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Board composition of FRFIs: Canada takes a closer look at interlocking directorates

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In its recent consultation paper regarding the review of Canada's *Bank Act*, the *Insurance Companies Act*, and the *Trust and Loan Companies Act* (the FI Acts), the Department of Finance invited comment on whether interlocking directorates should be prohibited or restricted within the financial sector, given the unique role of federally regulated financial institutions (FRFIs) in the Canadian economy.

The consultation paper very broadly defines an interlocking directorate as arising when a director of one firm is an employee, executive, partner, owner, or member of the board of directors of a second firm, or has another interest in the business of the second firm. Among other things, this definition captures any individual that serves as a director on more than one board within the financial sector. The Department of Finance notes that in some situations interlocking directorates can raise competition concerns and risks undermining decision-making that is in the best interest of the firm. It posits that limiting interlocking directorates could encourage a broader range of individuals to serve as directors, bringing in diverse perspectives and expertise which could support better governance of financial institutions.

In a prior bulletin, we questioned the need for restrictions on interlocking directorates and noted that FRFIs have been required to establish board conflict of interest polices since 1992, which we believe has been very effective at managing conflicts. This bulletin expands on those comments.

What you need to know

- The Department of Finance is seeking feedback on whether the FI Acts should be amended to prohibit or restrict interlocking directorates, arising where an FRFI director has interests in, or holds other roles (including serving as a director), in another firm within the financial sector.

- While management of director conflicts and the promotion of independent board decision-making are important objectives, we do not believe amendments to the FI Acts to address interlocking directorates are necessary or desirable because:
  - The Office of the Superintendent of Financial Institutions (OSFI) has considerable oversight of the corporate governance practices of FRFIs, requiring a rigorous assessment process for new directors, advanced notice of any proposed changes to the composition of the board and broad authority to disqualify or remove persons it deems not suitable to serve as a director.
  - Conflict policies and procedures, which FRFI boards are required to establish, are the more appropriate and flexible tool for boards to monitor and manage potential conflicts that may arise as a result of interlocking directorates on a case-by-case basis. A statutory restriction would, by its nature, be much less flexible and adaptable to evolving market factors, with a high risk that it could be overbroad or too narrow in its application and would thus inevitably fall short of achieving the desired objectives.
  - Competition and other corporate laws, as well as the market's evolving expectations, provide additional safeguards to ensure the independence of FRFI board decision-making.
- Amendments to the FI Acts for this purpose would be a notable departure from the government's approach to date, as the corporate provisions of the FI Acts have generally been modelled on the *Canada Business Corporations Act* (CBCA) and the CBCA does not currently prohibit or restrict interlocking directorates.

Background

When the FI Acts were overhauled in 1992, a decision was made to model the corporate provisions after the CBCA. Since then, any amendments to the FI Acts have typically been considered only following the adoption of equivalent CBCA amendments. In general, for the last 30+ years, the FI Acts have not gotten ahead of the CBCA on matters of policy that are of general corporate application. The CBCA does not currently prohibit or restrict interlocking directorates, so amendments to the FI Acts for this purpose would be a notable departure from the government's approach to date.

Prior to 1992, the 1980 *Bank Act* did include a prohibition on interlocking directorates between deposit-taking institutions and certain other entities; however, there were no restrictions on directors of a bank serving on the boards of insurance companies, unregulated lenders, or other entities which could compete directly with the banks and pose conflicts of interest. As part of the modernization of the FI Acts in 1992, this prohibition was replaced with a requirement that boards establish procedures to resolve conflicts of interest, including techniques for identifying potential conflict situations, restricting the use of confidential information, and designating a board committee to monitor those procedures.

Unlike a statutory restriction, conflict procedures allow boards to assess potential conflicts on a principled basis, taking into account the particular facts of each case and providing flexibility to adapt those procedures over time to reflect sectoral developments and evolving corporate governance practices. We believe these procedures have been very effective in identifying and addressing potential conflicts, all in a manner that allows the board to arrive at a careful, reasoned and thoughtful decision consistent with directors' duties to act in the best interests of the corporation.

OSFI's oversight

The consultation paper highlights this issue in the context of "the unique role of FRFIs in the Canadian economy". However, OSFI already has considerable oversight of the corporate governance practices of FRFIs, making statutory amendments to the FI Acts addressing interlocking directorates unnecessary and arguably less pressing when compared to other sectors.

OSFI first released corporate governance guidelines in 2003 and substantially overhauled those guidelines in 2013 following the financial crisis. In connection with this revision, OSFI considered best practices on corporate governance from around the world, including from the Basel Committee on Banking Supervision, the International Association of Supervisors and various other organizations at the forefront of corporate governance.

In its guidelines, OSFI focuses heavily on the composition, independence and qualifications of directors. It requires prior notice of any proposed changes to the composition of the board and requires FRFIs to conduct a thorough assessment of all proposed directors. This assessment is being significantly enhanced as a result of OSFI's new mandate to focus on integrity and security and, if there were specific concerns regarding conflicts of interest that were not currently being addressed (we are not aware of any), those could be added to the existing process.

OSFI regularly examines institutions for compliance with its corporate governance guidelines and sometimes requires self-assessments by the institutions or third-party reviews in assessing the appropriateness of corporate governance. If relevant, OSFI has various formal and informal powers under the FI Acts to ensure that any legitimate concerns about potential conflicts of interest are addressed by the institution in question. On occasion, the exercise of these powers has resulted in directors resigning or not being appointed. As such, there already exist robust and flexible tools to manage potential conflicts in the financial sector.

Scope of restrictions

The scope of any potential prohibition or restriction on interlocking directorates would be extraordinarily difficult to articulate by statute and would, by its nature, be inflexible and unable to adapt to evolving market factors. Service on more than one board is, of course, very common and should not by itself be problematic. In fact, the quality of board decision-making is often enhanced when directors have deep governance and sector expertise that comes from service on multiple boards. This is acknowledged in OSFI's "Corporate Governance Guideline," which states that there should be appropriate representation of financial industry and risk management expertise on boards and board committees.

Interlocking directorates within a consolidated group of companies also frequently occur. It would be inappropriate, for example, for a director serving on an upstream holding company to be prohibited from serving on the board of a downstream financial institution.

The consultation paper states that there are some situations where interlocking directorates would raise concerns, but it does not provide examples. Should such restrictions be aimed at limiting cross-directorships, where directors may serve on boards with one another or with top executives from the companies on which they serve as a director? We note that FRFIs already routinely limit cross-directorships in their corporate governance frameworks, with many allowing no more than two directors to serve on the same board. Would a prohibition or restriction be limited and only apply to directors who have roles with, or interests in, competitors? What would constitute a "competitor" for this purpose? What about suppliers, customers or minority shareholders (who may hold investments in a number of different FRFIs)? While conflicts could arise in these situations, these are all important stakeholders of the corporation and board decision-making may be improved when such perspectives are brought to the boardroom.

These situations are contextual and require assessment on a case-by-case basis by unconflicted board members using appropriate conflict of interest policies and procedures that are flexible enough to adapt to changing circumstances. A statutory prohibition or restriction would be too blunt a tool to address what is ultimately a more nuanced and evolving assessment of director independence.

Other safeguards

Competition laws

The *Competition Act* does not specifically prohibit interlocking directorates; however, it contains numerous substantive provisions which restrict the practical ability of competitors to have interlocking directorates, particularly where the interlock could lessen competition. The Competition Bureau is generally concerned that interlocking

directorates could lead to exchanges of competitively sensitive information between competitors through the common director, and/or that the director will be able to materially influence the economic behaviour of the interlocked firm(s), which may cause the companies to compete less aggressively. Issues of real concern arise rarely and are typically resolved on a case-by-case basis with customized remedies.

Corporate law

The FI Acts, like the CBCA, address director conflicts by requiring that directors (i) disclose the nature and extent of any interest they have in a material contract or transaction involving the corporation and (ii) subject to certain limited exceptions, abstain from voting on the matter giving rise to the conflict. This process is designed to promote transparency and unconflicted decision-making, while also recognizing that a director's role or interest in another company, even in overlapping sectors, may not necessarily taint his or her independence.

As fiduciaries, directors are also held to a very high standard of loyalty and good faith in their conduct in relation to the corporation. The duty of loyalty and good faith requires, among other things, a duty to avoid conflicts, protect the confidentiality of corporate information and not to use such information for any purpose other than for the discharge of the director's duties. In our experience, directors take these responsibilities very seriously and in the rare case that an irreconcilable conflict arises, they will resign to ensure they are able to properly and fully discharge their duties.

Additional guidelines applicable to public companies

Unconflicted board decision-making is a key feature underpinning Canadian securities laws and an expectation of the institutional investor community, which is reflected in the widely-adopted best practice of having a board comprised of a majority of independent directors and an independent Chair (or Lead Independent Director). In assessing a potential director's candidacy, boards will consider any relationship that may exist that could taint the director's independence. Importantly, however, this does not mean that a non-independent director (however defined) could not serve on the board, as it is the presence of a majority independent board that preserves the overall independence of the board process.

Proxy advisory firms also have guidelines in place that limit interlocking directorates. These jurisdictional-specific guidelines are refreshed annually and, like the conflict procedures adopted by FRFIs, may evolve over time to reflect particular market dynamics.

Conclusion

While directors' roles with other firms may pose legitimate questions regarding potential conflicts of interest, prohibiting or restricting interlocking directorates by statute in the FI Acts is not, in our view, the right approach. A robust framework for identifying and managing potential conflicts of interest arising from interlocking directorates already exists through the current provisions of the FI Acts, OSFI's "Corporate Governance Guideline" and oversight function, bolstered by competition laws and the market's expectations. While we view such restrictions as unnecessary generally, it would be particularly inappropriate to apply them exclusively to FRFIs when proper conflict management and good governance is not unique to the financial services sector.

To discuss these issues, please contact the author(s).

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

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