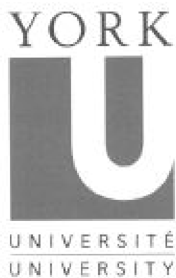

ATKINSON FACULTY
OF LIBERAL &
PROFESSIONAL
STUDIES

School of Administrative
Studies

4700 Keele St.
Toronto ON
Canada M3J 1P3
Tel 416 736 5210
Fax 416 736 5963

Professor Richard Leblanc
School of Administrative Studies, Atkinson
202A Atkinson College
York University
Toronto, Canada
M3J 1P3

April 20, 2009

Via E-Mail

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Nova Scotia Securities Commission
Office of the Attorney General, Prince Edward Island
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut

Me Anne-Marie Beaudoin, Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec H4Z 1G3
By Email: consultation-en-cours@lautorite.qc.ca

and

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8
By Email: jstevenson@osc.gov.on.ca

Dear Madame Beaudoin and Mr. Stevenson,

Re: 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*

Thank you for the opportunity to comment. I wish to address three issues:

(i) The disclosing of practices in achieving the objectives of broad-based principles *vs.* "comply or explain";

(ii) The need for the proposed reforms; and

(iii) Who is inside the boardroom?

My views represent my own.

(i) The Disclosing of Practices That Achieve the Objectives of Broad-Based Principles, *vs.* "Comply or Explain"

The movement to a more flexible, principles-based governance regime is supported by the academic literature. Academics (including authors of meta-studies) have been critical of highly prescriptive, 'one size fits all' governance regimes and certain guidelines.

See, *e.g.*, Richard Leblanc (2009)[1]:

> "There is ongoing debate among academics concerning the correlation between governance measures and future stock market performance and the causal relationship between better corporate governance and firm performance. Quantitative governance researchers write the following: '[T]he empirical evidence . . . supports the findings that firms with good governance changes do not have better performance than firms with bad governance changes'[2] and '[C]ontrary to claims in GIM [the authors Gompers, Ishii and Metrick[3]] and BCF [the authors Bebchuck, Cohen and Ferrell[4]],

[1] Leblanc, R. "Getting the Right Directors on Your Board," in Conger, Jay, ed., *Boardroom Realities: Building Leaders Across Your Board* (London: Josey-Bass, March 2009), 145-195.
[2] Chidambaran, N.K., Palia, D., and Zheng, Y. "Does Better Corporate Governance "Cause" Better Firm Performance?" Draft manuscript, March 2006, 42.
[3] Gompers, P.A., Ishii, J.L., and Metrick, A. "Corporate Governance and Equity Prices" *Quarterly Journal of Economics*, 2003, 118(1), 107-155.
[4] Bebchuk, L., Cohen, A., and Ferrell, A. "What Matters in Corporate Governance?" Working paper, 2004, Harvard Law School.

> none of the governance measures are correlated with future stock market performance.'[5]"
>
> ...
>
> "Daines, Pfeffer, and Rose write:
>
> 'We find that these governance ratings have either limited or no success in predicting firm performance or other outcomes of interest to shareholders. . . . Moreover, even when there is a statistical association with future outcomes, the economic or substantive effect seems small.'[6]
>
> 'ISS has some 65 rules and guidelines. . . . Yet there is almost no evidence that ISS's prescribed practices are actually related to outcomes such as higher rates of return for shareholders or improved company performance. . . . The rating of board management practices should be based on empirical evidence, not on guidelines seemingly plucked from thin air.'[7]
>
> 'Additionally, governance firms may be overstepping their expertise in proxy voting decisions and in governance rating, in part because of their reliance on "good governance metrics" for which there is little evidentiary support. Finally, erroneous governance metrics (and indeed, a reliance on one-size-fits-all governance checklists) . . . may have a more general, harmful effect on corporate governance regulation.[8]'"

Participants within the governance community (*e.g.*, certain rating firms, investor or advisory groups) may have a business model or preference predicated on comparing and contrasting governance "comparators," a "'floor,'"[9] "targets,"[10] "default position," "baseline," "generally accepted practices,"[11]a "common benchmark,"[12] or "bright line tests."[13]

Advocates for this approach appear not to have put forward empirical evidence supporting either (i) the correlative or causal relationship between these outputs and more

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[5] Bhagat, S., and Bolton, B. "Corporate Governance and Firm Performance." *Journal of Corporate Finance*, 2008, 14, 257.

[6] Daines, R., Gow, I., and Larcker, D. "Rating the Ratings: How Good Are Commercial Governance Ratings" Working Paper, June 26, 2008, 28-29.

[7] Pfeffer, J. "Beware the corporate raters: Board oversight is a good thing, but the procedures of the new governance firms leave a lot to be desired." [http://money.cnn.com/2007/09/04/technology/Corporate_raters.biz2/index.htm]. Sept. 5, 2007.

[8] Rose, P. "The Corporate Governance Industry." *The Journal of Corporation Law*, Summer 2007, 887.

[9] Puri, P. "ICD Roundtable Discussion April 1, 2009, regarding revisions to NP 58-201 and NI 58-101," 3.

[10] *Ibid.* at 5.

[11] Hansel, C., "Discussion Paper on Proposed Revisions to CSA Approach to Governance Regulations," March 27, 2009,10.

[12] *Ibid.* at 12.

[13] *Ibid.* at 13.

effective governance; or (ii) a balanced examination of the advantages of such outputs, versus the disadvantages. Indeed, the contrary to (i) and (ii) appears to be the case:

"Nevertheless, these external parties began to require, and measure, these indicators in earnest. In fairness, to a large extent this was all they could do. They needed something that was measurable and correlated with effective corporate governance practices. Jeffrey Sonnenfeld has previously reviewed the research to reveal that the easily measurable qualities of board structure have very little, if any, correlation or predictive power in explaining a firm's financial performance, operational performance, or even outright governance performance."[14]

"As a result, many boards have descended into adopting practices that check all the right boxes, but their overall governance has, at their own admission in many cases, become less effective. This is because these window-dressing practices devour undue amounts of time, leaving little time for the advising function of the board." …

"Ultimately, as the chapters in this book attest, good governance depends on the good character and leadership of the individual directors, and the board as a whole, not on mere compliance to outward signals of governance. In other words, the conventional wisdom of good governance indicators is really conventional mythology."[15]

What the new regime (*i.e.*, disclosure of practices in achieving the objectives of the principles) would seek to accomplish is to promote the qualitative, contextual judgment of a board and its individual directors. Whilst this qualitative model may lessen the application of rapid "check the box" comparators, a principle-based approach permits boards latitude to disclose how the practices they have adopted achieve the objectives of the principles, without being stigmatized that they do not "comply" with a particular guideline or bright line test at any point in time.

In other words, governance practices are changing and emerging. The rigid adherence to specific benchmarks or other comparables, simply because of past practice or ease of comparison, means that these guidelines would soon become stale or outdated. Broad-based principles mean that the practices underlying them could change, or be tailored to suit a particular company, whilst still conforming to the over-arching principle. The principle would remain constant, or near-to-constant.

(ii) The Need For the Proposed Reforms

The views that proposed changes to the corporate governance regulatory framework that have served the Canadian capital markets "so well"[16] are "unhelpful,"[17] or are simply

[14] Sonnenfeld, J.A., and Ward, A. "Conventional Wisdom, Conventional Mythology, and the True Character of Board Governance," in *Boardroom Realities*, *supra* note 1, 447.
[15] *Ibid.* at 446.
[16] ICD Roundtable Discussion, *supra* note 9, 5.

"reinventing the wheel,"[18] appear not to address (i) past findings of non-compliance by the CSA; (ii) the CSA's expressed intent to revisit NP 58-201 and NI 58-201; and, more broadly, (iii) the massive upheaval in capital markets and certain governance and regulatory oversight failures.

A 2007 compliance review by the CSA revealed significant deficiencies in the quality of governance disclosure under the present regime by Canadian companies examined.[19]

Conclusions such as "vague," "uninformative," "no disclosure," "failed to disclose," "insufficient," "unclear" and "Several issuers did not provide disclosure" appeared within the CSA's findings.

In the public media,[20] personnel from the OSC interviewed used wording such as "absolutely abysmal" in respect of disclosure along a continuum of the CSA's findings [author's emphasis]. Some salient items from the media report which put the degree of non-disclosure in perspective are as follows:

> "The review found 23 per cent of companies listed on the TSX Venture Exchange did not provide any governance disclosure – a complete violation of the requirement."
>
> ...
>
> "[OSC personnel] said companies were similarly vague about describing the processes
> they use to assess the performance of the board and individual directors.
>
> 'It's absolutely critical for investors to know how boards, committees and individual directors [are] assessed, because that lets an investor know their performance is being measured.'"

The OSC did not conduct qualitative research as part of this compliance study. One can infer from the findings of non-disclosure among venture issuers that it would be problematic to disclose why one chose to deviate from a particular guideline, and what reason would be viewed as adequate. It may be easier simply not to disclose that one does not comply. The barrier to non-disclosure would be much lower if small and mid-sized Canadian companies would have the option and flexibility of disclosing practices

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[17] *Ibid.* at 4. Other wording includes "prevailing sentiment," "consensus," and "overwhelming consensus." An expanded methodology for this review (*e.g.*, random sample selection, survey or interview protocol, *etc.*) is not apparent, in determining the generalizability to a population.
[18] *Ibid.* at 5.
[19] CSA Staff Notice 58-303 *Corporate Governance Disclosure Compliance Review*, June 29, 2007.
[20] McFarland, J. "Corporate Governance: Gaps revealed in mandatory disclosure: Provincial regulators say 23 per cent of TSX Venture Exchange companies violate new standards." *The Globe and Mail*, July 3, 2007.

that that they have adopted in meeting the objectives of broad corporate governance principles.

(iii) Who is Inside the Boardroom?

As the Chairman of the OSC has stated publicly, it is important to know 'who sits in the boardroom.'[21] The effectiveness of boards, committees and individual directors, inside the boardroom, forms part of the author's research interest.

The inclusion of the words "competencies and other attributes," to replace what was formerly "competencies and skills" of individual directors, within the proposed NP 58-201 and NI 58-101, is noted and a particularly encouraging development in this regard.

Based on the author's research, competencies and other attributes a board or committee chair could possess, many of which are not visible from outside the boardroom, include: integrity & accountability; leadership; mentoring, coaching & development; consensus orientation; conducting of meetings; and holding to account. Competencies and skills an individual director could possess could include integrity and accountability; financial literacy; knowledge of the business and industry; critical thinking; interpersonal style; commitment; and the will to act.

It is the foregoing items, including how the board functions as a group (including relationships and dynamics; communication; information and internal reporting; and decision-making quality), that may ultimately determine whether or not a board is effective at fulfilling its roles and responsibilities.

The recruitment and appointment of directors based on independence, competencies and other attributes is a positive development. The Securities and Exchange Commission appears to be studying proposals for greater disclosure of the qualifications of board members, particularly those involved in assessing risks and setting executive compensation.[22]

Conclusion

A movement to a principles-based disclosure regime is to be encouraged. This development may align disclosure requirements more closely with developments in corporate governance research that increasingly question the sufficiency of a "check the box" compliance system. Principles-based disclosure may also improve upon the deficiencies noted by the CSA in governance disclosures by freeing boards from the stigmatizing "comply or explain" regime. The problems with such compliance speak to

[21] Wilson, D. "North American Regulators' Main Initiatives, Current and Future" session, Governance and Financial Markets in North America conference, Institute of Corporate Directors, September 19, 2008, in notes taken by the author.
[22] Labaton, S. "S.E.C. Chief Pursues Tougher Enforcement" *The New York Times*, February 22, 2009. [http://www.nytimes.com/2009/02/23/business/23schapiro.html?_r=1&ref=business].

the need for reform.

Finally, the addition of the term "attribute" to supplement the concept of "competency" in the new regime may encourage boards to apply a greater focus on how the board functions inside the boardroom by stimulating the emphasis on a broader range of qualities possessed by directors, beyond experience, for example. Based on the author's research, that is a positive step in a new direction.

Yours truly,

Richard W Leblanc, BSc, LLB, JD, MBA, LLM, PhD
Assistant Professor and Area Coordinator
Corporate Governance, Law & Ethics
School of Administrative Studies
Atkinson Faculty of Liberal & Professional Studies
York University