surely central to the mission of a well-functioning board of directors. The CSA study reported compliance at 70% in their year earlier study.

TABLE 10
Audit committee
Multilateral instrument 52-110 *Audit Committees* and 52-110CP

	TSX Companies				TSX Venture Companies		
GUIDELINE	**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**		**REQ. NOT MET**	**REQ. NOT MET BUT DISCL.**	**MET REQ.**
13 Audit committee issues							
a. Audit committee: Composed of outside directors	2% (7)	0% (1)	97% (307)		54% (80)	1 (2)	45% (66)
b. Specifically defined responsibilities	2% (5)	0% (0)	98% (302)		3% (5)	0 (0)	97% (148)
c. Direct access to external and internal auditors	3% (9)	0% (0)	97% (298)		11% (16)	0 (0)	89% (132)
d. Responsibility for system of internal control	3% (10)	0% (0)	97% (296)		10% (15)	0 (0)	90% (133)
e. Disclose text of charter	2% (5)	0% (1)	98% (301)		8% (12)	0 (0)	92% (136)
f. Name of each audit committee member	1% (2)	1% (2)	98% (303)		1% (1)	0 (0)	100% (147)
g. Audit committee: Only independent directors	3% (11)	3% (8)	94% (288)		53% (79)	5 (7)	42% (62)
h. Audit committee: Entirely directors who are financially literate	3% (10)	0% (0)	96% (297)		12% (17)	1 (1)	88% (130)
i. Audit committee: Disclose education and experience that is relevant for each member	7% (22)	1% (4)	92% (280)		37% (56)	1 (2)	61% (90)
Index of overall details of fees paid to audit firms for a multiplicity of services	12%	1%	87%		7%	0%	93%
Audit fee disclosure; aggregate fees in each of the last two years	7% (22)	1% (4)	92% (280)		6% (9)	1% (1)	93% (138)
15a. Disclose that CEO/CFO has signed off on statements. Disclose sign-off	1% (2)	0% (1)	99% (303)		0% (0)	0 (0)	100% (148)

Commentary: This data has been separately reported in the Technical Report by S. Salterio, "Audit Committees on Canada's Big Board Fall into Line; Little Guys Continue to Lag" July 8, 2008. (Available at http://business.queensu.ca/centres/CA-QCG/centre_reports/index.php).

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April 16, 2009

Mr. John Stevenson, Secretary
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E-mail: jstevenson@osc.gov.on.ca

Dear Mr. Stevenson:

Re. Request for Comment – Proposed Repeal and Replacement of NP 58-201 Corporate Governance Guidelines, NI 58-101 Disclosure of Corporate Governance Practices, and NI 52-110 Audit Committees and Companion Policy 52-110CP Audit Committees

Please find attached two research studies prepared under the auspices of the CA-Queen's Centre for Governance that are pertinent to your recent call for comments. The newer of the two studies (co-authored with Joan Conrod of Dalhousie University) was released earlier this week and is entitled "Corporate Governance: Platitudes, Principles or Best Practices" and bears directly on questions 3, 4 and 5 of your call for comments. The second study, "Audit Committees on Canada's "Big Board" fall into Line; Little Guys Continue to Lag" was released last August and is related in a more general way to the same questions. The second study, Audit Committees also has implications for the wholesale rewriting of the audit committee independence rules to accommodate the special needs of controlled corporations.

The two studies focus on a common sample of 307 TSX listed companies and 148 TSX Venture companies first annual financial report after June 30, 2006 that were subject only to Canadian regulation (i.e. we excluded cross listed companies). The 307 TSX companies reported average (median) total assets of $2 billion ($160 million) and a market capitalization of an average (median) of $918 million ($167 million). The 148 TSX Venture companies were much smaller, with average (median) total assets of $19 million ($7.7 million) and average (median) market capitalization of $65 million ($7.7 million). More details are provided in the "Corporate Governance: . . ." report.

Corporate Governance

Based on the two studies, the following are my responses to your call for comments.

3. *What are the relative merits of a principles based approach for disclosure compared to a "comply or explain" model?*

The "principles" enunciated in the call for comments are not really principles in any sense of the word that I have ever seen used by regulators or standard setters (see Salterio, S. A Strategy for Dealing with Financial Reporting Fraud: Fewer Mandates More Auditing.

Accounting Perspectives. (2008) 111-122 for more on what makes principles). The current statements are more of the nature of "platitudes" as the attached report elaborates on in its first section. To illustrate the difference, I attach as an appendix to this letter an example of how a two of the statements could be reworded into principles that might be the basis for a fully elaborated principles model. Perhaps once a fully elaborated principles model was developed there would be a viable alternative system to the current "comply and explain" with best practices model but at present the alternative regime is not well developed and is bound to cause considerably less disclosure than is already the case.

At present, given the current set of "platitudes" being proposed in the guise of principles, there is no basis for evaluating principles versus "comply or explain" based on best practices model. Hence, the current model should be maintained and the companion policy revised to reflect the latest thoughts on corporate governance best practices.

4. *Is the level of disclosure . . . . . . appropriate . . . . .?*

The current level of disclosure under the "comply and explain" with best practices model is only adequate in the area where the Securities Commission have focused their attention. The contrast between the two attached reports prepared under the auspices of the Centre is marked. The Audit Committee report shows that where the Commissions did an initial study, found compliance well below desired levels, announced that they would carry out a follow-up study and promptly did so, corporate Canada listened and made vast strides in compliance with 52-110 Audit Committees. However, the Corporate Governance report shows that when the Commission did an initial study, rationalized away a high level of noncompliance, that noncompliance continued to be high even though the standard for compliance is the corporation had to explain why they were not complying with best practice. In other words, to be found in compliance with 58-101, Disclosure of Corporate Governance Practices in our study, the corporation only had to disclose its practice, its consistency or not with best practice in the Companion Policy and where it differed explain why. So when there are noncompliance rates reported in 10, 20 and 30% range for some disclosures in our Corporate Governance report, these rates suggest there is a widespread problem with enforcement of the current model. The implications for going to an even greater judgment model are staggering for appropriate disclosure in Canada.

Based on our study adding any more flexibility to the disclosure framework for governance would result in virtually a return to the pre-1995 days when Canadian corporations voluntarily disclosed what they wished about corporate governance. Our Corporate Governance report documents lack of compliance with the current standard combined with little uptake by the TSX Venture companies of the recommendations they voluntarily adopt the disclosures required of the TSX registrants. These findings strongly suggest that a less prescriptive regime would result in even less disclosure about governance. These findings also suggest that the Commissions revisit their hands off stance over policing disclosures under 52-110. The Commissions relative emphasis on aggressive enforcement of 52-110 versus the more passive stance on 58-101 is clearly reflected in the relative rates of compliance. See the studies for more details

5. *Should venture issuers be subject to the same disclosure requirements concerning their corporate governance practices as non-venture issuers?*

The question it would seem should revolve around market capitalization and spread of ownership not the exchange one is listed on. As we document in Corporate Governance, "Nearly 20% of the TSX Venture companies were greater in size than the bottom 25% of the TSX based on market capitalization; 11% of our Venture sample was greater in size then the bottom 25% of the TSX when based on total asset size." (p. 8). However, we deliberately sampled into the most actively traded TSX Venture issuers, the "500 actively-traded companies that are included in the TSX S&P Value Index." Nonetheless, the ongoing reluctance of Canadian regulators to use size based on market capitalization and spread of ownership as a key criteria rather than exchange listing has been an ongoing puzzle. If the goal of regulation is investor protection, one would think that a regulation capturing the widest traded companies would be the objective not ease of administration by exchange.

In principle, all companies that seek capital from the public enter into a contract with the investing public that requires them to give up a certain right to privacy in return for this equity capital. Among the rights to privacy given up, are secrecy in governance as well as secrecy in its financial dealings (i.e. published audited financial statements with quarterly unaudited financial statements). The key question is how much as a society are we prepared to trade off this contract in the hopes of producing a more entrepreneurial culture and are these tradeoffs warranted. To date there is no clear evidence one way or the other.

I would recommend a size test for disclosure requirements that considers market capitalization and breathe of share ownership as the basis for requirements for disclosure for firms on the TSX Venture in addition to all firms listed on the TSX or a single test for all registrants.

Audit Committee Independence

6. *In your view what are the relative merits of the proposed approach to independence compared to the current approach . . . . .*

The conclusion of the report "Audit Committees on Canada's "Big Board" fall into Line; Little Guys Continue to Lag" on audit committee independence was "97.39% of the TSX audit committees being 100% independent and 43.2% of the TSX Venture audit committees being 100% independent where such is not required by regulation." This area was one of the highest areas of compliance in the study and hence shows a great acceptance and understanding of the current rule by corporate Canada. The current rule is, in substance, the equivalent of rules in our largest trading partners. The key question then is why the wholesale rewriting of the independence rule?

Basically, the problem centers on Canadian corporations that have a significant shareholder or who are majority owned by another corporation, yet are still public companies that are widely traded. This is said to be one of the unique characteristics of the Canadian capital market along with the greater likelihood of a separate Chair of the Board from the CEO vis a vis the US capital markets. Under the current definition of independence it is difficult, if not impossible, for directors who represent, or who are, these shareholders to qualify as independent and hence be members of the audit committee despite their significant financial stake in the corporation. The general academic view of "blockholders" (i.e. significant individual non-controlling or institutional shareholders represented on the board) is they are a positive sign of increased monitoring of management (see Beasley, M. & S. Salterio. The Relationship Between Board Characteristics and Voluntary Improvements in Audit Committee Composition and Experience. *Contemporary Accounting Research.* (2001) 539-570 for the rather convoluted academic arguments and proofs advanced of this). However, these arguments do not generalize to controlling shareholders or controlling corporations where the literature on minority shareholder oppression comes into play (see evidence in

Bozec, Yves and Laurin, Claude. 2008. Large Shareholder Entrenchment and Performance: Empirical Evidence from Canada. *Journal of Business Finance & Accounting*; 35(1/2): 25-49).

Hence, while a case can be made for non-controlling large individual shareholders and intercorporate investors, it is difficult to make the case that controlling shareholders and controlling corporations are independent of management since they are likely to have a large say in hiring, firing and remunerating them as well as controlling potential career prospects within the overall corporate group. Furthermore, the research evidence suggests that such groups are likely to take advantage of their affiliation with management.

The case does not seem to have been made, in light of the overall pattern of non-compliance with more judgmental aspects of 58-101 to weaken the independence rule in 52-110 for ALL audit committee members and make it out of step with international norms.

At most, explicit exceptions should be made in 58-101 and 52-110 for boards and audit committees of controlled corporations subject to adequate protection for minority shareholders. These should be clear exceptions and NOT change the fundamental definition of independence.

This response makes responding to the remaining sequence of questions entirely hypothetical and hence I will go no further.

Should the Commission require further information about the studies cited in this response or wish a more in-depth briefing on the research, I would be pleased to provide the same.

Sincerely,

Steve

Steven E. Salterio PhD FCA

Attachments (1) and Enclosures (2)

APPENDIX

Examples of REAL Principles Based Governance

Preface

A corporate entity when entering the equity markets must understand that it is entering a social contract with the investing society, which given the current dominance of large pension funds and other institutional shareholders, is basically a covenant with a large portion of the citizens of the country. Hence, it can no longer act as a private company and in exchange for the liquidity a public listing provides, the management and/or the controlling shareholder has to accept certain restrictions on their "rights." These include implementing and reviewing from time to time the best thinking on corporate governance especially given the increasing evidence that there is long term value creation associated with good corporate governance even if there is not any association with yearly market returns.

CSA Principle 1 - Create a framework for oversight and accountability
An issuer should establish the respective roles and responsibilities of the board and executive officers.

Revised Principle 1 – The Board will be structured in such a manner that proper oversight of executive officers is achieved.

In any case, but where 50%+1 of the equity (broadly defined) of the company is held by a controlling shareholder or corporate entity (directly or indirectly), this is achieved through a Board that is independent of management or any controlling shareholder who controls less than 50%+1 of the equity. This requires that *an issuer will establish the respective roles and responsibilities of the board and executive officers.*

Commentary would discuss majority of independent board as a necessity to reach this principle and the options around splitting the Board Chair/CEO, the lead director and the independent members routinely meeting without management present.

Specific commentaries would be developed as to how controlled corporations would achieve their responsibilities as a blockholder on the board is often an excellent compensating control mechanism for management but can be problematic from the oppression of minority shareholders. Here the governance problem is a very different one and the attempt to make one size fits all is at the root of the problem.

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

Revised Principle 2 The Board will adopt a structure that allows it to govern effectively, not manage, the entity.

The board will be comprised of directors that will contribute to its effectiveness of its primary mission of oversight of management who are primarily charged with the mission of adding valuing to the corporation. The Board needs the skill set and structure such at it is alerted as soon as practicable that for whatever reason current management is unable or unwilling to take actions that can preserve or create value for the corporate entity so the Board may take appropriate action.

Commentary would then be on position descriptions, orientation, and other means of getting new directors up to speed. It would also discuss board size, minimum necessary committees (audit, executive compensation, nomination/governance), committee composition

CA-Queen's Centre for Governance

Technical Report

Steve Salterio Ph.D. FCA*

July 8, 2008
(with editorial changes on July 10, 2008)

Audit Committees on Canada's "Big Board" fall into Line; Little Guys Continue to Lag

NOTE: THE VIEWS EXPRESSED IN THIS REPORT ARE THOSE OF THE AUTHOR'S AND DO NOT NECESSARILY REPRESENT THOSE OF THE CENTRE, ITS SPONSORS OR THE UNIVERSITY.

* Regan Schmidt ABD CA, a Queen's doctoral student, managed the research team that collected the data that underlies this report. Without his leadership, this data would not have been collected. His comments on the final drafts of this manuscript are also appreciated.

Audit Committees on Canada's "Big Board" Fall Into Line; Little Guys Continue to Lag

After a rough introduction to the post-Sarbanes Oxley era, Canadian audit committees for TSX listed firms have mostly fallen into line with the reforms enacted by the Canadian Securities Administrators in 2004. A new study just completed shows that for a sample of over 450 Canadian companies that 90% or more complied with the regulatory requirements for Audit Committee member independence and financial literacy, assigned responsibilities acknowledged and audit firm fee disclosures.

All is not good news however. The study also found:

- TSX Venture companies continue to significantly lag TSX companies in required audit committee disclosures and in overall audit committee disclosures.
- Over 10% of TSX and TSX Venture companies have incomplete audit firm fee required disclosures.
- Nearly 10% of TSX Venture companies have a majority of non-independent directors on the audit committee in apparent violation of regulatory requirements.
- Nearly 10% of TSX companies do not provide support for the assertion that their audit committees are staffed with financially literate members as required.
- A majority of TSX Venture issues (57%) have a senior management member on the audit committee – an extremely poor governance practice as shown by realms of research studies and other regulator's rulings as it leads to a significantly less effective committee. [Note: This is not a regulatory requirement for Venture issuers.]

The 'made in Canada' approach of providing 'daylight' by requiring disclosure of poor governance practices hoping that it would lead to substantive changes quickly does not seem to be born out given the predominance of Venture firms having management members on Audit Committees despite several years of disclosure of this departure from 'best practice'. The lack of compliance in the area of mandated audit committee financial literacy disclosures among TSX companies is also problematic. 'Negotiations' among Canada's thirteen regulators lead to the requirement for a financial expert on the audit committee to be dropped and replaced with this disclosure - yet even that disclosure is not being uniformly followed. Compounding this is the practice of nearly 90% of Venture companies voluntarily disclosing they have financially literate audit committees but with almost a third not providing any information about how they support that assertion.

Nonetheless, the study concludes that the overall story is a good news one for Canadian regulators. In one of the rare cases where regulators went public with a strong statement of disapproval of the level of noncompliance in their first study and kept their promise to carry out the follow up study in the next fiscal year, corporate Canada as represented by those listed on the "Big Board" seemed to be convinced that the regulators were serious about enforcement of this regulation.

Audit Committees on Canada's "Big Board" Fall Into Line; Little Guys Continue to Lag

The Canadian Securities Administrators took the unusual step of publicly flogging corporate Canada in 2006 over the lack of compliance with the post Sarbanes Oxley audit committee reforms mandated by Multilateral Instrument 52-110 Audit Committees. The CSA participating administrators (Ontario, Quebec, Alberta, Saskatchewan and Manitoba with the 'usual' holdout of British Columbia[1]) released a review on January 13, 2006 of fiscal 2004 disclosures and characterized "the level of compliance was unacceptable" and promised further follow-up reviews (see CSA 52-312). In contrast to the norm of significant delay between announcement of follow-up and the actual implementation of one, the follow-up review was carried out in the next fiscal year (CSA 52-318). In a report dated June 29, 2007 apparently the CSA was pleased with the improvement despite finding that some audit committee charters did not reflect mandatory assigned responsibilities at rates up to 28%.

The CSA conclusion that no further regulatory action was necessary other than the vague assurance that "We therefore intend to review issuers' compliance with the Instrument selectively as part of our ongoing continuous disclosure review program" was somewhat surprising to us. The 2004 study was based on 95 companies overall including only 30 Venture companies and the 2005 study based on 25 companies overall with 10 Venture companies. These small samples were somewhat worrisome given the difficulty of generalizing to a population based on such small samples. Hence, we started a research project that examined detailed audit committee disclosures for a random sample of 307 TSX listed companies (average total assets $2 billion, median $160 million; market cap mean $918 million, median $167 million) and 148 TSX Venture companies (average total assets $19 million, median $7.7 million; market cap mean $65 million, median $17 million) in fiscal year 2006. In our sample we note that nearly 20% (11%) of the TSX Venture firms based on market capitalization (total assets) are greater in size than the bottom 25% of the of the TSX sample. Nearly 40% (25%) of TSX Venture companies are greater in size than the bottom 10% of the TSX sample. Even after adjusting for the resource industry base of many Venture companies that inflates size measures; we are still examining many significant size companies in the TSX Venture sample. This feature of our sample influences our recommendations.

We examine our sample for the following items based on MLI 52-110 Audit Committees:

- An overall measure of audit committee disclosures compliance.
- Disclosures of independence of and qualifications of audit committee members.

[1] The British Columbia Securities Commission is a regular holdout in investor protection oriented regulations agreed to by other Canadian securities commissions. It seems to be a classic example 'captive' regulator responding more to the regulatees than the investors it is supposed to be there to protect (for a reasonably readable review of this literature see Ernesto D. Bo (2006) Regulatory Capture: A Review. *Oxford Review of Economic Policy.* 22(2), 203-225.).

- Audit committee charter disclosure, external and internal auditor direct reporting responsibility to audit committee and responsibility of audit committee for oversight of internal controls.
- An overall measure of audit firm fee disclosures and specifically audit fee disclosure.

We evaluated each company's disclosure and assigned it to one of the following categories:

- The company has not stated whether it complied with the requirement (i.e., no disclosure).
- Our investigation of public disclosures shows company did NOT comply with the requirement AND it did not disclose the non-compliance.
- The company did NOT comply with the requirement and gave a reason why (permitted previously under TSX guidelines but not permitted under 52-110).
- The company did NOT comply with the requirement and did not give any reason.
- The company complied with the requirement.
- Our investigation of public disclosures shows company DID comply with the requirement but it did not disclose their compliance (a strange but true category).

Two of these categories bear explanation; the ones lead of by the words 'our investigation'. As we have constructed a large data base of information about Canadian public companies and their directors we are able to evaluate some of the items required to be disclosed by the various regulations and will be able to evaluate more as the data base grows. Hence, where possible, we examine cases of non-disclosure to determine whether the company complied with the requirements of the regulation and classify the non-disclosure accordingly.

Highlights

Highlights of our findings are:

- Overall, a high level of compliance with the requirements of 52-110 was found. Compliance rates with requirements of 52-110 that applied to TSX and TSX Venture exchanges near 90% or more. See Section 1 for details.
- Significant differences are present in the disclosures of TSX and TSX Venture companies about audit committees due to the differences in the regulatory requirements as would be expected given some TSX requirements are not mandatory, but only recommended for Venture companies. See Section 1 for details.
- However, significant differences also occur between TSX and TSX Venture companies where the requirements are mandated for both. See Section 3.1 and 3.2 for examples.

- A majority (57%) of Venture companies persist with the practice of having management as members of the audit committee – something that almost all corporate governance research[2] finds leads to less effective audit committees and other regulators[3] recommend or mandate against. See Section 2 for details.
- Nearly 10% of Venture companies have a majority of non-independent members of the audit committee – a finding not picked up on in the small samples used by the CSA in their investigations of compliance with 52-110. This finding appears to be a violation of 52-110 requirements. See Section 2 for details.
- 8% of TSX companies either do not disclose their financial literacy assessment or do not provide disclosures about the basis for their assessment (i.e. the educational and work experience that qualifies a member as financially literate), a rather high non-compliance rate for a mandatory requirement. This non-compliance is particularly problematic as this is a regulation that is already "watered down" from the original proposal that would have seen TSX companies having a financial expert on the audit committee (which most research supports as increasing audit committee value and effectiveness[4]) and clear definitions of what constitutes financial literacy (see 52-110 proposals for comments dated June 27, 2003)[5]. See Section 2.1 and 2.2 for details.
- 88% of TSX Venture companies voluntarily disclose their assessment that the members of their audit committees are financially literate. However, only 69% of those making the claim provide the recommended disclosures about education and professional experience to support the claim making it difficult to evaluate the claim of literacy. See Section 2.1 and 2.2 for details.
- Over 10% of the companies routinely omit required details about audit firm fee disclosures and 7% of companies on both the TSX and TSX Venture omit the required disclosure about audit fees themselves. Given the focus on audit firm fees and their effects on auditor independence in the last round of accounting scandals[6] it appears strange that these disclosures are not routinely being made by companies and enforced by regulators. See Section 4.1 and 4.2 for details.

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[2] For example, April Klein (2002). Audit committee, board of director characteristics, and earnings management. *Journal of Accounting & Economics*, 33(3), 375-400.

[3] For example, in addition to the US requirements for audit committees that predate SOX (Sarbanes Oxley Act of 2002) for the New York Stock Exchange, requirements that no managers (executive directors) be on the audit committee are found in Australia, Singapore and the United Kingdom among others.

[4] For example, Mark L Defond, Rebecca N Hann, Xuesong Hu. (2005). Does the Market Value Financial Expertise on Audit Committees of Boards of Directors? *Journal of Accounting Research*, 43(2), 153-193.

[5] To be technically correct, the original proposal required all companies to report who the financial expert was if they had one and if they did not have a financial expert why they did not have one on their audit committee. Most observers concluded, including the CSA, that this would require most large TSX companies to have a financial expert.

[6] For example, William R Kinney JR, Zoe-Vonna Palmrose, Susan Scholz. (2004). Auditor Independence, Non-Audit Services, and Restatements: Was the U.S. Government Right? *Journal of Accounting Research*, 42(3), 561-588.

Recommendations

Based on these findings we recommend that the Canadian Securities Administrators consider the following with respect to MLI 52-110 Audit Committees:

1. Enforcement focus on three areas:
    a. Enforcement of independence rules for audit committee members in Venture companies. Almost 10% of our sample of Venture companies featured audit committees committing this apparent clear breach of the regulation and of good governance practice.
    b. Enforcement of compliance with the background disclosures of education and experience of audit committee members. This is a critical disclosure for markets to judge true financial literacy of audit committees especially given that the CSA has chosen to (i) not regulate what constitutes financial literacy but rather allow 'daylight' disclosure to allow users to determine if financial literacy is achieved by members and (ii) has not required that a financial expert be required on audit committees of at least larger issuers. The rate of non-compliance approaching 10% on the TSX should not be considered acceptable at this stage of implementation.
    c. Audit firm fee disclosures be policed during continuous disclosure review as a low cost way of reminding companies that MLI 52-110 continues to be on the regulatory screen. Noncompliance with all or parts of the fee disclosure regulation exceeds 10% and again should not be considered acceptable at this stage of regulatory implementation.
2. Given that a majority of Venture companies have managers serving on the Audit Committee, and given that a substantial number of Venture companies are of a size comparable to TSX registrants, we recommend that a size test be developed instead of a blanket exemption for Venture companies with regard to having a manager on the Audit Committee. Governance research[7] shows a major decline in the actual and the perceived effectiveness of an audit committee with a manager on it and with the increasing size of Venture companies and wider shareholder base, a size test would make more sense than a blanket exemption.
3. That Venture companies be prohibited from claiming that their audit committee members are financially literate unless they also provided the background disclosures about education and experience to support that assertion. Given the Canadian approach is one

[7] Ibid see footnote 2.

of “daylight” rather than detailed definition of what financial literacy is, the assertion of financial literacy without the background information is essentially meaningless.

The data that lead to recommendations 2 and 3 call into question what might be called the “Dey” doctrine[8] in Canadian securities regulation. That doctrine can be summarized as requiring disclosures of actual governance practices benchmarked against securities commissions’ endorsed “best” practices with the unstated but implied belief that the dissenters will move towards best practices. In neither case does the evidence in our research provide support that disclosure alone will provide much improvement. We expect to provide further evidence on this issue in the near future in our broader examination of corporate governance disclosures.

[8] See the Dey Committee on Corporate Governance commissioned by the Toronto Stock Exchange in 1994 and its follow up report, Five Years to the Dey, in 1999.

Section 1. An overall measure of audit committee disclosure compliance

A combined measure of the 17 disclosure items we examined based on Multilateral Instrument 52-110 Audit Committee's requirements. All items are required disclosures for TSX companies whereas some items are best practice only recommendations for TSX Venture companies.

Company Disclosure Analysis	TSX #	(%)	TSX Venture #	(%)
No disclosure found	**325**	**6%**	**181**	**7%**
Our investigation shows company did not comply and did not disclose	**8**	**0%**	**11**	**0%**
Did not comply and gave reason for non-compliance	**50**	**1%**	**14**	**1%**
Disclosed non-compliance but did not give a reason	**32**	**1%**	**173**	**7%**
Complied and disclosed compliance	**4779**	**92%**	**2136**	**85%**
Our investigation shows company complied but it did not disclose compliance	**14**	**0%**	**1**	**0%**
TOTALS	**5208**	**100%**	**2516**	**100%**

Commentary: There is a highly significant difference ($\chi2(5) = 275$, $p < 0.0001$), as would be expected when one set of companies must follow regulations and the other set must only follow a subset of the regulations, between the degree of compliance with the practices and the disclosures in 52-110 audit committees. Overall, however the rate of compliance is much higher then found in the original CSA study (52-312 2006) for both TSX firms and for TSX Venture firms which examined a more limited set of items except in one area. Hence, our overall conclusion was that by 2006 compliance with 52-110 has substantially improved especially for TSX firms.

Section 2. Independence of audit committee members

Requirement: 100% of audit committee members should be independent. This is a requirement for TSX companies and a recommended best practice for TSX Venture companies.

Company Disclosure Analysis	TSX #	TSX (%)	TSX Venture #	TSX Venture (%)
No disclosure found	**1**	**0%**	**0**	**0%**
Our investigation shows company did not comply and did not disclose	**4**	**1%**	**5**	**4%**
Did not comply and gave reason for non-compliance	**8**	**3%**	**7**	**1%**
Disclosed non-compliance but did not give a reason	**6**	**2%**	**74**	**50%**
Complied and disclosed compliance	**286**	**93%**	**62**	**45%**
Our investigation shows company complied but it did not disclose compliance	**2**	**1%**	**0**	**0%**
TOTALS	**307**	**100%**	**148**	**100%**

Commentary: Consistent with prior research, the average size of an audit committee was just over 3 (3.30 on the TSX and 3.03 on the TSX Venture) with 97.39% of the TSX audit committees being 100% independent and 43.2% of the TSX Venture audit committees being 100% independent where such is not required by regulation. Even without statistics, it is obvious that Venture companies are highly statistically significantly different from the TSX companies in their compliance with this recommendation ($\chi2(3) = 169$, $p < 0.0001$).

These independence results are similar to those found by the CSA study in 2006 for the TSX companies (98%) and a marked improvement for the Venture companies (31%); an improvement that is statistically significant ($\chi2(2) = 6.16$, $p < 0.05$). Nonetheless, 19 Venture companies had 2 or more non-independent members of the audit committee and 14 of the Venture companies had audit committees that had a majority of non-independent directors on them – representing almost 10% of all Venture companies we examined.

This finding was not confined to the smallest Venture companies. Among those companies that we referred to earlier as meeting the 75% (90%) size test for market capitalization versus TSX companies we found that 100% (75%) had one manager and several had other non-independent members on the audit committee including three (four) companies that have a majority of non-independent directors on the audit committee.

In light of the overall significant improvement in Venture company voluntary compliance with 52-110 recommendation for 100% independent directors on the audit committee, this finding suggests that the small CSA sample of Venture issuers (30 companies in the first study and 10 in the second) used by the regulators is not sufficient to draw reliable conclusions about the characteristics of the Venture companies' audit committees.

Section 2.1 Audit Committee Members Financial Literacy Disclosure

Requirement: Each company should evaluate and disclose that all members of the audit committee are financially literate. Required for TSX companies and recommended as a best practice for TSX Venture companies.

Company Disclosure Analysis	TSX #	TSX (%)	TSX Venture #	TSX Venture (%)
No disclosure found	**10**	**3%**	**10**	**7%**
Our investigation shows company did not comply and did not disclose	**0**	**0%**	**0**	**0%**
Did not comply and gave reason for non-compliance	**0**	**0%**	**1**	**0%**
Disclosed non-compliance but did not give a reason	**0**	**0%**	**7**	**5%**
Complied and disclosed compliance	**296**	**97%**	**130**	**88%**
Our investigation shows company complied but it did not disclose compliance	**1**	**0%**	**0**	**0%**
TOTALS	**307**	**100%**	**148**	**100%**

Section 2.2 Audit Committee Members Education and Relevant Experience Disclosure

Requirement: To disclose the education and relevant experience to support the financial literacy determination. Required for TSX companies and recommended as best practice for TSX Venture companies.

Company Disclosure Analysis	TSX #	TSX (%)	TSX Venture #	TSX Venture (%)
No disclosure found	**21**	**7%**	**54**	**36%**
Did not comply and gave reason for non-compliance	**4**	**1%**	**2**	**1%**
Disclosed non-compliance but did not give a reason	**1**	**0%**	**2**	**1%**
Complied and disclosed compliance	**280**	**92%**	**90**	**61%**
TOTALS	**306**	**100%**	**148**	**100%**

Commentary: The rate of disclosure of financial literacy of audit committee members (97%) and the supporting disclosure to back it up for TSX companies is high (95% of those disclosing). However, with the combined non-disclosure and non-background information to evaluate the disclosures' veracity reaching near 10% on the TSX it is troublesome. 52-110 was "watered down" from requiring a financial expert plus all members being financially literate with detailed prescriptions about how financial literacy was to be obtained to just all members being financially literate with disclosures of how the company made that determination to give companies flexibility in staffing their audit committees (see 52-110 Summary of Comments and Responses January 16, 2004 among others). Hence, more regulatory attention to this matter appears warranted, otherwise the assertion of financial literacy given its lack of definition in the instrument is relatively meaningless.[9]

The assertion of audit committee financial literacy by so many of the TSX Venture companies (88%) while welcome, is not backed up by disclosures in over 30% of the cases where financial literacy is claimed. Again, given the weakness of the regulation it seems problematic that the literacy claim can be made without the supporting back-up if it is to be of any value to regulators or investors.

[9] 52-110 defines financial literacy as "an individual is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements." No requirements are given as to how it is to be obtained.

Section 3 Audit Committee Charter with Specific Responsibilities Disclosed

Requirement: All audit committees are required to have a charter that has specific responsibilities assigned to the committee from the Board of Directors. In this analysis we examine whether such a charter is disclosed with a list of enumerated responsibilities (but we did not check exhaustively for all responsibilities as laid out in 52-110).

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	**5**	**2%**	**11**	**7%**
Did not comply and gave reason for non-compliance	**1**	**0%**	**0**	**0%**
Disclosed non-compliance but did not give a reason	**0**	**0%**	**1**	**1%**
Complied and disclosed compliance	**301**	**98%**	**136**	**92%**
TOTALS	**307**	**100%**	**148**	**100%**

Section 3.1 External Auditor and Internal Auditor have direct access to Audit Committee

Requirement: To ensure that Audit Committee is perceived as the 'client' of both internal and external audit both auditors need to have direct access to the committee. Required for both TSX and TSX Venture companies

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	**9**	**3%**	**16**	**11%**
Did not comply and gave reason for non-compliance	**0**	**0%**	**0**	**0%**
Disclosed non-compliance but did not give a reason	**0**	**0%**	**0**	**0%**
Complied and disclosed compliance	**298**	**97%**	**132**	**89%**
TOTALS	**307**	**100%**	**148**	**100%**

Section 3.2 Audit Committee Assigned Specific Responsibility for Oversight of Internal Control

Requirement: 52-110 requires that the Audit Committee have oversight responsibility for internal controls. This disclosure is required of both TSX and TSX Venture companies

Company Disclosure Analysis	TSX #	(%)	TSX Venture #	(%)
No disclosure found	**9**	**3%**	**15**	**10%**
Did not comply and gave reason for non-compliance	**0**	**0%**	**0**	**0%**
Disclosed non-compliance but did not give a reason	**1**	**0%**	**0**	**0%**
Complied and disclosed compliance	**296**	**97%**	**133**	**90%**
TOTALS	**306**	**100%**	**148**	**100%**

Commentary: If an audit committee needs to use its charter to insist on holding management accountable, the audit committee is in the midst of a crisis. Nonetheless, the charter lays out the expectations of the Board of Directors for the areas that the audit committee is routinely expected to provide first line of oversight for on behalf of the Board. Hence, we examine the required disclosures for a Audit Committee Charter with specified responsibilities, and we look in particular for two responsibilities, direct assess of the committee to the external and internal auditor so the committee my effectively discharge its oversight of financial reporting and responsibility for oversight of internal control, a closely related area.

In all cases we find compliance at a high level, 97% and above for TSX companies and 89% and above for TSX Venture companies and in all cases we find that Venture companies have a statistically significant lower level of compliance (all p-values less than 0.01 for chi-squared tests). This was the largest area of concern from the two CSA studies and while our results are not directly comparable to theirs, it appears the concern is not as warranted for the TSX companies whereas the concern is still ongoing for the Venture companies, albeit at a lower level than before.

Section 4 Audit Fee disclosure and details supporting that disclosure

Section 4.1 Index of overall details of audit firm fee disclosures

Requirement: 52-110 requires details about audit fees, audit-related fees, tax fees and all other fees for services provided by the audit firm. This index is a combination of these items disclosures evaluated. All disclosures required for both TSX and TSX Venture companies.

Company Disclosure Analysis	TSX #	TSX (%)	TSX Venture #	TSX Venture (%)
No disclosure found	**244**	**11%**	**64**	**6%**
Our investigation shows company did not comply and did not disclose	**1**	**0%**	**0**	**0%**
Did not comply and gave reason for non-compliance	**30**	**1%**	**1**	**0%**
Disclosed non-compliance but did not give a reason	**17**	**1%**	**11**	**1%**
Complied and disclosed compliance	**1840**	**86%**	**960**	**93%**
Our investigation shows company complied but it did not disclose compliance	**9**	**0%**	**0**	**0%**
TOTALS	**2141**	**100%**	**1036**	**100%**

Section 4.2 Audit Fee Disclosure

Requirement: Audit fees "the aggregate fees billed by the issuer's external auditor in each of the last two fiscal years for audit services". This disclosure is required for both TSX and TSX Venture companies.

Company Disclosure Analysis	TSX #	TSX (%)	TSX Venture #	TSX Venture (%)
No disclosure found	**19**	**6%**	**6**	**4%**
Did not comply and gave reason for non-compliance	**4**	**1%**	**1**	**1%**
Disclosed non-compliance but did not give a reason	**3**	**1%**	**3**	**2%**
Complied and disclosed compliance	**280**	**92%**	**138**	**93%**
TOTALS	**306**	**100%**	**148**	**100%**