

# DAVIS & COMPANY

*Barristers & Solicitors*

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A SUMMARY AND ANALYSIS OF THE TSE CORPORATE GOVERNANCE GUIDELINES

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## The Toronto Stock Exchange Statement of Corporate Governance Practices

THE TORONTO STOCK EXCHANGE

# TSE

A Summary and Analysis of

“Where Were the Directors”

Guidelines for Improved Corporate Governance in Canada

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The Report of The Toronto Stock Exchange Committee on Corporate Governance in Canada

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## TSE Statement of Corporate Governance Practices

The Toronto Stock Exchange ("TSE") has recently implemented by-law amendments requiring every Canadian incorporated issuer with securities listed on the TSE to include a comprehensive statement of corporate governance practices in its annual reports or proxy information circulars. The new requirement takes effect for fiscal years ending after June 30, 1995.

Davis & Company has prepared this summary and analysis of the new requirements to assist our clients and other TSE-listed issuers in the process of understanding and complying with the new TSE requirements. Additional copies of this material are available, on request, for distribution to members of Boards of Directors of TSE-listed issuers and other interested parties.

### INTRODUCTION

The new corporate governance disclosure requirements are being imposed as a result of a recommendation set out in the *Report of The Toronto Stock Exchange Committee on Corporate Governance in Canada* (the "Governance Report") which contains a set of detailed corporate governance guidelines (the "Governance Guidelines").

Specifically, the TSE has amended Part XIX of its General By-law to require that annual reports or proxy information circulars of TSE-listed issuers contain detailed corporate governance disclosure made with reference to the Governance Guidelines. Where the issuer's system of corporate governance differs from the Governance Guidelines, an explanation of the differences must be included as part of the disclosure.

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## **SCOPE OF THE NEW REQUIREMENTS**

The new policy deals only with a limited range of corporate governance issues, primarily those relating to the role and functioning of the Board of Directors of the Corporation and its committees and its functional independence from management.

The intent of the policy is to cause the Boards of Directors of TSE-listed issuers to focus on their approach to corporate governance issues; to establish a benchmark, in the form of the Governance Guidelines, against which a Board of Directors can assess its current structures and procedures; and to provide the investment community with an explanation of the Corporation's approach to governance matters.

The policy does not directly address a wide array of other corporate governance issues such as a Corporation's response to unsolicited takeover bids, the adoption of shareholder rights plans, share structure and the use of subordinate or restricted voting shares, the use of confidential voting procedures, the format for annual shareholder meetings, the effectiveness of the proxy solicitation process, the procedures for electing directors, or the methods of distributing annual disclosure documents to shareholders.

## **RECOMMENDED COMPLIANCE PROCESS**

We recommend that our TSE-listed clients give consideration to taking the necessary steps now to put themselves in a position to comply with the new disclosure requirements when next year's annual reports or proxy circulars are prepared.

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The steps which will be required to ensure compliance are as follows:

- (a) **Appoint a Governance Committee:** Either the Board of the Directors as a whole, or an appropriate committee (such as a governance committee or a nominating committee) should assume responsibility for developing the Corporation's governance structures and procedures and, specifically, for coordinating the Corporation's response to the new TSE disclosure requirements.
- (b) **Review of Existing Governance Regime:** The Corporation's current corporate governance structures and procedures should be reviewed and benchmarked against the Governance Guidelines as recommended in the Governance Report. Differences between the Corporation's current governance regime and the regime recommended in the Governance Guidelines should be identified.
- (c) **Achieving Compliance:** To the extent that full compliance with the Governance Guidelines is assessed by the Board of Directors to be in the best interests of the Corporation, the Corporation should revise its current structures and procedures so as to bring the Corporation into full compliance with the Governance Guidelines.
- (d) **Justifying Non-Conformity:** If a considered decision is made by the Board of Directors to diverge from the Governance Guidelines, the Corporation should be prepared to articulate the rationale for such divergences as being in the best interests of the Corporation and its shareholders.

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- (e) **Preparation of Disclosure Statement:** Finally, the Corporation should draft a narrative discussion of its governance regime for inclusion in annual disclosure documents, detailing and explaining its divergences from the Governance Guidelines.

## COMMENTARY

Compliance with the new corporate governance disclosure requirements should not be difficult for the more senior TSE-listed issuers but may be more difficult for other TSE-listed issuers.

### Issuers Generally Complying with the Governance Guidelines

Senior TSE-issuers, particularly those whose shares are widely held by sophisticated institutional investors and which have made significant efforts in the last few years to modernize their corporate governance regimes, should have little trouble in complying with the new requirements.

Such Corporations are likely to already have in place sophisticated corporate governance systems (including features such as a non-executive chairman and a Corporate Governance Committee of the Board).

The main task for these issuers in achieving compliance will be to draft the required disclosure narrative describing the Corporation's existing governance regime. These issuers may also wish to eliminate any minor deviances from the Governance Guidelines rather than be required to disclose and justify such differences. Frequently, for example, even such issuers will currently lack formalized procedures for reviewing the performance of the Board and Board members as required by the Governance Guidelines.

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### **Issuers Diverging Substantially from the Governance Guidelines**

In other cases, an issuer's corporate governance regime may differ substantially from the Governance Guidelines. The Board of Directors of the issuer may wish to move the Corporation towards a greater degree of compliance with the Governance Guidelines or may believe that good and supportable reasons exist which justify the retention of existing divergences.

The Board of Directors may genuinely believe that features of the issuer's existing regime which diverge from the Governance Guidelines are more effective (eg. as an inducement to risk-taking in an emerging or high-tech industry) in maximizing shareholder value.

For example, an entrepreneurially-driven, emerging corporation which has only recently completed an initial public offering may wish to retain its traditional board made up of individuals chosen by the CEO, notwithstanding the Governance Guidelines pertaining to unrelated directors and nominating committees. The investment community may be comfortable with and accept such a Board and the dominant role of the existing CEO in the Corporation. Even in this situation, however, the Board should include a group of unrelated directors to ensure that there exists within the Board a point of view independent of management.

In other situations, available Board and management resources may make it difficult to immediately implement a corporate governance regime in full compliance with the Governance Guidelines. In some cases, such as with smaller issuers, full compliance may simply be too costly.

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In any of these cases, significant effort on the part of the issuer, its Board members, and their professional advisors will be required, not only to identify divergences from the Governance Guidelines, but also to articulate the Corporation's rationale and justification for advocating its existing governance regime as its preferred system for maximizing shareholder value.

### **SUMMARY OF THE SPECIFIC GOVERNANCE GUIDELINES**

The following is a brief summary of the fourteen specific Governance Guidelines contained in the Governance Report.

#### **Board Mandate**

1. **Principal Responsibilities:** The Board should expressly assume responsibility for strategic planning; risk management; appointing, training and monitoring of senior management; shareholder communications; and the integrity of corporate internal control and management information systems.

#### **Board Independence**

2. **Unrelated Directors:** The Board should include a majority of "unrelated directors"; i.e., directors who are free from any interest (other than as shareholder) and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the Corporation.

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3. **Minority Representation:** Where there is a Significant Shareholder (ie., one with the ability to exercise a majority of votes in electing directors), the Board composition should include directors independent of both the Corporation and its Significant Shareholder in a number proportionate to the minority's investment in the Corporation. In cases where a major shareholder holds less than a majority of voting shares, but still elects the Board, it is suggested that the Corporation nevertheless "have a meaningful number of Directors of the Board" not related to either the Corporation or the major shareholder.
  
4. **Independent Nominating Committee:** The Board should establish a nominating committee consisting only of outside directors, a majority of whom are unrelated directors.

### Board Effectiveness

5. **Directors Evaluations:** The Board should implement a process for regularly assessing the effectiveness of the board and its committees and the contribution of individual directors.
  
6. **Director Orientation and Training:** The Board should establish orientation and educational programs for new board recruits.
  
7. **Board Size:** The Board should review its size with a view, in many cases, to reducing its size to increase its effectiveness.
  
8. **Director Compensation:** The nominating committee should review the form and adequacy of compensation of Board members to ensure that it realistically reflects the responsibilities and risks involved in being a director.

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9. **Committee Independence:** Board committees should generally be composed of outside directors, a majority of whom are unrelated directors.
10. **Governance Committee:** The Board should establish a governance committee responsible for developing the Corporation's approach to governance issues.

### Board Relationship with Management

11. **Defining the Role of Management:** The Board should develop a position description for the CEO, set corporate objectives which the CEO is responsible for meeting and set limits on management authority.
12. **Non-Management Chairman:** The Board should either: (i) appoint a non-management chairman of the Board; or (ii) adopt alternative means to ensure that the Board can function independently of management such as establishing a committee with express responsibility for administering the Board's relationship with management.
13. **Audit Committee:** The audit committee should be composed solely of outside directors. The Board should define its responsibilities as including oversight of management's design and implementation of effective systems of internal control and should give it direct communication channels with internal and external auditors.
14. **Outside Advisors:** The Board should implement a system permitting individual directors to engage outside advisors at the Corporation's expense, as appropriate, subject to appropriate committee approval.

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## DETAILS OF THE SPECIFIC GOVERNANCE GUIDELINES

The Governance Report establishes fourteen suggested Governance guidelines against which any TSE-listed issuer's own corporate governance regime must be evaluated.

The following is a summary and commentary on each of these fourteen specific Governance Guidelines:

### 1. Board Mandate and Principal Board Responsibilities

The required disclosure must include a discussion of the mandate of the Board, setting out its duties and responsibilities.

The Board of Directors must explicitly assume the following five specific responsibilities to be in full compliance with the Governance Guidelines:

- (i) **Adoption of a Strategic Planning Process:** The Board should ensure that the CEO takes the lead in establishing long term goals and a strategic planning process. The Board should ultimately approve the strategy as it evolves and should monitor management's success in implementing the strategy.
- (ii) **Managing Risk:** The Board must identify and understand the principal risks of the Corporation's business and implement appropriate systems to monitor and manage these risks.
- (iii) **Appointment, Training and Monitoring of Senior Management:** The Board must appoint high calibre management and must ensure that the Corporation has in place programmes to train, develop and assess such management. This includes assessing the CEO's performance against objectives

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established by the Board and determining the CEO's remuneration pursuant to a formal process using established assessment criteria. The Board must also provide for the orderly succession of management.

- (iv) **Communications Policy:** The Board must ensure that the Corporation has in place a policy to enable the Corporation to communicate effectively with its shareholders. This policy must effectively accommodate feedback from shareholders.
  
- (v) **Internal Control and Management Information Systems:** The Board must ensure that the Corporation has effective mechanisms in place to monitor the implementation of its corporate strategies and an audit system to ensure the integrity of financial information and its compliance with appropriate accounting principles. Information gathered should go beyond assessing quantitative financial performance and look at other performance factors such as customer satisfaction and environmental performance. The Corporation should report on the adequacy of its internal controls relating to financial reporting and regulatory compliance as part of its annual report.

## 2. Unrelated Directors and Board Independence

The Governance Guidelines suggest that the Board of Directors of each Corporation should include a majority of individuals who qualify as "unrelated directors".

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An “unrelated director”, as defined in the Governance Report, is a director who is independent of management and “free from any interest (other than an interest or relationship arising from shareholdings) and any business or other relationship which could (or could reasonably be perceived to) materially interfere with the director’s ability to act with a view to the best interests of the corporation”.

Examples of “related” directors include members of management, directors who also provide legal or financial services to the Corporation, representatives of lenders of the Corporation who sit on the Board, and former CEO’s of the Corporation, at least until an interval of time has passed since their retirement.

By definition, a representative of a particular shareholder is not a “related” director. However, special rules (as described below) are applicable where members of the Board are not independent of a Significant Shareholder (as defined below).

The application of the definition of “unrelated director” to the circumstances of each individual director is the responsibility of the Board, which is required to disclose on an annual basis whether the Board has a majority of unrelated directors. In addition, the Board is required to include in the disclosure an analysis of the application of the principles supporting this conclusion.

### **3. Representation of Minority Shareholders**

In its final report, the Governance Committee recommended that special rules apply in circumstances where a “Significant Shareholder” exists, being one with the “ability to exercise a majority of the votes for the election of directors attached to the outstanding shares of the Corporation”. In such a case, in addition to the requirement that the Board of Directors include a majority of directors unrelated to the Corporation, the Board should also include proportionate representation of directors who do not have

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interests in or relationships with the Significant Shareholder. The intent is that the composition of the Board should “fairly reflect the investment in the Corporation by shareholders other than the Significant Shareholder”.

In the original draft Governance Report, the definition of “related director” included directors related to a Significant Shareholder. This position was, however, reconsidered in the final Governance Report in recognition of the fact that a Significant Shareholder should be able to elect individuals “related” to that shareholder to the Board and to control the Corporation in that fashion. In fact, many minority shareholders rely on the Significant Shareholder to exercise such control and execute its strategy for the Corporation. In addition, there are established procedures under Canadian securities laws to deal with related party situations where the interest of the Corporation conflict with the interest of a Significant Shareholder.

In cases where a major shareholder holds less than a majority of shares but still elects the Board, the Corporation is nevertheless expected “to have a meaningful number of directors on the Board not related to either the corporation or the holder, i.e., a sufficient number to establish a balance with the directors related to the Corporation or the holder”. This latter recommendation is not, however, given the weight of a Governance Guideline.

#### **4. The Nominating Committee**

The Governance Guidelines suggest that the Board of every Corporation appoint a committee composed exclusively of outside directors, a majority of whom are unrelated directors, to propose new nominees to the Board and to assess directors on an ongoing basis. The purpose is to remove from the CEO the general responsibility for constituting the Board, to ensure the true independence of those recruited and to ensure an appropriate separation from management. The nominating committee should

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not have the delegated power to implement its recommendations. Rather, the actual decision as to who should be nominated should be the responsibility of the full Board after considering the recommendations of the nominating committee.

The Governance Report does not propose express Governance Guidelines to further delineate the qualifications of directors, leaving this matter to the nominating committee. The Governance Report does, however, express a preference for limiting the number of members of management on Boards, while at the same time recognizing the desirability of including at least a second member of management in order to address matters such as succession. The Governance Report rejects suggesting a maximum term for directors, but leaves it to the nominating committee to propose a turnover of Board members when a fresh approach is appropriate. Similarly it rejects a guideline limiting the maximum number of directorships a person may hold and, instead, leaves it to the nominating committee to take into account an individual's other commitments, resources and time available for input to the Board when assessing the suitability of candidates.

The Corporation's annual statement of corporate governance practices must include a discussion of procedures in place for recruiting new directors.

### **5. Assessing Board Performance**

The Governance Guidelines suggest that each Board should implement a process, to be carried out by the nominating committee, for assessing the effectiveness of the Board as a whole, the committees of the Board and the contribution of individual Directors. This is clearly one recommendation of the governance Committee which will require positive steps by many Corporations to implement since currently very few Boards have in place a formalized assessment process.

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In appropriate cases, the required assessment might simply take the form of a retreat at which the Board addresses its effectiveness, with input from management. Alternatively, it might take the form of an interview of each Director by the nomination committee and the application of standard criteria by the committee. Each Director might, for example, be required to complete a comprehensive questionnaire.

The intent of the guideline is to provide constructive feedback to each Director as to how to improve his or her contributions to the Board and to enhance Directors' input by making each Director aware that his or her contributions are being assessed.

The Corporation's annual statement of corporate governance practices must include a discussion of performance enhancing measures, such as the assessment of Board performance.

### **6. Orientation and Education of New Directors**

The Governance Guidelines suggest that every Corporation, as an integral element of its process for appointing new Directors, provide an orientation and education programme for new recruits to the Board.

This programme could be a one or two day seminar with appropriate experts educating the director as to the nature of the business, current issues within the Corporation and the corporate strategy, the expectations of the Corporation and the general responsibilities of Directors. It might include an orientation manual, visits to facilities, meetings with corporate officers and external courses.

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## **7. Size of the Board**

The Governance Guidelines suggest that every Board of Directors should examine its size with a view to determining the impact of the number of its members upon effectiveness. The suggestion of the Governance Committee is that many Boards are too large to be effective and that Corporations, where appropriate, should undertake a programme to reduce the number of Directors to a number which facilitates more effective decision-making.

A Board must be large enough to ensure that it has enough Directors to perform its functions and to discharge its responsibilities. At the same time, a Board that is too big can inhibit effective decision-making. In the view of the Governance Committee, if the Board is too big, the individual Director risks losing a sense of responsibility, may feel constrained about actively participating in deliberations and may have little sense of accountability for Board decisions.

## **8. Remuneration of Directors**

The guidelines recommend that the Board of Directors should review the adequacy and form of the compensation of Directors to ensure that the compensation realistically reflects the responsibilities and risks involved in being an effective Director.

The level of remuneration should be appreciable, reflecting the responsibility and time commitment accompanying Board membership, but not excessive, as would cause a Director to lose his or her independence.

The Governance Report favours share compensation as a way of facilitating Director identification with shareholder interests and does not object to the granting of Director's options so long as the value of such options does not exceed what would otherwise be reasonable compensation and so long as the conditions attached to the options discourage short-term exercise and trading.

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## **9. Independence of Board Committees**

The required annual corporate governance disclosure must include a description of Board committees, their mandates and their activities. The view expressed in the Governance Guidelines is that committees of the Board of Directors should generally be composed of outside Directors, a majority of whom are unrelated Directors. Some Board committees, such as the executive committee (the existence of which is not favoured in the Governance Report), may include one or more inside directors (i.e. a director who is an officer or employee of the Corporation or of any of its affiliates). Typical committees in a large Corporation would include a nominating committee, a human resources and compensation committee, a governance committee and an audit committee. The granting to committees of authority to act on behalf of the full Board should be the exception rather than the rule.

## **10. Governance Committee**

The Board of Directors should expressly assume responsibility for, or assign to a governance committee, the general responsibility for developing the Corporation's approach to governance issues. The governance committee's responsibilities would include supervising the Corporation's response to the new TSE disclosure requirements and for moving the issuer towards greater compliance with the Governance Guidelines.

If the Chair of the Board is separate from the CEO, such Chair might be an appropriate person to also chair the governance committee. Membership of the committee could rotate, to prevent creating two classes of members on the Board.

The governance committee might also serve as a forum for issues not readily discussed in full Board meetings, such as the performance of an individual member of management or of the Board.

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## **11. Defining the Role of Management**

The Board must disclose its expectations of management in its annual statement of corporate governance practices and should approve or develop the corporate objectives which the CEO is responsible for meeting.

The Board of Directors, together with the CEO, should develop position descriptions for the Board and the CEO, including a definition of the limits to management's authority and responsibilities. The required disclosure must include a description of decisions requiring Board approval. The Board must actively question, scrutinize and monitor management.

## **12. Assuring Functional Independence from Management**

The Board of Directors must either appoint a strong chairman who is independent from management (whose principal responsibility is to manage the Board of Directors) or must implement and disclose in its annual statement of corporate governance practices alternative structures and processes to facilitate the functioning of the Board independently of management. In the original draft Governance Report only the first alternative would have sufficed to constitute compliance with the Governance Guidelines.

Appropriate structures and procedures may involve the Board meeting on a regular basis without management present or may involve expressly assigning the responsibility for administering the Board's relationship with management to a committee of the Board or to a single Director (someone referred to as the "lead" Director) responsible for managing the processes of the Board and for ensuring that the Board discharges its responsibilities.

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The Board should specifically allocate the responsibility for setting the Board agenda and for organizing and circulating information relevant to the agenda on a timely basis. Information should not just be historical or bottom-line oriented but should be forward-looking.

### **13. Audit Committee**

The audit committee should be composed only of outside directors and its role and responsibilities should be specifically defined so as to provide appropriate guidance to audit committee members as to their duties. These duties should include oversight of management reporting on internal controls and ensuring that management designs and implements an effective system of internal controls.

The audit committee should have direct communication channels with the Corporation's internal and external auditors to discuss and review specific issues as appropriate.

### **14. Outside Advisors**

The Board of Directors should implement a system which enables an individual Director to engage an outside adviser, at the expense of the Corporation, in appropriate circumstances for the purpose of assisting the Director in overseeing management. The engagement of the outside advisor should be subject to the approval of an appropriate committee of the Board.

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## 15. Shareholder Communications

The Governance Report requires that a Corporation's annual statement of corporate governance practices discloses measures in place for receiving shareholder feedback and measures for dealing with shareholder concerns, but does not provide a Governance Guideline dealing with such matters.

Each Corporation should have in place a corporate policy for dealing with communications from shareholders. For example, such communications may be referred to a particular officer responsible for providing the Board with ongoing reports on comments received or concerns expressed by shareholders of the Corporation.

The system for responding to shareholder communications should ensure that information is not provided to any particular shareholder that is not generally available to all shareholders. The Governance Report appears to suggest that otherwise undisclosed material information may be given to particular institutional investors, with other shareholders having to wait for more general disclosure, so long as the Corporation is satisfied that the particular shareholder will not use the information to trade in securities of the issuer until the information is generally disclosed or is no longer material, and the particular shareholder agrees to abide by these terms.

In our view, this approach would be imprudent on the part of the Corporation. Corporate officers should be briefed prior to meetings with large institutional shareholders on the sensitivity of material non-disclosed information and debriefings should be carried out after such meetings to confirm that no such information has been disclosed. If such information is inadvertently disclosed, a general disclosure should be immediately made, with analysts, brokers and other financial intermediaries given access to such information on the same basis as large institutional investors.

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## CONCLUSION

It is too early to assess the final impact of the new corporate governance disclosure requirements. Clearly, however, as with the recent imposition of the executive pay disclosure rules, it is likely that the new governance disclosure rules will result in the governance structures and processes of TSE-listed issuers coming under greater public scrutiny.

If the Governance Guidelines find favour within the institutional investor community, or if compliance with the guidelines becomes a means of attracting highly qualified nominees for corporate directorships (which, in turn, may depend on the extent to which the courts, in imposing director liability, adopt the Governance Guidelines as an indicator of prevailing governance standards and as a reasonable standard against which the conduct of Boards will be judged), then compliance with the Governance Guidelines may become an important corporate objective. At minimum, however, the Corporation will have to incorporate compliance with the new disclosure requirements into its process of preparing its annual proxy information circular and annual report.

## FURTHER INFORMATION

For further information on the Governance Guidelines and the new TSE disclosure requirements, or if you would like to receive a copy of the complete Governance Report, please call Al Hudec at (604) 643-6463, Mike Logie at (604) 643-2954 or any other member of the Securities Group at Davis & Company.