Symposium on Corporate Governance Sound Practices:
A Case for Financial Markets Stability
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PANEL I: Understanding the Role of Corporate Governance

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Good morning. I want to thank the Capital Markets Authority of Kuwait for inviting me to this Symposium. On behalf of the Ontario Securities Commission, I extend greetings to you all. It is a pleasure to attend this event and get to know our regulatory counterparts in Kuwait and many other nations.

I'll begin my remarks with a quick explanation of the role of the Ontario Securities Commission in Canada's regulatory system. Then I'll focus on:

- a high-level overview of Canada's corporate governance framework;
- how the OSC has responded to recent tests to our framework, in particular the lessons learned in the Sino-Forest matter; and
- the crucial role that we see corporate governance playing in support of investor protection, fair and efficient markets and attracting capital.

The views expressed are my own and do not necessarily represent the views of the Commission or its Staff.

Overview of Our Securities Regulation Regime

Canada has a decentralized securities regulatory structure: each of the country's 13 provinces and territories has its own regulator. The OSC is the regulatory body for the Province of Ontario, which has the largest share of Canada's capital markets, and regulates the Toronto Stock Exchange (TSX). Our statutory mandate is:

- to provide protection to investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets and confidence in capital markets.

As part of that mandate, we monitor and oversee compliance with Ontario securities law by approximately 1,300 public companies and 3,600 investment fund issuers that offer securities for sale in Ontario. We also regulate approximately 1,300 registered firms and 66,000 registered individuals that are in the business of advising or trading in securities or commodity futures in Ontario, or managing investment funds.

Of course, Ontario's markets operate within the context of global markets that are becoming more interconnected. For example, the number of foreign companies listed on the TSX and TSX Venture Exchange grew by 80 per cent between May 2007 and May 2012. We believe that enhanced co-operation with our international partners has become more important in delivering on our commitment to protect investors, foster the efficiency and integrity of capital markets and mitigate risk. In this context, we're making significant contributions to the global reform agenda, including in OTC derivatives regulation.

With that introduction, I'll provide a brief overview of the corporate governance framework for public companies in Canada.

The Canadian Corporate Governance Framework

Securities regulators play a central role in corporate governance. We impose specific governance requirements and we take active steps to ensure that boards of directors are engaged and taking their governance responsibilities seriously. Over the past decade, Canada developed a principles-based approach to issuer governance that reflects our diverse capital markets and the requirements of Canadian securities and corporate law. Our regulatory regime imposes measures that are comparable to international practices. Corporate governance captures a broad range of activities and processes, including the structure and function of the board, disclosure practices, financial reporting and shareholders' rights.

Canada's securities framework has similarities to the regime in the United States but, in some respects, there are significant differences that address domestic factors such as the proportionately higher number of both junior issuers and controlled companies in Canada.

Audit Committee Role

One of the cornerstones of our regulatory regime is our Audit Committee Rule (NI 52-110), which is intended to reinforce the independence of the external auditor from management of the issuer and to provide financial expertise and oversight of the issuer's financial reporting. The rule requires an issuer's external auditor to report directly to its audit committee.

TSX-listed issuers are required – and junior issuers are encouraged – to have audit committees that are comprised of members who are independent of management and are financially literate.

The independence of the external auditor is reinforced by requiring that the audit committee recommend to the board the appointment of the external auditor and their compensation, and directly oversee the external auditor.

Generally, the rule requires that the audit committee review the issuer's financial statements, Management's Discussion and Analysis (MD&A), and annual and interim financial media releases before they are publicly disclosed. The committee must also be satisfied that adequate procedures are in place for the review of the issuer's public disclosure of financial information extracted or derived from its financial statements.

Other Rules

In addition to the Audit Committee Rule, we have a number of other rules that, collectively, set a high bar for issuers in providing full, clear and transparent disclosure of their financial results. Those rules address:

- Immediate disclosure of material changes in an issuer's business;
- Continuous disclosure obligations for issuers;
- Certification of disclosure in issuers' annual and interim filings.

Overall Approach to Corporate Governance

With the exception of the matters referred to above, our overall approach to corporate governance can be characterized as primarily a "disclose and explain" model. Under that model, issuers must disclose their practices against guidelines setting out best corporate governance practices. These guidelines are not prescriptive, rather they are meant to encourage issuers to develop their own practices in areas such as:

- Maintaining a majority of independent directors on the board;
- Having a board code of business conduct and ethics;
- Articulating the board's mandate and governance responsibilities.

Our objective is to ensure that investors receive consistent disclosure of material information on a timely basis so they can be confident of the quality of the information they receive. We want international investors to remain confident that the disclosure and governance standards in Canada are as robust as those anywhere in the world. We want boards of directors to take an active role to ensure they meet these standards. In our view, Canada's framework for financial reporting and board governance clearly articulates our priorities and expectations to issuers, intermediaries and investors.

Shareholder Rights

Our regulatory regime focuses on the role of the board and special committees of independent directors in approving special transactions such as related party transactions and change of control transactions. Our regime focuses on and is designed to protect shareholder rights in change-of-control or conflict-of-interest transactions.

Measures we have taken to protect shareholders have included:

- Intervening in mergers, acquisitions and significant related-party transactions;
- Providing guidance to market participants about the take-over bid process;
- Improving shareholder access to proxy-related materials; and
- Addressing board governance.

We have a direct interest as securities regulators in facilitating responsible and effective shareholder engagement.

Election of Directors

Last October, the OSC approved amendments to TSX rules that require listed companies to adhere to new rules governing the election of directors. The rules came into effect on December 31st, 2012, and they require TSX-listed issuers to, among other things:

- Elect directors annually;
- Elect directors individually and not by slate;
- Disclose whether they have a majority voting policy; and

- Publicly disclose the votes received for the election of each director.

In announcing the amended rules, the TSX said the changes "bring additional transparency to the board-selection process and help to strengthen our markets' reputation while aligning our practices to other major international jurisdictions."

Our approach to enhancing the director election process is just one example of how we're looking at governance issues from a broader policy perspective, as part of our analysis of the entire shareholder rights regime.

The Sino-Forest Collapse

As you have seen, our corporate governance regime encompasses a broad range of activities and processes. Through our governance requirements, we attempt to ensure that boards of directors understand their oversight role and are actively engaged on governance issues.

Our governance regime has been tested from time to time. Most recently, in the matter related to Sino-Forest Corporation (Sino-Forest).

Some background first. Sino-Forest is a public company that, until May 9, 2012, was listed on the TSX. It engaged primarily in the purchase and sale of timber located in the People's Republic of China. By March 31, 2011, Sino-Forest's market capitalisation was well over CAD$6.0 billion. On June 2, 2011, the company's share price plummeted after a private analyst made public allegations of fraud against it. Sino-Forest is now in receivership.

The OSC has commenced an administrative proceeding alleging, among other things, that five of Sino-Forest's executive management team "engaged in a complex fraudulent scheme to inflate the assets and revenue of Sino-Forest and made materially misleading statements in Sino-Forest's public disclosure record…"

Because this matter is currently before our Commission in an administrative proceeding, I won't comment further on the specifics of the matter. What I would like to talk about are the wider governance issues and lessons arising from Sino-Forest, as well as the important role of boards of directors in ensuring appropriate corporate governance.

Regulatory Review of Emerging Markets Issuers

The OSC responded to the public concerns raised by the Sino-Forest matter by conducting a regulatory review of 24 selected emerging market issuers listed on the TSX. This review recognised our globalized marketplace and the need to protect Ontario investors and the integrity of our markets. OSC staff assessed the quality and adequacy of the issuers' compliance with disclosure and other regulatory requirements. Staff also assessed the adequacy of the gatekeeper roles played by auditors, underwriters and the exchanges on which those issuers are listed.

Our review identified material disclosure deficiencies in 15 of the 24 issuers. We published our findings and recommendations in a report issued on March 20, 2012. The report identifies areas of concern related to emerging market issuers – one of those areas is corporate governance. In a number of cases, the level of engagement by boards and audit committees in their oversight of management and sense of responsibility for the stewardship of the issuer was deficient. We were also concerned with the extent of the

knowledge of boards and audit committees of the political, cultural and business practices in the jurisdictions in which the issuers operated.

Our review led to several outcomes. The disclosure deficiencies identified were corrected through restatements and refilings or by prospective enhancements of disclosure. Several issuers were referred to our Enforcement Branch for further investigation. We also provided additional guidance to issuers, which is what I want to talk about now.

As a result of our emerging markets issuer review, we recognized that board members of such issuers may face a steeper learning curve to understand the issuer's business and operating environment. Also, time zones, language and the location of key records may make communication and appropriate oversight especially challenging. We decided to provide specific guidance to our market to highlight areas of risk that require focus and to clearly articulate the OSC's expectations regarding compliance with our corporate governance requirements.

Issuer Guide for Companies in Emerging Markets

This past November, we published an "Issuer Guide for Companies Operating in Emerging Markets" (the Guide). The Guide is intended to provide assistance to emerging market issuers and their directors and management on their governance and disclosure responsibilities in light of the unique challenges they face. The Guide also assists other issuers in understanding and addressing their governance responsibilities.

The Guide identifies eight areas for consideration. In each area, we presented matters to consider, questions to ask and disclosure tips for issuers and their boards. I'll focus on the key governance matters featured in that guidance.

I'll start with an issuer's business and operating environment.

Business and Operating Environment

Our Guide emphasizes that a company's board and management must have a thorough understanding of the political, cultural, legal and business environments of the countries in which they operate. Canadian directors of emerging market issuers must exercise additional diligence to close any knowledge gaps. Regardless of the location of a company's operations, Canadian reporting issuers, their management and boards are required to adhere to Canadian regulatory requirements.

We recommended that boards enhance their knowledge of the business and operating environment of the particular emerging market. For example, by understanding how the role a foreign government or regulatory authority may affect an issuer's business and operations.

Corporate Structures

Emerging market issuers may face challenges in designing a corporate structure that takes into consideration the political, cultural and business realities of emerging markets. Our Guide includes several questions to help boards assess the risks of a complex corporate structure, including:

- Has the need for a complex structure been carefully assessed by the board and management, including whether the company's objectives could be achieved through a simpler structure?

- Is the company's corporate structure consistent with its business model and the political, cultural and legal realities of the jurisdiction in which its principal business operations are located?

This issue harkens back to the Enron matter where the use of Special Purpose Entities was so strongly criticised.

Related Party Transactions

Related party transactions may represent a heightened risk for emerging market issuers because of differences in cultural norms, legal requirements and business practices.

The board has a particularly important role to ensure that policies and procedures are in place to identify, independently evaluate and approve related party transactions. Comprehensive disclosure – encompassing both quantitative and qualitative information – is essential for investors to understand and evaluate related party transactions.

In assessing the risks of related party transactions, the board should consider questions such as:

- Has management implemented effective policies and procedures to identify related parties and any transactions with such parties, evaluate the merits of such transactions, and require that the transactions be reported to the board and be subject to prior board approval?

- Are directors and senior management required to obtain board approval or the approval of independent or disinterested directors before entering into transactions in which they have an interest?

Risk Management

Our regulatory requirements state that "the board should adopt a written mandate in which it explicitly acknowledges responsibility for, among other things, the identification of principal risks of the company's business and oversight of the implementation of appropriate systems to manage these risks." The board oversees management, which is responsible for identifying and quantifying a company's exposure to risks and for adopting suitable risk management systems to address such risks.

Risk management is an area where boards should be particularly focused. Boards should have a clear understanding of all of the risks associated with operations in an emerging market and how they impact operations. Boards should consider the risk analysis and mitigation techniques that may be appropriate in the North American context, but they should recognise that such techniques may be less effective in emerging markets.

Disclosure of risks is an important investor protection. Boards should ensure that investors are provided with sufficient information about the risks associated with operating in an emerging market.

Internal Controls

Under our current regulatory requirements, officers of a non-venture issuer are required to certify that they have established and evaluated, on an annual basis, the effectiveness of the issuer's internal controls. If material weaknesses in internal controls are identified, this fact must be disclosed in the issuer's MD&A.

The unique risks of operating in an emerging market magnify the importance of strong internal financial controls. The audit committee of the board should actively oversee the monitoring of any identified weaknesses in internal controls, as well as the risks they create for the company. Remediation plans should be put in place to address deficiencies. Board members should hold management accountable if the remediation of deficiencies and weakness has not progressed according to plan.

Oversight of the External Auditor

The last area of guidance I want to mention addresses oversight of the external auditor, who's an important gatekeeper, to ensure that a company's financial statements are presented fairly.

In considering the appointment of an auditor, the audit committee should take into consideration factors relating to the auditor's competence, experience and qualifications in the foreign market. Similar considerations should apply where a company's domestic auditor delegates a portion of the audit to a foreign "component" auditor.

It's important to foster an environment for the open and frank ehange of information. The audit committee should pay particular attention to any signs of delays in the audit schedule or unusual management intervention in the audit process.

To conclude, this has been a very brief review of some of the areas addressed by the Guide. The Guide is available on our website and we expect emerging market issuers to carefully consider the guidance provided. The Guide has received significant attention in our jurisdiction and we have received extensive positive feedback that the Guide does a good job of articulating our expectations to market participants. Overall, we're encouraged that our messages are cascading down to issuers.

Conclusion

Sino-Forest is an example of a case where the OSC, as a securities regulator, felt compelled to fully investigate an issuer with substantial operations in another jurisdiction, despite the investigative and jurisdictional challenges. We also felt we had to respond to the broader governance concerns that came to light as a result of that investigation. The OSC took steps to address important challenges posed by issuers who do business in jurisdictions with different legal frameworks and business cultures.

Our Guide is meant to help directors and management of emerging market issuers to respond to the issues we've identified. But it also articulates, clearly and consistently, the OSC's expectations for all market participants. The Guide reinforces our expectation that boards of directors of all issuers in Ontario – regardless of where their business operations are located – will rigorously comply with the regulatory scheme in Ontario including our governance requirements.

The issues arising from Sino-Forest highlight the importance of governance issues and the key role they play in promoting financial market stability and integrity. Boards of directors have a crucial role in ensuring governance requirements are effectively addressed for the protection of investors.

We understand that corporate governance is constantly evolving and that specific regulatory rules vary from jurisdiction to jurisdiction – but the underlying principles must be consistent internationally. It's incumbent on securities regulators to be adaptable and responsive in developing and imposing appropriate governance frameworks. Those frameworks should, however, promote investor protection, market integrity and the capital formation necessary for vigorous economic growth at both a domestic and international level.

Thank you for your attention. I look forward to your questions.