

Follow the Leader: OSFI releases draft advisory for financial institutions who change their senior leadership

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Background

In January of 2013, the revised Corporate Governance Guideline (“**CGG**”) previously issued by Canada’s regulator of financial institutions, the Office of the Superintendent of Financial Institutions (“**OSFI**”), took effect. Heavily influenced by international standards, the purpose of the CGG is to provide guidance to federally-regulated financial institutions (“**FRFIs**”) in relation to corporate governance matters. An important aspect of the CGG is its requirement that FRFIs provide notification to OSFI of any proposed changes to the FRFI’s board and senior management (“**Senior Leadership**”). However, the CGG is silent as to the details of such notification.

In an effort to clarify the process for such notification, a draft advisory entitled “Changes to the Membership of the Board or Senior Management” (the “**Draft Advisory**”) was released recently by OSFI. The Draft Advisory includes specific notification requirements for FRFIs in the event of a potential change to Senior Leadership. The requirements of the Draft Advisory, if adopted, would affect insurers, banks, and trust and loan companies incorporated in Canada. Commentary regarding the proposed changes will be accepted by OSFI until February 28, 2014.

Proposed Changes

The changes proposed within the Draft Advisory can be divided into two parts: (1) the requirements for early notification by an FRFI, including timing and form, of proposed changes to its Senior Leadership; and (2) OSFI’s right, in its discretion, to request an introductory meeting with newly-appointed or -elected members of Senior Leadership.

Early Notification

The timing requirements for notification to OSFI of proposed changes to Senior Leadership vary depending on the position. If a change is proposed to the membership of senior management, based on the Draft Advisory OSFI would require that notification be provided to OSFI a minimum of 30 days prior to the appointment taking effect. The criteria of who qualifies as “senior management” will vary across institutions as set out in the CGG. Therefore, it is important that FRFIs consider their organizational structure in its entirety to determine whether notification is required; this matter is discussed further below. If a change is proposed to the membership of the board of directors, based on the Draft Advisory OSFI would require that notification be provided “as soon as the preferred nominee for election or appointment is identified”. The exact time when a director becomes “identified” is unclear, but would presumably occur prior to his or her nomination for election or appointment.

The content for notification to OSFI of proposed changes to Senior Leadership is also set out in the Draft Advisory. OSFI will expect to receive (1) the *curriculum vitae* of the candidate demonstrating the candidate’s suitability for the position; (2) the rationale for the candidate’s selection; and (3) the effective date of the proposed appointment. OSFI will also want a copy of the draft announcement of the proposed appointment and the results of the “Responsible Persons assessment” conducted by the FRFI in accordance with OSFI Guideline E-17 (Background Checks on Directors and Senior Management of FREs) (“**Guideline E-17**”) as part of the requirement to conduct certain background checks on candidates for Senior Leadership positions.

Guideline E-17, which took effect in 2008, is aimed at mitigating risks to FRFIs associated with the leadership of an organization. It requires that federally regulated financial entities adopt and implement written policies aimed at assessing the suitability and integrity of “responsible persons”, including senior management and directors.

The pre-appointment notifications described above would, if included in a final advisory, be in addition to existing statutory notice requirements, and not in place of these requirements.

Introductory Meetings

The Draft Advisory would, as written, permit OSFI to request an introductory meeting with the newly-appointed or -elected Senior Leadership member of “large, complex FRFIs” (which would include domestic systemically important banks), the purpose of which would be to allow OSFI to meet and become acquainted with that new member, apprise the new member of his or her duties, discuss the points of interaction between OSFI and the FRFI and explain OSFI’s supervisory activity in relation to the applicable FRFI. Ostensibly, the meeting offers OSFI a chance to confirm the suitability of the new member of Senior Leadership and potentially take follow-up action if the meeting is unsuccessful.

If a meeting is requested by OSFI, it will typically be scheduled within four months of appointment or election, but no later than six months following appointment or election.

Implications of the Draft Advisory

The Draft Advisory, if implemented, would provide OSFI with a great deal of oversight in the appointment by FRFIs of new members of Senior Leadership. In particular, the Draft Advisory provides that, “[t]o the extent that OSFI may have any specific concerns regarding the appropriateness of a candidate, OSFI will inform the Board of the FRFI...prior to the candidate’s appointment or nomination for election.” If the Draft Advisory comes into force without material changes, the final advisory would:

- 1) provide OSFI with the ability to restrict whom an FRFI appoints or elects to Senior Leadership and would provide a *de facto* veto of proposed new appointees;
- 2) require FRFI’s to provide OSFI with notice of changes to their Senior Leadership within the timelines noted above, together with the necessary background documentation. It would be important for FRFIs to consider the most effective way to present the required documents. It remains important for FRFIs to maintain comprehensive records of relevant materials obtained during the selection or hiring process, such as results of background checks performed in the context of Guideline E-17; and
- 3) give OSFI the ability in its discretion to require a meeting with any proposed new member of Senior Leadership, the purpose of which would be to not only give OSFI an opportunity to assess the new member, but also to emphasize the statutory obligations of FRFIs and the obligations of Senior Leadership together with OSFI’s expectations.

The future of Guideline E-17

The Draft Advisory’s intersection with Guideline E-17 suggests that OSFI has determined that Guideline E-17 was insufficient or incomplete. While Guideline E-17 requires FRFIs to adopt policies and procedures to assess “responsible persons”, together with performing certain ongoing assessments, the obligation to assess a responsible person’s suitability and integrity previously remained with the FRFI. As

noted above, the Draft Advisory goes further and requires that FRFIs inform OSFI of the results of these checks. This will also provide OSFI with evidence that the FRFI is complying with the background check requirements of Guideline E-17.

The combination of OSFI's meeting with all new members of Senior Leadership, OSFI receiving the results of Guideline E-17 background checks and OSFI's apparent veto over proposed or new members of Senior Leadership suggests that, if the Draft Advisory is brought into effect in the current form, FRFIs will want to protect themselves if a member of Senior Leadership is unsatisfactory to OSFI. In addition to guarding against public relations concerns, FRFIs should advise candidates for Senior Leadership positions of the process set out in the final advisory and OSFI veto risks. In particular, the hiring of any candidate should continue to be conditional upon satisfactory initial and continued Guideline E-17 background checks and "for cause" grounds of termination should include expressed OSFI concerns in general and unsatisfactory Guideline E-17 background checks in particular. FRFIs should continue to require, as a condition of employment or appointment, consent from Senior Leadership to the conduct of appropriate and applicable background checks, together with regular attestations.

Additional Thoughts

While the Draft Advisory provides some clarity as to the information that OSFI is seeking about proposed changes to Senior Leadership and when it expects to receive these materials, the Draft Advisory nevertheless leaves some questions unanswered. For example, as noted above, it is not clear at what point OSFI will consider a director to have been "identified" for the purposes of notification to OSFI. This might occur upon initial meeting, at some other point when the candidate is actually being considered for the position, or when the candidate agrees that his or her name may be put forward. Our general view is that such identification of a candidate should not be considered to have occurred merely by virtue of a name being informally proposed conversationally; an FRFI should consider a candidate to have been "identified" for this purpose only after a decision has been made by the board of directors, or relevant committee of the board of directors, to formally propose the candidate at an upcoming meeting of shareholders (subject to OSFI clearance). Further, in the case of a director nominee put forth by a group of dissident shareholders, it is unclear if OSFI will expect to receive the applicable information about this nominee prior to the election, at a point when the institution considers it likely that the dissident candidate will be successful, or after the election. If OSFI does not review this nominee until after the election and OSFI elects to exercise its apparent veto, OSFI will run the risk of being seen as interfering in a shareholder dispute over the business.

The varying composition and titles and roles of senior management across organizations also adds complexity to the situation. While OSFI has rightly noted in the Draft Advisory that the composition of senior management will vary among institutions, there will be occasions when it will be unclear if a position qualifies as "senior management". For the purposes of the Draft Advisory, senior management consists of the chief executive officer and their direct reports (such as, but not limited to, the chiefs of major business platforms or units), and may also include those executive members responsible for oversight, including the Chief Financial Officer, Chief Risk Officer, Chief Compliance Officer, Chief Internal Auditor, and Chief Actuary. Changes to this list will vary by institution, but it is likely that the list should include, at minimum, these persons considered "Responsible Persons" for the purposes of Guideline E-17.

As noted above, OSFI is accepting comments on the Draft Advisory until February 28, 2014. Dentons Canada LLP will continue to monitor the progress of this initiative and will provide updates when available.

For more information about the Draft Advisory, please contact [Hartley Lefton](#) (+1 416 863 4353 or hartley.lefton@dentons.com).

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