THE SENATE

NAVIGATING THROUGH "THE PERFECT STORM": SAFEGUARDS TO RESTORE INVESTOR CONFIDENCE

Report of the Standing Senate Committee on Banking, Trade and Commerce

Chair
The Honourable E. Leo Kolber

Deputy Chair
The Honourable David Tkachuk

June 2003

Ce rapport est aussi disponible en français

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The Committee

The following Senators have participated in the study:

The Honourable E. Leo Kolber, Chair of the Committee
The Honourable David Tkachuk, Deputy Chair of the Committee

and

The Honourable Senators:

W. David Angus
Michel Biron
D. Ross Fitzpatrick
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James F. Kelleher, P.C.
Richard H. Kroft
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Raymond C. Setlakwe

Ex-officio members of the Committee:

The Honourable Senators: Sharon Carstairs, P.C. (or Fernand Robichaud, P.C.) and John Lynch-Staunton (or Noël A. Kinsella)

Other Senators who have participated from time to time on this study:

The Honourable Senators Tommy Banks, Roch Bolduc, Jane Cordy, Ione Christensen, Consiglio Di Nino, Joan Fraser, George Furey, Elizabeth Hubley, Colin Kenny, Frank W. Mahovlich, Marie-P. Poulin, *Nicholas W. Taylor, Herbert O. Sparrow, Peter Stollery and Terry Stratton (*retired from the Senate)

Staff from the Parliamentary Research Branch, Library of Parliament:

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Staff from the Committees and Private Legislation Directorate:

Denis Robert, Clerk of the Committee

Order of Reference

Extract from the *Journals of the Senate* of October 23, 2002:

"The Honourable Senator Kolber moved, seconded by the Honourable Senator Maheu:

That the Standing Senate Committee on Banking, Trade and Commerce be authorized to examine and report upon the present state of the domestic and international financial system;

That the papers and evidence received and taken on the subject during the First Session of the Thirty-seventh Parliament and any other relevant Parliamentary papers and evidence on the said subject be referred to the Committee;

That the Committee be empowered to permit coverage by electronic media of its public proceedings with the least possible disruption of its hearings;

That, notwithstanding usual practices, the Committee be permitted to deposit an interim report on the said subject with the Clerk of the Senate, if the Senate is not sitting, and that the said report shall thereupon be deemed to have been tabled in the Chamber; and

That the Committee submit its final report no later than June 19, 2003.

After debate,

With leave of the Senate and pursuant to Rule 30, the motion was modified to read as follows:

That the Standing Senate Committee on Banking, Trade and Commerce be authorized to examine and report upon the present state of the domestic and international financial system;

That the papers and evidence received and taken on the subject during the First Session of the Thirty-seventh Parliament and any other relevant Parliamentary papers and evidence on the said subject be referred to the Committee;

That the Committee be empowered to permit coverage by electronic media of its public proceedings with the least possible disruption of its hearings; and

That the Committee submit its final report no later than June 19, 2003.

The question being put on the motion, as modified, it was adopted."

Paul Bélisle
Clerk of the Senate

Recommendations

Legislation be introduced that would require a majority of the members of the board of directors to be independent, recognizing the special circumstances that may be faced by closely held corporations and small and medium-sized businesses. As well, the independent directors should be required to meet *in camera* on a periodic basis. Moreover, legislation should require the development of a code of ethics to be followed by all members of the board of directors. Finally, the federal government should encourage provincial/territorial governments and private sector stakeholders to develop specifically tailored education and training initiatives that would enhance the knowledge of members of the board of directors in areas that are outside their expertise. (page 8)

Legislation be introduced that would require all audit committee members to be independent and financially literate; moreover, at least one member should be a financial expert. The audit committee should also have the ability to select and take advice from an independent audit advisor. As well, legislation should require *in camera* meetings between the audit committee and the auditor. Finally, the federal government should encourage provincial/territorial governments and private sector stakeholders to develop specifically tailored education and training initiatives that would enhance the level of financial literacy among boards of directors in Canada, particularly among audit committee members. (pages 11-12)

Legislation be introduced that would prohibit compensation committee members from being a member of management and would require them to have a level of expertise in the areas of compensation and human resource management. The compensation committee should also have the ability to select and take advice from an independent compensation consultant. Moreover, legislation should require *in camera* meetings between the compensation committee and the company's compensation consultant. (page 14)

Legislation be introduced that would limit the non-audit services that auditors can provide to their audit-clients. These restrictions should not necessarily apply to small and medium-sized businesses. The rules developed by the Canadian Public Accountability Board should be used as a guideline. (page 17)

Legislation be introduced that would require the audit committee to oversee the auditor selected by the company's shareholders. (page 18)

Legislation be introduced that would require rotation of the lead audit partner every seven consecutive years. (page 21)

Relevant laws and regulations be reviewed with a view to ensuring that the accounting profession benefits from modified proportionate, rather than joint and several, liability. (page 22)

Legislation be introduced that would obviate real or perceived conflicts of interest by financial analysts. (page 24)

The federal government review current legislative and regulatory provisions regarding fraud, insider trading and other offences, including the adequacy of any penalties, with a view to implementing any needed changes as expeditiously as possible. It should also examine the extent to which existing procedures and resources are adequate to ensure that instances of corporate corruption are properly prosecuted. (page 31)

Legislation be introduced that would establish whistleblower protection for employees with respect to the reporting of financial irregularities and failed corporate governance. (page 33)

The role of Chief Executive Officer and Chair of the Board of Directors be split, bearing in mind the special circumstances that may exist with closely held companies and small and medium-sized businesses. (page 34)

The federal government take a leadership role and work with Canadian stakeholders in undertaking discussions with the U.S. Financial Accounting Standards Board, the International Accounting Standards Board and others that will result in all relevant parties working expeditiously toward the development of global uniform accounting standards. (page 38)

The federal government convene a meeting of all stakeholders to discuss the entity that should have responsibility for the setting of – and, importantly, revisions to – accounting standards and rules. The government must take a leadership role in ensuring that the entity to which responsibility is given has the necessary independence, accountability and transparency to safeguard investor confidence. (pages 39-40)

Legislation be introduced that would require an organization's Chief Executive Officer and its Chief Financial Officer to certify that the annual financial statements fairly present, in all material respects, both the results of the organization's operations and its financial condition. (page 41)

NAVIGATING THROUGH "THE PERFECT STORM": SAFEGUARDS TO RESTORE INVESTOR CONFIDENCE

If we are to attract both foreign and Canadian investors, they must have confidence in the safety of our markets. At the same time, if we are to attract issuers, we need a regulatory system that is not too burdensome or costly. That is the balance that we must achieve to ensure that our markets remain competitive. (Ontario Securities Commission)

The Standing Senate Committee on Banking, Trade and Commerce has long had an interest in corporate governance, and has issued a number of reports with many recommendations over the last decade. For example, in August 1996 the Committee released *Corporate Governance*, which contained recommendations in such areas as directors' liability, non-executive Chairmen, residency requirements for directors, insider trading, shareholder communication and proxy solicitation rules, take over bids and going-private transactions, and corporate governance and institutional investors. The Committee continued its focus on governance with a November 1998 report, *The Governance Practices of Institutional Investors*, which provided additional recommendations in this area. As well, the Committee has examined amendments to the *Canada Business Corporations Act*, most recently in 2001. Clearly, Committee members have both an interest, and considerable expertise, in corporate governance.

… Committee members have both an interest, and considerable expertise, in corporate governance.

In May 2002, in the wake of the Enron scandal and suspected corporate scandals in other U.S. companies, the Committee began a study of the circumstances resulting in these scandals in the United States, with a particular focus on whether these circumstances – with a similar result – would be likely to occur in Canada and, if so, how they might be avoided. We were also mindful of reduced confidence among Canadian investors because of a large number of interlisted companies as well as declining share values in Nortel, Livent, Cinar, Bre-X and Laidlaw, among others.

Analysts generally agree that the financial scandals … were the result of some combination of at least three factors: failed corporate governance; lax auditing and accounting standards and oversight; and the incentives provided by executive compensation systems.

Analysts generally agree that the financial scandals appearing almost daily for months in the media were the result of some combination of at least three factors: failed corporate governance; lax auditing and accounting standards and oversight; and the incentives provided by executive compensation systems. In the United States, following the Enron scandal, a number of stakeholders began to make changes in rules, procedures and guidelines on a voluntary basis. Unfortunately, the situation with Enron was quickly followed by other scandals, notably WorldCom, which has been described by several observers as "the perfect storm." At that point, some argued that voluntary action was inadequate, and that a legislative response was needed. The result was the *Public Company Accounting Reform and Investor Protection Act of 2002*, commonly known as the *Sarbanes-Oxley Act of 2002*, or "SOX."

… during the course of our study, a number of legislative and policy changes were made and proposed … in Canada that should contribute to increased confidence.

It was within this context that the Committee heard from a wide range of witnesses in Ottawa and travelled to New York, N.Y. and Washington, D.C. in an effort to understand better both the nature of the problems giving rise to the instances of corporate corruption and the solutions, both implemented and proposed. (See Appendix A for a summary of the evidence received during the Committee's trip to the United States, where we met with a number of senior decision makers.) Moreover, during the course of our study, a number of legislative and policy changes were made and proposed by governments, securities commissions, stock exchanges and professional organizations in Canada that should contribute to increased investor confidence. This report summarizes the testimony received by the Committee on the three factors noted above, and offers suggestions about how investor confidence might be restored within Canada.

Just as the Committee was finalizing this report, the Minister of Justice introduced Bill C-46, An Act to amend the Criminal Code (capital markets fraud and evidence-gathering). While the Bill addresses some areas of concern to us, our examination of the range of actions required to restore investor confidence goes beyond enforcement and whistleblower

protection. We look forward to the Senate's examination of Bill C-46 in light of the recommendations we make in this report.

In the Committee's view, restoring investor confidence is paramount, since investors – and the capital they provide – are at the heart of our nation's economic health and prosperity. We believe that while integrity cannot be legislated or regulated, and human nature is such that some people will always find a way around rules, the implementation of the recommendations contained in this report – most of which will require legislation – will contribute to restored investor confidence through Canadian leadership in transparency and good governance, making us a magnet for investment and enabling us to enjoy economic growth.

… *restoring investor confidence is paramount, since investors – and the capital they provide – are at the heart of our nation's economic health and prosperity.*

FAILED CORPORATE GOVERNANCE

Important issues of corporate governance have been raised by the Enron collapse … . These issues are not confined to markets or countries. They also have the effect of creating tensions between and among professions, countries and, in the case of accounting standards, continents. Clearly, we are at a critical juncture. (TSX Group)

Recent financial scandals in the United States … have been characterized by some as a failure of corporate governance.

Recent financial scandals in the United States – including Enron, WorldCom, ImClone, Tyco and Health South, among others – have been characterized by some as a failure of corporate governance. In particular, the practices of the board of directors, the audit committee and the compensation committee have been criticized for indulgence and potential conflicts of interest, although problems with external auditors and financial analysts have also been identified. While the Committee's witnesses – and consequently this report – focussed on the audit and compensation committees, we also acknowledge the important role played by the nominating committee in contributing to high-quality corporate governance.

A. The Board of Directors

No other function of modern business has so consistently failed to perform as the board of directors. … Too many directors are overextended, sitting on too many boards at the same time. Too many are clothed as being independent but really have lucrative side deals with management … . [T]he greatest single factor in the failure of boards can be traced to their composition and the resulting obsession with compensation matters … . (Centre for Corporate & Public Governance)

Witnesses shared with the Committee their views about the extent to which current corporate scandals were the result of inadequacies of the board of directors. For example, the absence of a code of ethics for board members was highlighted by the Centre for Corporate & Public Governance, which told the Committee that "at present there is no professional body

that accredits directors or establishes and enforces a code of ethics that embraces both legal requirements and generally accepted standards of performance. … [T]he most important force in improving boards and minimizing the disasters over which they … preside will be the creation of a business culture, championed by the leaders of business itself, where it becomes unthinkable for directors to fail to direct and where an unswerving commitment to ethical values of fairness, decency and sound judgment in the boardroom becomes commonplace." In speaking about a code of ethics, the Association de protection des épargnants et investisseurs du Québec argued that "[i]t is not simply enough for a company to adopt a code of business ethics if no mechanism is implemented to promote staff buy-in to those ethical values, and if no monitoring measures are set up or sanctions imposed on those who fail to abide by the code."

Comments were also made about whether there should be a limit on the number of public boards on which a director can serve, with Caldwell Securities Ltd. suggesting that "[f]ive is not a bad number." The TSX Group argued that "[g]iven the increasing demands on directors, they will have a difficult time serving and doing their job as a director well if they serve on too many boards. A number of influences are occurring that will likely reduce the number of directorships that any one individual can hold concurrently." Ms. Penny Collenette, of the Kennedy School of Government at Harvard University, suggested, however, that "we have to look at … circumstances. Are they retired? Do they have full-time jobs? Do they know the sectors to which they are being appointed?"

Comments were also made about whether there should be a limit on the number of public boards on which a director can serve …

A number of witnesses, including the Investment Dealers Association, expressed concern about "a limited pool of qualified, independent directors in Canada relative to the number of public companies, particularly if restrictions are placed on multiple directorships." Mercer Human Resource Consulting identified "the pool of competent independent directors" as the biggest challenge in the future, and noted that "many directors feel that they are beholden to the [Chief

Executive Officer] for the prestigious position of being on a board. That is a bad place to start if your job is to oversee the Chief Executive Officer]. The fostering of a more independent culture among Canadian directors would be a positive move … ."

The Advisory Group on Corporate Responsibility Review made particular mention of financial literacy, arguing that "it would be a bigger challenge for the smaller companies to get qualified financially literate people on their board than it would be for large companies. … I think that 'financially literate' is a question of having significant experience, either as an accountant, a financier or a financial analyst, in dealing with and working with financial statements. … [Y]ou do not have to be an accountant to have that kind of experience. … You want to avoid a situation where you unduly restrict the pool of eligible directors."

… a desire for "refreshment" and managing demographics on the board were also identified as considerations prompting term limits.

The Committee also received testimony about recent initiatives in the United Kingdom, including requirements that no individual can chair two public companies, and that no two directors can sit on different boards together. Moreover, term limits on directorships have also been suggested; some held the view that two or three three-year terms might be appropriate. The argument has been made that after this period of time independence begins to be lost; a desire for "refreshment" and managing demographics on the board were also identified as considerations prompting term limits. Mr. Peter Dey, however, indicated that "once you go on a board, there has to be an orientation period of 18 months to two years before you really understand what is happening."

The Weir Group PLC described the system in the United Kingdom as "less rules-based and prescriptive than Sarbanes-Oxley," while Mr. Derek Higgs noted that the "Combined Code on Corporate Governance" does not have any "force of law, other than the remote, ultimate sanction of removing listing of companies on stock exchanges … [although it] does deal with the same things as Sarbanes-Oxley." In support of a principles-based approach, he argued that "if you set up a series of rigorous rules backed by

the law the exercise becomes one of finding your way around the rules. If you set up a series of principles and this flexible framework of 'comply or explain,' you then encourage responsible behaviour and intelligent judgment and discussion. … After some of the corporate problems occurred … there was a sense that a legislative approach might be required in the U.K. because of loss of public confidence in corporate responsibility and corporate governance. The passing of the Sarbanes-Oxley Act, for most people in the U.K., had the effect of reinforcing the value of the flexible framework rather than the legislative one."

Witnesses shared a variety of views about the independence of directors, the definition of the term "independence" and whether small companies would encounter difficulties in attracting the required number of independent directors. Support for training and accreditation of directors – perhaps through the Institute of Corporate Directors or within the business schools of universities – was mentioned by witnesses, including Mr. Purdy Crawford and the Canadian Coalition for Good Governance, which suggested that "corporate directors should have qualifications. There should be a short course that directors must … pass before being qualified to be on a major board."

The diversity of backgrounds that would contribute to board success, including business, economics and psychology, was also highlighted. On the issue of compensation, Mr. William Dimma shared his view that Canadian directors are undercompensated, and should be paid about the same amount, on a *per diem* basis, as the organization's Chief Executive Officer since he or she "plays just as important a role … if [he or she] is doing what he [or she] should be doing … ." The Certified Management Accountants of Canada urged the adoption of additional tools to evaluate corporate leadership, corporate performance and a board's own performance.

The diversity of backgrounds that would contribute to board success, including business, economics and psychology, was also highlighted.

The Committee believes that a majority of the members of the board of directors must be independent, should follow a code of ethics, should be accredited in some manner and

… directors should be circumspect with respect to the number of boards on which they serve …

should be drawn from a variety of backgrounds. Regarding independence, we are reminded of a comment made during our trip to the United States, where it was suggested that the "acid test" of independence is an affirmative response to the question: "As a director, could you fire the Chief Executive Officer or deny the Chief Executive Officer a bonus?" Moreover, directors should be circumspect with respect to the number of boards on which they serve; however, we have no particular recommendation about the precise number that is appropriate, since it very much depends on the time that they have available, the industries with which they already have familiarity, etc., but feel that three to five directorships is the appropriate range. We are aware that limits on the number of board appointments could increase the demand for directors, and recognize the concerns by some that the pool of directors in Canada is limited. Nevertheless, we believe that greater efforts must be made to recruit board members from a wide range of backgrounds, and that this recruitment exercise is facilitated where board members are properly compensated, trained and supported. From this perspective, the Committee recommends that:

Legislation be introduced that would require a majority of the members of the board of directors to be independent, recognizing the special circumstances that may be faced by closely held corporations and small and medium-sized businesses. As well, the independent directors should be required to meet *in camera* on a periodic basis. Moreover, legislation should require the development of a code of ethics to be followed by all members of the board of directors. Finally, the federal government should encourage provincial/territorial governments and private sector stakeholders to develop specifically tailored education and training initiatives that would enhance the knowledge of members of the board of directors in areas that are outside their expertise.

B. The Audit Committee

> *Audit committees are an essential link in a good governance strategy. They can add value to an organization. Properly constituted and operated independent[ly] audit committees can improve communications, help directors be more accountable, help internal and external auditors maintain independence, improve the quality of reporting and controls, and enhance the reputation of the organization by increasing public confidence in its reports.* (Grant Thornton Canada)

Observers have identified a number of concerns related to the audit committee, including whether rules about the independence of directors serving on audit committees are adequate to protect investors, whether committee members possess the right mix of technical and general knowledge to ask appropriate questions, what the relationship between the audit committee and the external auditor should be, and whether the audit committee should be able to access expertise in addition to the external auditor.

1. Independence, Experience and Expertise

Audit committee members must be able to recognize the financial and accounting weaknesses of the company in order to be effective guardians of shareholder interests and the public trust, and must be independent and comfortable pursuing any inadequacies that they perceive to exist. In Canada, the *Canada Business Corporations Act* requires that the audit committee have at least three members, a majority of whom cannot be officers or employees of the company or any of its affiliates; the audit committee of federally regulated financial institutions are required to have a majority of unaffiliated directors and no committee members can be officers or employees of the financial institution or its subsidiaries. Moreover, the Toronto Stock Exchange has existing and proposed guidelines regarding audit committees, and legislation in Ontario and Quebec gives securities commissions within their jurisdiction rule-making powers regarding audit committees.

Audit committee members must be able to recognize the financial and accounting weaknesses of the company in order to be effective guardians of shareholder interests and the public trust …

In the United States, the *Sarbanes-Oxley Act of 2002* requires disclosure of whether the audit committee has at least one financial expert and, if not, why not; it also requires that all audit committee members be financially literate. As well, it also addresses the issue of audit committee independence, with independence existing if the audit committee member does not accept any consulting, advisory or compensatory fee from the company other than those associated with his or her capacity as a member of the audit committee, the board of directors or any other committee board; moreover, he or she must not be an affiliated person of the company or any of its subsidiaries.

… audit committee members should have at least some level of financial literacy, although not all members need be financial experts.

There is general agreement that independence must exist, and that audit committee members should have at least some level of financial literacy, although not all members need be financial experts. It is felt that the skills and experiences brought by financial experts and financial literates would be complementary and mutually reinforcing. The former have the expertise to ask detailed questions, while the latter are likely to ask the types of questions that shareholders would like to be answered. Financial literacy can be achieved through training programs for committee members, as well as through enabling the committee – at the organization's expense – to hire outside expertise if it requires additional information and/or has particular questions about an audit.

What is needed is people with high integrity who will ask questions …

Several of the Committee's witnesses commented on whether an audit committee should be able to hire an auditor independent of the accounting firm undertaking the audit in order to provide advice. While such an initiative could be costly, its benefits must be weighed against any costs. Such an arrangement could assist the audit committee members in identifying the questions that should be asked of the organization's auditor, and would provide a "fresh set of eyes." Most believe that such a function would be complementary, rather than repetitive, and noted that it is unreasonable to expect that every audit committee will be comprised of accounting and financial experts. What is needed is people with high integrity who will ask questions when they do not

understand something. Rosen & Associates Limited noted that such an advisor could "point out to the audit committee areas that need further thought," while Caldwell Securities Ltd. suggested that companies should "provide funds for outside, independent advisors and auditors to advise the audit committee." Others cautioned, however, that the result should not be a second audit, which in essence would involve an auditor auditing the auditor. Moreover, some witnesses argued that audit committee members require more pay and more time to devote to their audit duties, in addition to greater independence from management and the ability to meet with the auditor without management being present.

In the Committee's view, audit committee members must be independent, represent a diversity of backgrounds, and be adequately trained and properly compensated. They should also have the ability to hire outside expertise, funded by the company, should they desire, particularly given the high level of expertise that exists, for example, among retired auditors. The audit committee must meet *in camera* with the auditor, since we believe that candid dialogue is encouraged when management is absent. We reiterate that the goal is restoring investor confidence. A properly functioning audit committee that is independent and either has or can access the information it needs is key in this process. From this perspective, we urge companies to fund the hiring of outside expertise when requested by the audit committee, and support the legislative provisions that currently exist regarding audit committee members. Nevertheless, the Committee also recommends that:

… audit committee members must be independent, represent a diversity of backgrounds, and be adequately trained and properly compensated.

Legislation be introduced that would require all audit committee members to be independent and financially literate; moreover, at least one member should be a financial expert. The audit committee should also have the ability to select and take advice from an independent audit advisor. As well, legislation should require *in camera* meetings between the audit committee and the auditor. Finally, the federal government should encourage provincial/territorial governments and private sector stakeholders

to develop specifically tailored education and training initiatives that would enhance the level of financial literacy among boards of directors in Canada, particularly among audit committee members.

2. The Relationship with the Auditor

One way to improve the quality and completeness of the information received by audit committee members may be to strengthen the relationship between the audit committee and the external auditors. The *Sarbanes-Oxley Act of 2002* contains provisions requiring auditors to report to the audit committee of the public company. In Canada, in May 2002 the Assurance Standards Board of the Canadian Institute of Chartered Accountants issued new standards for communications between auditors and those responsible for the financial reporting process, which is usually the audit committee.

… ensure that the relationship of the auditor is with the audit committee, rather than with management.

There was general agreement among the Committee's witnesses about the need to ensure that the relationship of the auditor is with the audit committee, rather than with management. As noted above, the Committee believes that *in camera* meetings between audit committee members and the external auditor must occur, and that the reporting relationship between the auditor and the audit committee must be made clear, recognizing that the auditor is selected by shareholders and that the audit committee of the board of directors is the guardian of shareholder interests.

C. The Compensation Committee

> *Very often we present reports to the compensation committee, and they do not have many questions. They do not really understand all the principles of executive compensation … . I think it would be important that board members get the appropriate training to be able to ask the appropriate questions.* (Aon Consulting)

While the Committee's witnesses presented limited testimony about compensation committees, many of the concerns voiced with respect to audit committees – including independence and expertise – were repeated. Professor Richard Long of the University of Saskatchewan told the Committee that the board of directors generally establishes a compensation committee, which hires a compensation consulting firm to provide data on the level and type of compensation received by executives in comparable companies.

Professor Long noted that the companies selected by compensation consultants as being comparable have a significant impact on the data provided, and suggested that "in collecting data, if anything, they tend to err on the high side. … [As well, the] research shows that most boards consider their executives to be above average. They would not want to think that they are only average because the board appointed these people. … Finally, many outside directors are themselves chief executive officers and can be sympathetic about executive compensation." Mr. Peter Dey indicated to the Committee that "we must have compensation committees that … understand how compensation can define the culture of a corporation."

… independence, expertise and the ability to hire outside expertise should … exist …

Earlier, the Committee expressed its support for independence and expertise among audit committee members, as well as the ability of committee members to engage outside expertise. We believe that independence, expertise and the ability to hire outside expertise should also exist with respect to

The compensation committee should have the authority to select and oversee the company's compensation consultant …

the compensation committee. The compensation committee should have the authority to select and oversee the company's compensation consultant, and should meet *in camera* with the consultant selected by it. From this perspective, the Committee recommends that:

Legislation be introduced that would prohibit compensation committee members from being a member of management and would require them to have a level of expertise in the areas of compensation and human resource management. The compensation committee should also have the ability to select and take advice from an independent compensation consultant. Moreover, legislation should require *in camera* meetings between the compensation committee and the company's compensation consultant.

D. The Auditor

> *Research suggests that auditors, the second link in the financial reporting quality chain, are generally alert to management's attempts to manage earnings* … . (Professor Daniel Thornton)

In the financial system, auditors play a central role, since investor confidence in the integrity of a corporation's financial statements is at the heart of our capital markets. From this perspective, it is important that the auditors be properly selected and free of real and perceived conflicts of interest, and that their role be clearly defined.

… auditors play a central role, since investor confidence in the integrity of a corporation's financial statements is at the heart of our capital markets.

1. The Provision of Non-audit Services

Observers have argued that potential conflicts of interest, arising when auditors provide consulting services to their audit-clients, lead to a breakdown of the audit function since auditors may become an "extension of management" rather than independent guardians of the integrity of a company's financial statements. The potential problems increase when non-audit services generate more revenue than do the audit services provided to a particular client.

Not everyone, however, agrees that accounting firms that provide both consulting and auditing services for an audit-client would necessarily lose their ability to provide independent judgments. Mr. Harvey Pitt, former Chairman of the U.S. Securities and Exchange Commission (SEC), has argued that separating audit-related and non-audit consulting services would not result in greater independence by auditors because they would become more dependent on their audit fees. According to him, separating the services could result in auditors becoming more lenient. Others do not support a

restriction on the provision of consulting services for other reasons. For example, the Certified General Accountants Association of Canada told the Committee that "the unique relationship between a [small and medium-sized enterprise, or SME] and its accountants [must be considered]. In the case of a privately held SME, the accountant typically provides a broad range of services to the client. We believe that limiting consulting activities of SME accountants to non-auditing clients would not serve this sector well and would be unnecessary."

In the United States, the *Sarbanes-Oxley Act of 2002* provides that, subject to case-by-case exceptions granted by the U.S. Public Company Accounting Oversight Board, registered public accounting firms are prohibited from providing specified non-audit services, and pre-approval by the audit committee of the public company is required for non-audit services not expressly forbidden by law.

In Canada, a number of companies have limited the types of services provided to them by their auditors. For example, the Canadian Imperial Bank of Commerce was the first major Canadian corporation to announce that its two audit firms – Arthur Andersen LLP and PricewaterhouseCoopers LLP – would no longer be eligible for non-audit consulting contracts. Shortly thereafter, the Toronto Dominion bank announced that it would impose similar prohibitions on its external auditors. Recently, the Toronto Stock Exchange has proposed that audit committee pre-approval of non-audit services be addressed as a guideline.

It is not only real conflicts of interest that can undermine investor confidence, but also the perception of conflict.

The Committee believes that auditors play a central role in the proper functioning of capital markets and that, consequently, all possibilities of conflict of interest must be avoided. It is not only real conflicts of interest that can undermine investor confidence, but also the perception of conflict. From this perspective, we believe that it is appropriate that restrictions be placed on the range of non-audit services that auditors can provide to their audit-clients. While we recognize requirements imposed by the Canadian

Public Accountability Board, we believe that investor confidence would be further enhanced by legislative restrictions on the types of non-audit services that can be provided by a company's auditors. For this reason, the Committee recommends that:

Legislation be introduced that would limit the non-audit services that auditors can provide to their audit-clients. These restrictions should not necessarily apply to small and medium-sized businesses. The rules developed by the Canadian Public Accountability Board should be used as a guideline.

2. The Selection Process

In practice … the company's management team often chooses, and to a considerable degree directs, the auditor.

In addition to the activities they are permitted to perform, central to auditors' independence is the manner in which they are selected. In Canada, the *Canada Business Corporations Act* and financial institutions statutes require that shareholders appoint the company's auditor; they may also fix the auditor's remuneration, and may remove the auditor at a special meeting of shareholders. In practice, however, the company's management team often chooses, and to a considerable degree directs, the auditor. In these situations, there is a danger that management can effectively "punish" auditors with termination should management not support the findings of the audit.

To resolve this problem, some analysts have suggested that auditor independence could be improved by ensuring that auditors are truly selected by – and directly accountable to – a board of directors that is truly independent of management and accountable to shareholders. Others have suggested that auditors could be chosen by an outside private or government entity, which could result in increased independence. Moreover, if the entity were to finance company audits, the

negotiation of fees between an auditor and the company would not occur, also perhaps resulting in increased independence.

The situation in Canada differs from that in the United States under the *Sarbanes-Oxley Act of 2002*, which requires the audit committee of a public company to appoint, compensate and oversee the auditor. Nevertheless, an exemption has been received from SEC rules deeming shareholder appointment of auditors under certain circumstances to be equivalent to the requirements of the *Sarbanes-Oxley Act of 2002*. The Committee is pleased that this issue has been favourably resolved and supports the appointment of the auditor by the company's shareholders. Nevertheless, we believe that the audit committee should provide guidance to the shareholders in this regard, as well as oversight of the auditor once selected. Consequently, the Committee recommends that:

Legislation be introduced that would require the audit committee to oversee the auditor selected by the company's shareholders.

3. The Role of the Auditor

Even if auditors are properly selected and there is no possibility of conflict of interest or undue management influence, … a question arises about their proper role …

Even if auditors are properly selected and there is no possibility of conflict of interest or undue management influence, such as might occur when external auditors are subsequently hired by client firms as internal auditors or senior management, a question arises about their proper role: is it their role to ensure that the financial statements are prepared according to standards and that everything "adds up," or does their role extend to ensuring that business practices are proper and are not intended to deceive? In essence, should they ensure that Generally Accepted Accounting Principles have been followed to the letter, or that the financial statements reflect a "fair and balanced" representation of the company's financial situation?

Instructive in this regard is the 1997 decision of the Supreme Court of Canada in the case of *Hercules Management Ltd.* v. *Ernst & Young* ([1997] 2 S.C.R. 165) confirming a prior decision of the Manitoba Court of Appeal which limited the extent of auditors' liability for allegedly deceptive audit reports. The Supreme Court recognized that a corporation's audited financial statements can be used for a variety of purposes by a variety of people and entities – by banks and other lenders in determining whether to loan money to a corporation, by trade creditors in determining whether to supply product and on what terms, by regulatory and licencing bodies in deciding whether to grant licences or other approvals, etc. – none of which falls within the basic and primary purpose for which audited financial statements are prepared: to assist shareholders collectively to review and assess the performance of a corporation's management. In the Supreme Court's view, auditors should not be liable to people who may choose to rely on audited financial statements for any of these extraneous purposes, absent special circumstances, because otherwise auditors would face the prospect of exposure to indeterminate liability.

The Committee does not elaborate on this issue, other than to indicate our belief that the nature of the auditors' role must be clearly communicated to them, and to note the priority of restoring and maintaining investor confidence and the importance of "accurate" financial statements in attaining this goal. Our view on auditor liability is discussed below.

The Committee … note[s] the priority of restoring and maintaining investor confidence and the importance of "accurate" financial statements in attaining this goal.

4. Auditor Rotation

The issue of auditor rotation was raised by a number of the Committee's witnesses. In the United States, the *Sarbanes-Oxley Act of 2002* requires that a registered public accounting firm cannot provide audit services to a public company if the lead or the review partner has performed audit services for that company in each of the five previous fiscal years, thereby

instituting a five-year rotation cycle. Moreover, the firm cannot perform statutorily mandated audit services for a public company if the company's senior management had been employed by the accounting firm and participated in an audit for the company during the one-year period preceding the audit initiation date.

Witnesses identified both positive and negative aspects of a requirement for auditor rotation.

Witnesses identified both positive and negative aspects of a requirement for auditor rotation. Some argued against rotation, suggesting that such a requirement could lead to a "loss of depth," since rotation results in the loss of valuable company-specific expertise and experience. Mr. Peter Dey argued that "[i]f you have an effective relationship between the external auditor and the audit committee, some of these other issues about rotating the partner disappear, or can be dealt with within the judgment of the audit committee." Nevertheless, others noted that rotation might diminish the personal relationships that could lead to conflicts of interest, and would introduce a "fresh pair of eyes" that could enhance independence and the quality of reporting.

Others commented on whether the audit firm should be rotated on a periodic basis, rather than simply the lead auditor.

Others commented on whether the audit firm should be rotated on a periodic basis, rather than simply the lead auditor. The Canadian Institute of Chartered Accountants told the Committee that "it would be pretty inefficient and costly to do that," and noted that Italy alone has such a requirement. Grant Thornton Canada indicated that it "does not support the rotation of audit firms. Some research has indicated that many failures will occur in that initial period after a change of auditors." The Shareholder Association for Research and Education, on the other hand, urged the adoption of a "five-year limitation on the period that any accounting firm can provide audit services to a corporate client with the ability of corporations to retain the firm again after 10 years."

The Committee supports the notion of auditor rotation on a periodic basis, believing that it diminishes the possibility of personal relationships developing, promotes greater independence, and brings a new perspective to the audit function that may result in better financial reporting. We are aware of the requirement by the Canadian Public

Accountability Board with respect to a seven-year auditor rotation cycle, but believe that a legislative basis is required. We do not, however, support a requirement for rotation of the audit firm, since in our view valuable company-specific experience would be lost. For this reason, the Committee recommends that:

We do not … support a requirement for rotation of the audit firm …

Legislation be introduced that would require rotation of the lead audit partner every seven consecutive years.

5. Liability Concerns

Several of the Committee's witnesses shared their concerns about auditor liability. PricewaterhouseCoopers Canada informed the Committee that "[auditors] operate in an environment where we can be put out of business and partners' personal assets are put at risk every time we perform a major public audit. … [While all] businesses must operate within an appropriate liability framework … we recommend consideration be given to … introducing proportionate liability into corporate and securities statutes." It also recommended that accountants "be allowed to avail themselves of full shield limited liability protection, LLP, status or, alternatively to incorporate."

Several of the Committee's witnesses shared their concerns about auditor liability.

Liability reform was also urged by KPMG Canada, which argued that "liability should be proportionate – that is, limited to the auditor's share of responsibility for a plaintiff's loss. … We also stress the need for legislation that would provide greater protection for the personal assets of partners in audit firms in liability judgments … . [W]e recommend broadening the existing LLP legislation to provide full-shield protection against both professional and commercial liabilities." It also told the Committee that six provinces have legislative provisions that protect partners' personal assets from claims against their firm, save and except responsibility for the

wrongdoing. There is, however, no consistency across provinces. In the view of Ernst & Young, "[t]he current liability scheme in Canada … places audit firms in an unfair position where they can be forced to pay for the mistakes of others."

The Committee … support[s] a review of appropriate laws and regulations with respect to the possibility of modified proportionate liability for the accounting profession.

The Committee, in its March 1998 and September 1998 reports *Joint and Several Liability and Professional Defendants* and *Modified Proportionate Liability (Interim Report)* respectively, recommended changes to Canada's liability regime. We find the arguments presented by PricewaterhouseCoopers Canada, KPMG Canada and Ernst & Young to be compelling, and support a review of appropriate laws and regulations with respect to the possibility of modified proportionate liability for the accounting profession. It is from this perspective that the Committee recommends that:

Relevant laws and regulations be reviewed with a view to ensuring that the accounting profession benefits from modified proportionate, rather than joint and several, liability.

E. Financial Analysts

> *Analysts perform a crucial role in capital markets by interpreting and analyzing financial information and results and by valuing publicly traded companies. Investors have a right to know they can trust the motivation of the people they turn to for research analysis. They need to know that analysts are objectively assessing stocks, not touting them.* (Investment Dealers Association)

In recent years, there has been a growing impression among investors that financial analysts' recommendations are biased by undisclosed conflicts of interest, that the language used by financial analysts is unnecessarily confusing and that the compensation system applicable to them is based on investment banking deals. Most observers agree that financial analysts and advisors should be required – at a minimum – to disclose clearly any conflict of interest they have with respect to the stock of companies on which they report. In light of the recent financial scandals, however, other issues have also arisen.

For investment banks, security issuance is often their most lucrative business, a situation that may prompt them to recommend, through their brokerage branch, the stock of companies that pay them fees. There must be no conflict of interest between financial analysts and the institutions employing them.

There must be no conflict of interest between financial analysts and the institutions employing them.

The *Sarbanes-Oxley Act of 2002* contains provisions designed to avoid potential conflicts of interest by securities analysts. For example, the Securities and Exchange Commission must adopt rules restricting the pre-publication clearance or approval of research reports by persons either engaged in investment banking activities or not directly responsible for investment research, other than legal or compliance staff, and limiting the supervision and compensatory evaluation of securities analysts to officials who are not engaged in investment banking activities. As well, the Commission must adopt rules establishing structural and institutional safeguards to ensure that securities analysts are

separated by appropriate informational partitions within the investment firm from review, pressure or oversight by those whose involvement in banking activities might bias their judgment or supervision. Rules must also exist requiring securities analysts and brokers/dealers to disclose specified conflicts of interest.

In Canada, in June 2002 the Investment Dealers Association approved new rules designed to limit securities analysts' conflicts of interest, which following comments by provincial securities regulators were strengthened and open for comment until May 2003. Moreover, the Association has issued new disciplinary guidelines that contain more onerous penalties for securities dealers and firms that break Association rules.

The Committee believes … that appropriate safeguards must exist with respect to barriers between financial analysts and the investment banks that employ them.

The Committee believes that conflicts of interest must not exist with respect to financial analysts, and that appropriate safeguards must exist with respect to barriers between financial analysts and the investment banks that employ them. Consequently, the Committee recommends that:

Legislation be introduced that would obviate real or perceived conflicts of interest by financial analysts.

F. Improved Governance

> *Corporate governance is not just about regulatory or structural remedies. It is about culture. It is a culture in which there is a common understanding of the roles of management and of the board. It is a culture in which both parties respect each other's role. It is a culture of continuous open dialogue and communication in which there is strong board leadership. In the end, it is all about people. It is about people doing the right thing, not just what the rules tell them to do.* (Canadian Institute of Chartered Accountants)

In Canada, the current focus on corporate governance continues a long interest in the subject. For example, in December 1994, the Toronto Stock Exchange's Corporate Governance Committee released its report *Where Were the Directors? Guidelines for Improved Corporate Governance in Canada*, often referred to as the Dey Report. The release of the report prompted the Exchange to adopt corporate governance guidelines in 1995, and follow-up reports have been published in 1999 and 2001, including what is known as the Saucier report. During the Committee's study, the report by the committee chaired by Purdy Crawford on the review of Ontario securities legislation was released and witnesses reminded the Committee of earlier reports released by us on the topic of corporate governance.

… witnesses reminded the Committee of earlier reports released by us on the topic of corporate governance.

More recently, a number of corporate governance initiatives have occurred in Canada. In April 2002, the Toronto Stock Exchange proposed changes to its guidelines, expanding the role of the board of directors in the strategic planning process, requiring the appointment of a lead director to manage board meetings where management is not present, requiring all members of the audit committee to be financially literate, and announcing that it will annually review the governance practices of its listed issuers. In August 2002, the Ontario Securities Commission requested that the Exchange re-examine its corporate governance guidelines, and on September 2002 the Toronto Stock Exchange proposed changes that would enhance the independence of boards of directors and require that audit committees be comprised of a majority of unrelated directors; it also indicated that it would

support legislation requiring Chief Executive Officers to certify annually the accuracy of their disclosure.

In June 2002, major Canadian institutional investors established the Canadian Coalition for Good Governance as a vehicle for sharing information and working together for better governance practices at Canadian public companies, and in September 2002 the Canadian Council of Chief Executives released a statement outlining actions that Chief Executive Officers and boards of directors can take to strengthen corporate governance, including proposals for greater independence by boards of directors and audit committees. Moreover, in November 2002 the Society of Management Accountants of Canada released a new corporate governance guideline to improve the performance of boards of directors, Chief Executive Officers and corporations, while in January 2003 the Office of the Superintendent of Financial Institutions released new guidelines on corporate governance for federally incorporated financial institutions.

1. Independence

… Canada has the potential to be a world leader in corporate governance, and thereby enjoy the lower costs of capital and other benefits that are likely to occur as a result.

As noted earlier, Canada has the potential to be a world leader in corporate governance, and thereby enjoy the lower costs of capital and other benefits that are likely to occur as a result. At present, the *Canada Business Corporations Act* requires that at least two non-employee directors be on the board of directors and that, for federally regulated financial institutions, at least one-third of the board must be unaffiliated and no more than 15% of the board can be employees. Moreover, the Toronto Stock Exchange has proposed changes and guidelines regarding independence and board meetings without management, Alberta has a legislative initiative addressing boards and board committees, and the federal government has announced that it would be consulting on corporate governance proposals for changes to the statutes under its jurisdiction.

Nevertheless, corporate governance remains a concern. The Ontario Teachers' Pension Plan Board stressed that Canada cannot afford to gamble with its reputation: "People outside of Canada do not have any reason to invest here in particular … . If they have any question at all about the integrity of our markets, then it is easy for them to say, 'Do not worry about Canada. It is too small anyway.' We must not give people a reason not to invest in our country." Other witnesses also expressed the view that governance is critically important. Caldwell Securities Ltd. told the Committee that "[t]he broader governance concerns are the real threat to the system."

… Canada cannot afford to gamble with its reputation …

The Ontario Teachers' Pension Plan Board gave the Committee a number of recommendations that it believes would give the basic tools needed to do its job better. A number of the Board's recommendations would require amendments to the *Canada Business Corporations Act*. For example, it recommended that the Act be amended to require all publicly traded companies to disclose publicly the results of all votes at shareholder and special meetings in order that interested shareholders are better informed about how much support there is for change, and to remove the limit on the ability of shareholders to talk with each other about company issues and to press for change; in its view, the current limit of 15 other shareholders makes it difficult for them to compare thoughts and ideas with a view to change. The Shareholder Association for Research and Education similarly noted the inability of shareholders to identify other shareholders, and made comments about proxy voting; the issues of disclosure of proxy voting policies and how votes were cast on particular shareholder concerns were also raised by the Social Investment Organization.

The Ontario Teachers' Pension Plan Board also proposed an amendment that would require audit committees to adopt specific recommendations for audit committee duty and performance which are currently voluntary, and recommended legislative change to require the income statement of publicly traded companies to include the cost of stock option plans.

Moreover, the Ontario Teachers' Pension Plan Board proposed an amendment to the federal *Pension Benefits Standards Act* to require all pension fund managers to have proxy voting guidelines and to disclose publicly every year the results and details of their voting, since many proxy votes are currently not used. Finally, the Board proposed an amendment to the *Income Tax Act* to remove the differential treatment of various types of stock-based compensation plans, since the granting of stock options over other types of equity such as share grants and restricted share units is currently favoured. Other witnesses also mentioned the tax treatment of stock plans.

In the United States, a number of entities have a role to play in corporate governance standards – auditor independence standards, board independence, audit committee member independence, independent compensation and nominating committees, mandatory meetings without management, etc. – including the New York Stock Exchange, the NASDAQ and the Securities and Exchange Commission. Moreover, companies must disclose whether they have a code of ethics for senior financial officers.

… investors – including institutional investors – must be provided with the tools to do their job better.

The Committee believes that a number of suggestions made by the Ontario Teachers' Pension Plan Board and other witnesses have merit, and feels that investors – including institutional investors – must be provided with the tools to do their job better. While we did not thoroughly examine the full range of suggestions and recommendations presented to us -- believing that some of them exceeded the scope of our current study -- we feel that they could aid in the restoration of investor confidence through better decision-making about investments, and encourage the Department of Finance to investigate them.

2. Enforcement

In the United States, the *Sarbanes-Oxley Act of 2002* established and increased penalties for a variety of crimes, including: the Chief Executive Officer knowingly signing false financial statements, knowingly altering/destroying/concealing documents during an investigation, and executing securities fraud; penalties for filing false statements with the Securities and Exchange Commission also exist. Moreover, the Chief Executive Officer and Chief Financial Officer must reimburse bonuses and certain other compensation following restatement due to material non-compliance, and the Securities and Exchange Commission has the power to ban directors and officers found guilty of violating securities laws.

Canada's *Criminal Code* has comparable offences, including fraud, fraud affecting the market price of stocks and publishing a false prospectus, all of which carry a maximum penalty of ten years, although there is no maximum for fines. In the United States, prison terms are 20 or 25 years, and fines range from $5 million to $25 million. Bill C-46, An Act to amend the Criminal Code (capital markets fraud and evidence-gathering), introduced in the House of Commons on 12 June 2003, proposes changes to the *Criminal Code*.

Moreover, the *Canada Business Corporations Act* has provisions regarding insider trading, and provincial securities commissions have a variety of powers and penalties, for example with respect to banning unsuitable persons from acting as officers or directors, ordering repayment when investors lose money because of improper conduct, ordering that perpetrators disgorge ill-gained profits, and giving investors in the secondary market a simple procedure for suing companies, directors, officers, underwriters and experts that make misleading or untrue statements or that fail to give full and timely information. The Office of the Superintendent of Financial Institutions has certain authorities in respect of federally regulated financial institutions.

… the Canada Business Corporations Act *has provisions regarding insider trading, and provincial securities commissions have a variety of powers and penalties …*

… the most recent federal budget announced up to $30 million annually in funding for a co-ordinated national enforcement approach …

As well, the most recent federal budget announced up to $30 million annually in funding for a co-ordinated national enforcement approach, with integrated units in financial centres that will strengthen investigation and prosecution of the most serious corporate frauds and market illegalities. It also announced plans to introduce federal legislation on corporate governance, with amendments to the *Canada Business Corporations Act* and financial institution statutes. As well, the Royal Canadian Mounted Police has started work on a RECOL (Reporting Crime On-Line) Centre that would provide a single point of entry to lodge a complaint concerning fraud and would have it directed to the appropriate law enforcement agency for action. The initial phase of the RECOL Centre will create a link between the Royal Canadian Mounted Police, the Ontario Provincial Police and the U.S. Federal Bureau of Investigation.

… we are reminded of the testimony … about the impact of televised "perp walks" on investor confidence.

Despite these legislative and other initiatives and requirements, many witnesses appearing before the Committee mentioned that enforcement within Canada does not occur in the manner it should. The Investment Dealers Association argued for the delegation of certain enforcement powers to a specialized, integrated capital markets investigation unit, which would combine "federal and provincial policy and regulatory resources and expertise to root out market malfeasance." It also suggested that Canada needs special courts to deal with "lengthy, complex white-collar crimes." The need for enhanced enforcement was also mentioned by the Shareholder Association for Research and Education, which told us that "a strong regulatory and enforcement regime is required in areas such as board accountability, corporate disclosure and accounting practices." In the opinion of Mr. Peter Dey, "perhaps the most effective way to improve investor confidence is to sanction in a very significant way those who violate the securities rules. The publicity attached to that might do more to improve investor confidence than all of the regulation one could pass." In this regard, we are reminded of the testimony received in the United States about the impact of televised "perp walks" on investor confidence.

In addressing the issue of enforcement, the British Columbia Securities Commission spoke to the Committee about the "three-legged stool of deterrence in the securities markets. An effective system of deterrence against misconduct has three legs. One leg is regulatory enforcement or regulation generally. The second is criminal enforcement. The third is civil liability." Market Regulation Services Inc. told us that "[d]eterrence comes in many forms: enforcement, guiding principles and education. While many are calling for tougher penalties and more regulation, … enforcement after the fact is actually the least effective form of deterrence."

Like our witnesses, the Committee believes that greater enforcement of existing, and any future, requirements is needed. While legislation to protect investors contributes to confidence, that confidence is greatly diminished, in our view, if instances of insider trading and other violations are not suitably punished. Initiatives such as the national enforcement approach and the RECOL Centre are likely to result in increased investor confidence, but we believe that more must be done. In particular, the political will is needed to prosecute offenders with appropriate penalties, and adequate resources must be devoted to ensuring that all stakeholders comply with legislative and regulatory requirements. From this perspective, and notwithstanding Bill C-46, the Committee recommends that:

… *the political will is needed to prosecute offenders with appropriate penalties, and adequate resources must be devoted to ensuring that all stakeholders comply with legislative and regulatory requirements.*

The federal government review current legislative and regulatory provisions regarding fraud, insider trading and other offences, including the adequacy of any penalties, with a view to implementing any needed changes as expeditiously as possible. It should also examine the extent to which existing procedures and resources are adequate to ensure that instances of corporate corruption are properly prosecuted.

3. Whistleblower Protection

Whistleblower protection is provided in the United States through provisions in the *Sarbanes-Oxley Act of 2002*. In particular, complaint mechanisms, civil remedies and criminal sanctions are addressed. According to the legislation's provisions, a company cannot discharge, demote, suspend, threaten, harass or in any other manner discriminate against an employee because the employee has provided information, caused information to be provided or assisted an investigation regarding any conduct. In Canada, the *Canada Business Corporations Act* requires directors and officers to report material errors and misstatements in financial statements to the auditor and the audit committee, and auditors are likewise required to inform directors of such issues. Bill C-46, noted earlier, also contains provisions for whistleblower protection.

Mr. Peter Dey, among other witnesses, expressed his support for whistleblower protection, and told the Committee about independent services, published within the organization, that give employees a 1-800 number or access to some objective party who receives inquiries.

Often, it is employees – in addition to directors and officers – who are best positioned to detect irregularities.

The Committee too believes that whistleblower protection must exist within Canada, both generally and with respect to situations involving financial reporting irregularities and failed corporate governance. Often, it is employees – in addition to directors and officers – who are best positioned to detect irregularities. They must know to whom these situations should be reported, and should be assured that they will not suffer negative repercussions as a consequence of taking action. In our view, whistleblower protection is another measure that, when implemented, is likely to contribute to restored investor confidence. For this reason, and notwithstanding Bill C-46, the Committee recommends that:

Legislation be introduced that would establish whistleblower protection for employees with respect to the reporting of financial irregularities and failed corporate governance.

4. The Chair and the Chief Executive Officer

A number of witnesses appearing before the Committee commented on the relationship between the Chair of the Board of Directors and the Chief Executive Officer, arguing that a separation of these functions must occur. According to Mr. William Dimma, "[e]veryone should be accountable to someone. You cannot report to yourself. The [roles of Chair and Chief Executive Officer] are designed to be complementary through what has been called creative tension and [constructive] interaction. You really cannot do that effectively if one person is playing both roles. … [The Chief Executive Officer] of a widely held company must report unequivocally and unambiguously to shareholders through the board as a whole led by an independent chairman. … Where the chairman and [Chief Executive Officer] roles are combined, this kind of reporting not only does not happen, it cannot happen."

A number of witnesses appearing before the Committee commented on the relationship between the Chair of the Board of Directors and the Chief Executive Officer, arguing that a separation of these functions must occur.

Mr. William Dimma also argued that the Chair should not be a previous Chief Executive Officer or other insider, and should not be a provider or previous provider of services to the organization. Moreover, he or she should be compensated fairly and competitively, at the same rate per hour or *per diem* as the Chief Executive Officer.

Another of the Committee's witnesses, Mr. Josef Fridman of McGill University, shared his view that "[i]t would appear illogical that the person who is responsible for charting a course of action … should chair a meeting where his [or her] proposal is being addressed. Furthermore, … this issue is not addressed, in practice, by appointing a 'lead director,' … . A lead director, in practice, only replaces the [Chief Executive Officer]/Chairman on an exceptional basis … ."

… the role of Chair of the Board of Directors and Chief Executive Officer must be separate.

Like our witnesses, the Committee believes that the role of Chair of the Board of Directors and Chief Executive Officer must be separate. We feel that this separation would contribute to enhanced investor confidence in Canada, and would provide investors with an enhanced sense that proper oversight of the Chief Executive Officer's actions is occurring. Regarding lead directors, our view mirrors that of our witness. In our opinion, the appointment of a lead director is inadequate to meet the independence that we believe should exist. From this perspective, and consistent with a recommendation made by us in our August 1998 report, *Corporate Governance*, the Committee recommends that:

The role of Chief Executive Officer and Chair of the Board of Directors be split, bearing in mind the special circumstances that may exist with closely held companies and small and medium-sized businesses.

LAX AUDITING AND ACCOUNTING STANDARDS AND OVERSIGHT

A. Financial Reporting

> *Canada's role is not to be a follower; it should be – as it has always been – to be an honest broker between the rules and the principles, the left and the right, and to help strike a balance that is in Canada's interest ultimately of a better system at the global level.* (Centre for Collaborative Government)

Incomplete and inaccurate corporate disclosure and financial reporting is a fundamental hindrance to the working of effective capital markets, since they negatively affect investor confidence. A lack of financial transparency is an important issue for every stakeholder, including shareholders, investors, lenders and auditors. In the aftermath of recent scandals, many investors feel betrayed, and see an opportunity to improve companies' disclosure of essential information and to enhance the quality and clarity of financial statements. Information disclosed is often incomplete and lacks specificity, such as the assumptions used. Even when significant accounting matters are disclosed in financial statements, they can appear in different footnotes throughout the statements and the language used may be overly technical or abstract, with the result that the reader is unable to understand the substance of the information provided.

A lack of financial transparency is an important issue for every stakeholder, including shareholders, investors, lenders and auditors.

1. Generally Accepted Accounting Principles

Generally Accepted Accounting Principles – or GAAP – are a set of standards intended to bring clarity and uniformity to the financial reporting of corporations, which allows

comparisons over time and across organizations. In Canada, the *Canada Business Corporations Act*, as well as provincial corporations and securities legislation, generally require that companies prepare financial statements in accordance with GAAP. The Accounting Standards Board sets accounting standards, with public oversight of the Board provided by the Accounting Standards Oversight Council, which was created by the Canadian Institute of Chartered Accountants. These standards are distinct from the Generally Accepted Assurance Standards, or GAAS, which are set by the Assurance Standards Board and govern the conduct of independent audits.

Witnesses shared with the Committee a variety of views about U.S. GAAP, Canadian GAAP, and whether one is preferred to the other …

Witnesses shared with the Committee a variety of views about U.S. GAAP, Canadian GAAP, and whether one is preferred to the other, since they often yield different results. In the view of Professor Daniel Thornton of Queen's University, "[w]e cannot import U.S. GAAP … into Canada without the necessary regulatory infrastructure." Others pointed out that U.S. GAAP resulted in several corporate scandals; from this perspective, they questioned why we would want U.S. GAAP in Canada.

The Accounting Standards Board suggested that while a movement to U.S. GAAP might have considerable appeal for Canadian public companies that are listed in the United States, there are a significant number of Canadian companies that are listed in Canada only and consequently have no interest in U.S. GAAP. Moreover, the Board "has been eliminating most of the major differences on the major points of principle between Canadian and U.S. GAAP. This makes it easier for a Canadian company that wants to comply with both … GAAP to do so." The process is referred to as harmonizing, which is not the same as adopting U.S. GAAP. A recommendation by PricewaterhouseCoopers Canada would supplement global GAAP with "a second-tier of industry-specific standards to allow for apples-to-apples comparisons between similar companies in the same industry" and a third tier for "company-specific information."

During the Committee's hearings in Ottawa and the United States, witnesses discussed the extent to which global accounting standards are needed, or are being pursued. Mr. Robert Herz, Chairman of the U.S. Financial Accounting Standards Board, or FASB, informed the Committee that the Financial Accounting Standards Board – the private sector body that develops accounting and auditing standards in the United States – is actively involved in discussions with the International Accounting Standards Board, or IASB, with a view to harmonizing standards globally. We also learned that European Union countries are expected to have a common standard in place by 2005. In the view of the Certified General Accountants Association of Canada, "[t]he debate should not be about whether we move to international standards, but rather when and how."

To date, standards in the United States have been relatively rules-based, while those in Canada and internationally have been relatively principles-based and judgment-driven, recognizing that, as indicated by the Centre for Collaborative Government, "every system combines rules and principles … . It is not a rules versus principles debate in the final analysis; it is a question of which ones and which balance." The Ontario Teachers' Pension Plan Board informed the Committee that it "prefer[s] global standards to different national standards." Global standards could also help to alleviate the concern expressed by Caldwell Securities Ltd. that "Americans always see 'different from them' as inferior to them."

To date, standards in the United States have been relatively rules-based, while those in Canada and internationally have been relatively principles-based and judgment-driven …

The Committee supports the notion of global auditing and accounting standards, since we believe that such an approach is fully consistent with the global marketplace within which businesses operate, issuers issue and investors invest. We are encouraged by the testimony of Mr. Robert Herz and others that global accounting standards are likely to be adopted, possibly as early as 2005. From this perspective, the Committee recommends that:

The federal government take a leadership role and work with Canadian stakeholders in undertaking discussions with the U.S. Financial Accounting Standards Board, the International Accounting Standards Board and others that will result in all relevant parties working expeditiously toward the development of global uniform accounting standards.

2. Standard Setting and Changes to Standards

In the rapidly changing world of finance, corporate practices and financial instruments are constantly evolving.

In the rapidly changing world of finance, corporate practices and financial instruments are constantly evolving. Consequently, some have argued that accounting standards and rules should be updated regularly to account for changing practices because they may represent potential areas for abuse. Professor Thornton told the Committee that, for about the last decade, the finance profession has been "one step ahead" of the accounting profession in designing "exotic" instruments and transactions. In his opinion, while designing a new or exotic financial instrument can take only a few minutes and be instituted immediately, accounting standard setting is a "rather ponderous" process.

Some argue that accountants themselves are best positioned to design and update accounting principles because they, to a greater extent than any government agency, are aware of evolutions in financial and accounting systems, and can therefore react more quickly. Others believe that better government oversight of self-regulating standard-setting organizations is needed. In the view of the Certified General Accountants Association of Canada, "in the interests of propriety and integrity, a body operating independently and at arm's length from all professional accounting bodies needs to be vested with the responsibility for the setting and oversight of accounting standards in Canada." It also told the Committee that "in an effort to put some independence into the process, … all of the industrialized countries, except Canada and Denmark, have separated the role of accounting standard setting from the accounting profession."

Rosen & Associates Limited informed the Committee that "Canada is unique in the world among the large nations because it gives both auditing and accounting responsibilities to the same group." In its view, Regulation 44 to the *Canada Business Corporations Act* should be changed so that a separate rule-making body would determine accounting rules.

Initiatives are underway in Canada. In May 2002, the Accounting Standards Oversight Council, which was established in 2000 and oversees the Accounting Standards Board, held hearings to discuss the implications of the Enron scandal for Canadian accounting standards, and during Summer 2002 the Board released a number of guidelines. Moreover, in September 2002 the Council held a meeting to discuss the expensing of employee stock options and the process for standard setting in Canada. As well, in October 2002 the establishment of the Auditing and Assurance Standards Oversight Council was announced. This Council, which has the majority of its nine to 12 members selected from outside the auditing profession, oversees the setting of auditing and assurance standards. Moreover, the Committee is aware of the work done by the Certified General Accountants Association of Canada and its release of a document entitled *A Question of Standards: Accounting in the 21st Century* and another document which compares Canada's approach to standard setting with that of a number of other developed countries.

The Committee believes that constant vigilance is required to ensure that accounting standards and rules keep pace with evolutions in corporate practices and financial instruments. What is not clear to us, however, is who should have the responsibility in this regard. For this reason, the Committee recommends that:

… constant vigilance is required to ensure that accounting standards and rules keep pace with evolutions in corporate practices and financial instruments.

The federal government convene a meeting of all stakeholders to discuss the entity that should have responsibility for the setting of – and, importantly, revisions to – accounting standards and rules. The government must take a leadership role in ensuring that the

entity to which responsibility is given has the necessary independence, accountability and transparency to safeguard investor confidence.

3. Certification of Financial Statements

In the United States, the *Sarbanes-Oxley Act of 2002* mandates the Securities and Exchange Commission to require the Chief Executive Officer and the Chief Financial Officer of a public company to certify that periodic financial statements filed with the Commission fairly present, in all material respects, the results of operations and financial condition of the company. Moreover, the Commission must require the disclosure of all material off-balance-sheet transactions, arrangements, obligations and other relationships that may have a material current or future effect on the financial condition, results of operations, liquidity, capital expenditures or resources, or significant components of revenues or expenses of a public company. As well, rules must be issued requiring a public company to disclose whether or not – and if not, the reason why not – it has adopted a code of ethics for senior financial officers of a public company and whether its audit committee includes at least one member who is a financial expert.

In Canada, the Canada Business Corporations Act *and securities regulations require directors to approve financial statements.*

In Canada, the *Canada Business Corporations Act* and securities regulations require directors to approve financial statements. Although directors are not required to attest to their quality, the statements must not be misleading or untrue. Moreover, a September 2002 statement on corporate governance by the Canadian Council of Chief Executives expressed support for Chief Executive Officer certification of annual and quarterly reports.

Many witnesses appearing before the Committee mentioned the certification of a company's financial statements by the Chief Executive Officer and the Chief Financial

Officer of the company, although there was some scepticism about the extent to which these individuals could truly know whether the financial statements fairly present, in all material respects, the results of operations and financial condition of the company.

It appears to the Committee that certification of financial statements by the Chief Executive Officer and other senior officers of a company provided the witnesses – and thus investors – with some level of confidence. Recognizing the need for this investor comfort and the statement by the Canadian Council of Chief Executives, and notwithstanding the approval of financial statements by directors that is currently required, the Committee recommends that:

… certification of financial statements by the Chief Executive Officer and other senior officers of a company provided the witnesses – and thus investors – with some level of confidence.

Legislation be introduced that would require an organization's Chief Executive Officer and its Chief Financial Officer to certify that the annual financial statements fairly present, in all material respects, both the results of the organization's operations and its financial condition.

4. The Requirement for High-Quality Reports

A number of the Committee's witnesses provided their thoughts on financial reporting, including Professor Thornton, who argued that "[t]here is a financial reporting quality chain that consists of several links forged in a competitive international market. Strong regulatory oversight … is an important mediating factor. … [R]egulatory oversight can only temper a chain that is already strong. … If information is poor or if the other links are weak, the chain will still fail to produce quality financial information."

In his view, there are four links in the financial reporting quality chain:

- management incentives and attitudes;
- audit quality;
- audit committee expertise; and
- strong accounting standards.

Regulatory oversight is the mediating factor, in Professor Thornton's view, and he believes that the U.S. Securities and Exchange Commission is the world's premier regulator, although he cautions that better regulation and strong oversight can only temper a chain that is already strong. He believes that regulatory oversight in the United States is preferable to that which occurs in Canada.

Professor Thornton also elaborated on what he believes is an emerging consensus on five essential qualities for financial reporting, in particular that they be as clear and simple as possible; reveal the results of business segments through the eyes of management; be forward looking and timely; segregate non-recurring items from normal revenues and expenses and convincingly explains why they are non-recurring; and identify intangible assets and key performance indicators, including those that accounting does not explicitly recognize, such as a high-quality workforce or patents not shown at market value. A subset of high-quality financial reporting is accounting or earnings quality, which has three attributes: it adheres to generally accepted accounting principles but also discloses cashflow; it is neutral; and it discloses the management basis for all estimates on the financial statements.

Another report that is required is the Management Discussion and Analysis report, or MD&A.

Another report that is required is the Management Discussion and Analysis report, or MD&A. In November 2002, the Canadian Institute of Chartered Accountants issued new guidance in this regard, designed to assist management in preparing this statement in order to aid investors, potential investors, analysts and others in understanding how the organization has created shareholder value to date, and how it intends to continue to do so in the future. A number of witnesses argued that this statement is important in helping

both the board of directors and investors, since it provides a broader context within which interested parties can understand the organization, its performance and management's assessment of its future prospects. Some, including the Canadian Institute of Chartered Accountants, assert that "enhanced MD&A disclosure leads to [a] lower cost of capital, better capital allocation decisions, and improved corporate governance."

The Committee supports the preparation of the Management Discussion and Analysis report, believing that it allows interested parties to assess a company's financial statements in a broader context, hopefully leading to better investment decisions and thereby enhanced returns and confidence, as well as a lower cost of capital.

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B. Oversight

> *In today's world ... the [Canadian Public Accountability Board] represents an appropriate balance between public oversight, on the one hand, and self-regulation on the other. What is also interesting, and some find remarkable, is that unlike the approach south of the border, this regime, with all its federal/provincial jurisdictional issues, will be put in place by way of contract and agreement with the major firms responsible for performing public audits without any legislation.* (PricewaterhouseCoopers Canada)

1. The Canadian Public Accountability Board

In July 2002, the creation of an independent public oversight system to oversee the quality and integrity of audits of publicly listed companies conducted by Canadian accounting firms was announced.

In July 2002, the creation of an independent public oversight system to oversee the quality and integrity of audits of publicly listed companies conducted by Canadian accounting firms was announced. Created by securities regulators across Canada, the federal Superintendent of Financial Institutions and the Canadian Institute of Chartered Accountants, beginning in October 2002 a new, eleven-member Canadian Public Accountability Board assumed supervision of Canada's six largest auditing firms; within three years, it will also assume supervision of Canada's other smaller auditing firms. The mission of the Board is "to contribute to public confidence in the integrity of financial reporting of Canadian public companies by promoting high quality, independent auditing." The Board's five-member Council of Governors is comprised of: the Chair of the Canadian Securities Administrators; the Chairs of two provincial securities commissions; the Superintendent of Financial Institutions; and the President and Chief Executive Officer of the Canadian Institute of Chartered Accountants. The Council appoints the Chair and Board members.

Seven members of the Board, including the Chair, are

from outside the accounting profession. Mr. Gordon Thiessen, former Governor of the Bank of Canada, was appointed as the Canadian Public Accountability Board's founding Chair in October 2002. Board appointees are expected to have several years of experience as a director of a large public company, a large public sector organization or a large not-for-profit organization or charity and, preferably, will have served as an audit committee member. As well, Board members are expected to be well-informed about corporate governance and business issues, to be credible trustees of – and advocates for – the public, to have a breadth and diversity of professional experience, insight and judgment, and to have adequate time to perform the duties of the position.

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Major firms undertaking audits of public companies are reviewed annually by the National Inspection Unit, and their quality-control policies and procedures are subject to more comprehensive review. Sanctions will be applied in situations where firms fail to remedy significant deficiencies identified by the Board, and this failure will be communicated to appropriate regulators, who may take action. Sanctions also include limits on the range of practice and referral of disciplinary actions to provincial accounting bodies.

Rules exist with respect to rotation of the audit engagement partner at least every seven consecutive years, a second partner review of every audit in order to assess objectively the appropriateness of the key judgments made and the conclusions reached in formulating the audit report, and stringent standards on auditor independence, including limits on the types of consulting services that can be provided to public company audit-clients, specifically with respect to internal audit services, information technology system design and implementation services, valuation services, legal services, actuarial services and corporate finance services.

The Certified General Accountants Association of Canada expressed to the Committee its disappointment with the "non-inclusive" structure of the Canadian Public Accountability Board, since Canada has three recognized accounting bodies but only one is represented on the Board.

The group urged legislative and regulatory reforms to ensure transparency and independence in accounting standard-setting in Canada. Without a more inclusive structure, it posed the following analogy: "Would you make one of the big three car manufacturers responsible for setting safety standards for the entire automotive industry? That is the situation we have here." Similarly, the Certified Management Accountants of Canada argued that the Board fails to consider the activities of certified management accountants, who are involved in auditing, and suggested that "a more inclusive approach would bring greater transparency to, and public confidence in, [the Board's] activities."

Other witnesses, however, expressed support for the Board. PricewaterhouseCoopers Canada, for example, told us that "the Canadian Public Accountability Board represents an appropriate balance between public oversight on the one hand and self-regulation on the other."

Since the investor confidence objectives of the Canadian Public Accountability Board mirror those of the Public Company Accounting Oversight Board in the United States, Canada is seeking an exemption for Canadian audit firms from the *Sarbanes-Oxley Act of 2002* requirements regarding oversight of domestic and foreign auditors of public companies subject to U.S. federal securities laws by the Oversight Board. The Committee is aware of the ongoing discussions in this regard, and notes that the mandate, operations, etc. of the Canadian Public Accountability Board and the U.S. Public Company Accounting Oversight Board are similar. We are, however, somewhat concerned about the representations made to us about the composition of the Canadian Public Accountability Board and, for this reason, urge the Board, securities regulators, the federal Superintendent of Financial Institutions and the Canadian Institute of Chartered Accountants to revisit the Board's composition with a view to greater inclusiveness. More generally, we believe that, at some future date, consideration should be given to providing a legislative basis for the Canadian Public Accountability Board, with federal agency oversight. This change would mirror the situation that currently exists in the United States.

… we believe that, at some future date, consideration should be given to providing a legislative basis for the Canadian Public Accountability Board, with federal agency oversight.

2. The U.S. Public Company Accounting Oversight Board

In many ways, the Canadian Public Accountability Board resembles the U.S. Public Company Accounting Oversight Board established by the *Sarbanes-Oxley Act of 2002*. The independently funded, non-profit Board oversees the audit of public companies that are subject to securities laws and related matters, and registers and periodically inspects public accounting firms that prepare audit reports for public companies. Moreover, it is responsible for establishing or adopting auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for public companies. Oversight, power of appointment and enforcement authority over the Board has been given to the Securities and Exchange Commission, unlike the situation in Canada where oversight and enforcement over the Canadian Public Accountability Board has not been assigned.

… *oversight and enforcement over the Canadian Public Accountability Board has not been assigned.*

The U.S. Public Company Accounting Oversight Board is smaller than its counterpart in Canada, being comprised of five full-time members -- all of whom have a demonstrated commitment to the interests of investors and the public as well as an understanding of the financial disclosures required of public companies by U.S. securities law and of the obligations of accountants with respect to audit reports -- and two members who are or have been certified public accountants. Board members are prohibited from engaging in any other professional or business activity while serving, and in general may not share in any profits of, or receive payments from, a public accounting firm, other than fixed continuing payments.

THE INCENTIVES PROVIDED BY EXECUTIVE COMPENSATION SYSTEMS

Research has shown that executives, as is true of most people, tend to pursue actions that will maximize their compensation. It is therefore very important that the compensation system promote executive behaviour that fosters achievement of organizational goals and serves the long-term best interests of the organization. (Professor Richard Long)

In order to provide executives with an incentive to focus on the long-term health of the organization, long-term incentives … are an increasing portion of chief executive compensation …

In general, the main components of executive compensation are: base pay; short-term incentives; long-term incentives; benefits; and perquisites. For many corporate executives in North America – particularly in the United States – base pay represents a relatively small portion of their total earnings, with the largest portion coming from the exercise of stock options, followed by earnings from other incentives and bonuses. In order to provide executives with an incentive to focus on the long-term health of the organization, long-term incentives – such as stock options, restricted stock and long-term unit/share plans – are an increasing proportion of chief executive compensation, and may be an important factor in the recruitment and retention of executives.

Since the incidents of corporate corruption, questions have arisen about such aspects of compensation as stock options, aligning executive and shareholder interests, and the level and range of executive compensation. Certain initiatives are already underway in Canada in a number of these areas. For example, in June 2002 the Canadian Securities Administrators made a proposal that would require corporate information circulars to include the disclosure of new equity compensation plans for staff, while in August 2002 the Toronto Stock Exchange proposed new rules requiring that listed companies must obtain shareholder approval prior to adopting some types of compensation

arrangements for employees. The September 2002 statement by the Canadian Council on Chief Executives proposed linking executive compensation to short- and long-term corporate performance. Finally, in November 2002 the Canadian Securities Administrators released results of a review of compliance by public companies with executive compensation disclosure requirements.

It is important to examine the incentives for behaviour provided by compensation systems and the manner in which various compensation items are treated within the tax system. Professor Long told the Committee that "rather than rewarding good management and improving company performance, many executive compensation systems today actually create incentives for mismanagement and are harmful to company performance, shareholder interests and the Canadian business sector as a whole." In his view, there are three main problems with executive compensation today: the amount, the structure and the process by which it is determined.

It is important to examine the incentives for behaviour provided by compensation systems and the manner in which various compensation items are treated within the tax system.

A. The Expensing of Stock Options

> *In terms of the stock option issue, stock [options are] not by definition bad and not by definition counter to the interests of the shareholders – far from it. It is how those option regimes are administered that is important.* (Advisory Group on Corporate Responsibility Review)

In the current debate, the treatment of stock options – in particular, whether they should be treated as an expense – is an important issue. According to one view, if stock options are viewed as an element of compensation, then they should be treated in the same manner as salaries and other employee-related costs. On the other hand, stock options may be difficult to value and expensing them could confuse investors. Nevertheless, it must be recognized that stock options do result in diluted ownership for shareholders.

In the current debate, the treatment of stock options – in particular, whether they should be treated as an expense – is an important issue.

The issue of whether stock options should be treated as an expense was not addressed within the *Sarbanes-Oxley Act of 2002*. Nevertheless, a number of companies in the United States – as well as in Canada – have announced that they will treat employee stock options as an expense.

In 2001, the Canadian Accounting Standards Board issued an accounting standard setting out financial reporting requirements for Canadian companies. This standard permits the disclosure of the effect of employee stock options in a footnote, rather than recording the stock options in the organization's income statement.

… the Accounting Standards Board advocated a global standard on stock-based compensation, and expressed support for the expensing of all stock-based payment transactions with stock options accounted for at fair market value.

Nevertheless, in December 2002 the Board issued a proposal that would require the expensing of employee stock-based compensation transactions, and that highlighted differences between its proposal and an International Accounting Standards Board (IASB) draft proposal on share-based payments and its proposal. In responding to the IASB draft proposal in March 2003, the Accounting Standards Board advocated a global standard on stock-based compensation, and expressed support for the expensing of all stock-based payment transactions with stock options assessed for at fair market value. The comment period for the Accounting Standards Board's proposal ended 31 March 2003, and the Board is currently evaluating the comment letters received. As well, in May 2003 the International Accounting Standards Board eliminated major differences between its proposal and the methodology currently used in Canada and the United States to measure the fair market value of employee stock options and to record that value as an expense.

The Accounting Standards Board informed the Committee that the most commonly used method of accounting for employee stock options is the intrinsic value method, whereby no compensation expense is generally reported provided the exercise price is at least equal to the market price when the option is granted. Since this is most often the case, companies rarely report any expense in their income statement for employee stock options. We were also

told that this valuation method fails the desired tests of producing information that is "neutral, unbiased and [a faithful reflection of] economic reality." It is for this reason that the Board, in 2002, issued the proposal that would measure stock-based compensation at fair market value and record it as an expense in the income statement. The Board indicated that both the International Accounting Standards Board and the U.S. Financial Accounting Standards Board have adopted the same two fundamental principles with respect to stock-based compensation, with a view to finding a single, global standard. It is hoped that a new standard will be in place for 1 January 2004.

Nevertheless, the Committee also learned that the reliability of option pricing models is a concern for some, although we were told by the Accounting Standards Board that accounting boards "have consulted various experts with substantial experience in option pricing. … [T]he technology exists today to price employee stock options reliably and without undue cost or effort. Option pricing is already a crucial part of our capital markets." The Board intends to hold a meeting to discuss concerns and the appropriate solutions for pricing employee stock options of small-cap companies, thinly traded companies and private companies.

… the Committee also learned that the reliability of option pricing models is a concern for some …

Two particular option pricing models – Black-Scholes and a binomial model – were noted by the Board, which also told us that "[t]here is widespread concern that option pricing models tend to overstate the true fair market value of options and that inconsistent application of measurement techniques could impair comparability among companies." The Board also told us, however, that "there is no requirement to use any particular model provided the following … factors are taken into account:

- exercise price;
- expected life (often shorter than the contractual term);
- current price of underlying stock;

- expected volatility (which may differ from historical volatility);
- expected dividends on the stock; and
- risk-free interest rate for the expected life (based on zero-coupon Canadas with a remaining term equal to the expected life)."

The Committee was told about the likely impact on reported earnings of the expensing of stock options, which is a concern for some. The Accounting Standards Board shared with us the results of a report which found that the impact "depends very much on the facts and circumstances of the individual company."

In the Committee's view, stock options are an element of compensation, and must be treated as an expense like any other compensation item.

In the Committee's view, stock options are an element of compensation, and must be treated as an expense like any other compensation item. We have no opinion on which method is appropriate for valuation of options, but believe that the forthcoming meeting of the Accounting Standards Board will make a useful contribution in this area.

B. The Alignment of Interests

> *The market, with the right information, will be able to discipline boards of directors, compensation committees and [Chief Executive Officers] so that the compensation systems align more effectively the interests of key employees of the corporation with the longer term interests of institutional and public shareholders.* (Mr. Peter Dey)

Some observers have questioned whether stock options should be provided at all. On the one hand, they are thought to provide executives with an incentive to align their interests with those of shareholders, a change that some analysts see as an improvement on the absence of any management stake in the company which characterized executive compensation in

the 1970s and early 1980s. Whether stock options have been successful in aligning the goals of executives with those of stakeholders is uncertain, however. Stock options cause dilution for shareholders and could provide an incentive to take actions that will maximize share value in the short term, even if the result is detrimental to the long-term health of the organization. This latter concern, however, can be addressed through such mechanisms as vesting requirements that would only allow executives to exercise their options at a somewhat distant date, and perhaps only after they are no longer employed by the company. As well, some analysts believe that, more generally, tighter shareholder and director control on the manner in which stock options are awarded is needed.

Another problem is the separation that may exist between executive and firm performance on the one hand, and share price on the other. In some cases, mediocre decision making and marginal firm performance have resulted in executives realizing substantial sums from their stock options as the market climbed, but in other cases exemplary decision making and firm performance have not always resulted in increased share price. From this perspective, some analysts believe that compensation committees should reward only genuinely superior performance, and that executives should not benefit if a firm's share price rises for such extraneous reasons as a fall in interest rates, a rise in the stock market or for other reasons. Consistent with this approach, rewards linked to share price should, perhaps, be triggered if the firm outperforms the market as a whole or an industry "peer" group, or on the basis of sustained performance at a company rather than short-term earnings.

In some cases, mediocre decision making and marginal firm performance have resulted in executives realizing substantial sums from their stock options as the market climbed …

Professor Long told the Committee that while executive stock options should focus executive attention on raising share prices and thus shareholder wealth, thereby linking executive compensation to executive performance as measured by share price, "[t]he problem is that share price is not a good measure of executive performance; it is not even a good measure of corporate performance. Studies show that about two-thirds of the variation in share price has nothing to do with the

performance of the firm. It has to do with industry conditions, economic conditions and market conditions."

A variety of possibilities for closer alignment of executive and shareholder interests were suggested by witnesses, including: long vesting times for options, perhaps a number per year for five years; a requirement that options not be given until certain performance criteria are met over a long period of time; a requirement that, when exercised, shares be held for some prescribed period of time; a slowed vesting period; a requirement that, if an individual leaves the organization, the stock cannot be sold for a period of time; a requirement that stock be held until departure or retirement; and a requirement that a significant portion of the after-tax proceeds from the exercise of stock options remain vested in company stock for a minimum period.

The Committee acknowledges that stock options are one element of a compensation package that could result in the alignment of executive and shareholder interests. Given concerns about potential adverse effects and unintended consequences, however, we question whether stock options are the best tool to use to bring about this alignment in most cases. We are particularly concerned about ensuring that the elements of the compensation package for executives attain two objectives: an incentive to focus on long-term increases in shareholder value; and decision making focussed on benefits for shareholders, rather than self-interest.

… greed … must not be permitted to destroy investor confidence.

In the Committee's view, greed – which prompts some executives and directors to pursue their self-interest at the expense of shareholders and the health of the Canadian economic system – must not be permitted to destroy investor confidence. The prospect of a steady increase in personal wealth must not be allowed to result in a steady decrease in ethical corporate behaviour.

The Committee believes that a fundamental cause of unethical corporate behaviour is excessive executive

compensation. Notwithstanding the incentive that some compensation committee members might have to approve high levels of compensation for the Chief Executive Officer – since, for example, they may be Chief Executive Officers with the Chief Executive Officer in question serving on their compensation committee – we feel that vigilance must occur and due care taken to design an executive compensation system that provides the proper incentives. We are convinced that there is a fundamental responsibility on Chief Executive Officers themselves to consider the public interest and investor confidence in the actions that they take. They must support an ethical corporate governance culture and take responsibility for ensuring that this culture permeates the organization.

We are convinced that there is a fundamental responsibility on Chief Executive Officers themselves to consider the public interest and investor confidence in the actions that they take.

C. The Level and Range of Executive Compensation

> *Abuses of compensation terms have been a major contributor to the dramatic loss of investor confidence and public trust in the governance of publicly traded companies and in the integrity of financial markets.* (Association de protection des épargnants et investisseurs du Québec)

Another issue related to executive compensation is the determination of the level and range of compensation items received. In large corporations, it is typically the case that a compensation committee struck by the company's board of directors determines executive pay. This committee, which is normally comprised of several independent directors, often hires a compensation firm to provide data on the compensation of "comparable" chief executives, with these data used as a basis for compensation decisions.

Limited evidence was received from witnesses about the level and range of executive compensation, although Aon Consulting told the Committee that there are five components to executive compensation: base salary, pension benefits and perquisites, which constitute fixed compensation, and

short-term and long-term incentives, which constitute variable compensation. We were informed that levels of compensation – and the allocation between fixed and variable compensation – vary with the function and the level of the position in the organization, the size of the organization, the industry and individual negotiating ability. In the opinion of the witness, long-term incentive levels should be identical to the levels of short-term incentives in order to provide incentives for a focus on short-run operating profitability and long-run growth and value creation.

Caldwell Securities Ltd. argued that "the insane levels of management compensation, usually through the abuse of stock options, is a major contributor to our present circumstance. … [C]ompensation committee members [have said] that they have to pay presidents of … companies significant amounts for fear they are going to the U.S." This view was also expressed by Mr. Purdy Crawford, who told the Committee that "the problem in Canada is that we are very much one market with the U.S., and we have to recruit people from the world, or at least from North America, and we have to deal with the compensation levels of the U.S."

The link between executive compensation and corporate performance – or lack thereof – was noted by some witnesses.

The link between executive compensation and corporate performance – or lack thereof – was noted by some witnesses. The Shareholder Association for Research and Education indicated its support for executive compensation "more in line with corporate performance and in … relation to the salaries of the employees of a company," and saw no harm in submitting plans for the compensation of senior corporate officers to shareholders for approval. According to the Investment Dealers Association, "[w]hat makes compensation obscene is that not only is it large but it is unrelated to corporate performance."

The Committee shares the views of witnesses who commented that regulators cannot, and should not, determine either the level or type of executive compensation, although they should establish rules that would ensure compensation

committee independence. We believe that the incentives inherent in the structure of executive compensation systems have the potential either to promote the type of corporate decision making desired by shareholders, or to have completely the opposite effect. From this perspective, we reiterate the view that compensation committees must exercise due care in the establishment of executive compensation systems, and the systems must be structured in a way that will allow desirable decision making to occur.

… *the incentives inherent in* … *executive compensation systems have the potential either to promote the type of corporate decision making desired by shareholders, or to have completely the opposite effect.*

CONCLUSION

> *[T]he best thing directors can do to guard against misbehaviour, compromised accounting, fraud, et cetera, is to be satisfied with the values and integrity of the [Chief Executive Officer] and that the [Chief Executive Officer] and other senior officers have spread their values throughout the culture of the organization – that is, they walk the talk*. (Mr. Purdy Crawford)

… actions must be taken to restore investor confidence in publicly traded companies and capital markets, since this confidence is needed for sustained economic growth.

The Committee launched its study in an effort to learn the circumstances resulting in recent corporate scandals in the United States, and to assess whether similar circumstances exist in Canada with a view to actions that would avoid such a result here. Having heard from a large number and broad range of witnesses, and having travelled to the United States, the Committee remains convinced that actions must be taken to restore investor confidence in publicly traded companies and capital markets, since this confidence is needed for sustained economic growth. It is fairly well accepted that corporate scandals diminish investor confidence, and lead to higher capital costs, decreased shareholder wealth and, ultimately, lower economic prosperity.

… we feel that regimes that involve mandatory disclosure and voluntary compliance, voluntary rules, or policies developed by boards and self-regulating organizations do not go far enough and do not have the same effect as legislated and regulatory requirements.

The Committee is fully aware of the actions taken recently by a number of stakeholders in Canada, including professional organizations, securities commissions, stock exchanges, governments and others. We applaud their initiatives, feeling that they will contribute to restored investor confidence. Nevertheless, we feel that regimes that involve mandatory disclosure and voluntary compliance, voluntary rules, or policies developed by boards and self-regulating organizations do not go far enough and do not have the same effect as legislated and regulatory requirements. As indicated to us by the Ontario Securities Commission, "[t]he integrity of our capital markets is too important to be left entirely to voluntary action." It was for this reason that, in a number of areas, the Committee has recommended legislative initiatives.

A key question that must be answered for the future is: what federal government efforts should be undertaken to restore investor confidence? Throughout this report, the Committee has urged stakeholders to take certain actions. Specific recommendations by the Committee to the federal government are difficult to make for at least two reasons: moral and ethical behaviour cannot be legislated; and the federal levers in the areas addressed in this report are relatively limited. Nevertheless, as the country moves forward in its efforts to restore investor confidence, one issue that must be resolved is whether Canada should continue with its relatively principles-based focus or whether we should become relatively rules-based in our orientation. The Superintendent of Financial Institutions told the Committee that he "would never argue for a solely rules-based or judgment-based system. You have to have a bit of both because you cannot legislate effective behaviour. You can have some checks and balances that try to promote effective behaviour, and you can have guidance from regulators and others … ." The Canadian Council of Chief Executives expressed the view that "rules define the minimum that is acceptable. Principles move personal and corporate behaviour beyond the legal minimum."

In addition to ensuring the proper legislative and regulatory structure, key contributors to restoring investor confidence are a sense of corporate responsibility and the right corporate culture, neither of which can be legislated. Conventional management theory suggests that the key influence on an organization's corporate culture and governance practices is the Chief Executive Officer. From this perspective, he or she must promote, foster and nurture the values of long-term commitment, responsibility and ethical behaviour. Good governance is key. The Canadian Council of Chief Executives told the Committee that "individually and collectively, business leaders must earn the public trust they need to build their enterprises and strengthen the economy. No government can legislate that trust. No regulator can restore it. Business has to earn it." A somewhat different perspective was presented to the Committee by Professor Anita Anand of Queen's University, who told us that "[t]rust has limited relevance when trying to understand the

… key contributors to restoring investor confidence are a sense of corporate responsibility and the right corporate culture, neither of which can be legislated.

relationship between shareholders and management. The relationship between managers and shareholders is based not on trust, but on legal contract wherein shareholders, as rational investors, diversify their portfolios and exit the company if management does not maximize shareholder wealth."

We support both rules to be followed and principles to be upheld, with rules set at a high level and principles that go well beyond.

The Committee endorses the views of witnesses who believe that good behaviour cannot be legislated, including Professor Thornton who said that "[t]here will always be someone exhibiting extreme behaviour. What percentage of offences can [we] tolerate? … There will always be an Enron cooking some place. How many would be acceptable? Zero is what we would all like … . There will always be an Enron in the making. It is a question of whether the links in the chain are strong enough to stop it before it boils to the surface." We also believe that there is some truth in Mr. William Dimma's view that "greed is a natural and normal part of the human condition. It is an essential motivator. It is part of the engine of economic growth in a free enterprise system." Like him, however, we also believe that "it must be checked and kept under control. … Corporate greed without the appropriate checks and balances leads too often to corporate disaster." We support both rules to be followed and principles to be upheld, with rules set at a high level and principles that go well beyond.

The Committee also considered the fundamental issue of whether a Canadian version of the *Sarbanes-Oxley Act of 2002* is necessary, or sufficient, to restore investor confidence. Opinions presented by witnesses were varied. Some believed that we have no option but to enact an equivalent Canada law, feeling that this is necessary to entice investors. Others argued that more enforcement is needed rather than more legislation, particularly legislation that could impose an undue burden on our smaller companies.

The Ontario Teachers' Pension Plan Board, for example, argued that major reforms are not needed; rather, "with a few amendments to some existing statutes, [there would be] an immediate and improving effect on corporate

governance and accounting standards." In its view, "if you do not have strong enforcement and sanctions, it will not achieve the desired result. If you want to get the most leverage for the effort the government can make, … focus on enforcement and penalties. Our rules in Canada are not that bad. … The problem in this country is we do not expect high standards of conduct of the people, and when they do not perform properly, we do not prosecute them. We do not sanction them."

A similar view was expressed by Caldwell Securities Ltd., when it argued that "where there is wilful or damaging action, criminal penalties should be pursued more vigorously," and by Mr. Purdy Crawford, who told us that "Canadian "securities laws are as good as those in the U.S., although we may have been lax in enforcing them."

Some of the Committee's witnesses cautioned against legislation and regulation, and highlighted the "pitfalls" of what they see as a one-size-fits-all approach; in their view, governance must be appropriate to the size and type of an organization's operations. In the view of many who made presentations to us, Canada should not simply "import" the *Sarbanes-Oxley Act of 2002*. Rather, they advocated a "Made-in-Canada" approach that recognizes our current strengths, minimizes potential regulatory overlap between Canada and the United States, and implements the proper requirements given our markets and the particular needs of our small and medium-sized businesses.

Some of the Committee's witnesses cautioned against legislation and regulation, and highlighted the "pitfalls" of what they see as a one-size-fits-all approach …

Ernst & Young argued that "it is not in the best interests of Canadian investors, or business generally in Canada, to adopt all the elements of Sarbanes-Oxley. … The size of our Canadian market and our market mix dictate a made-in-Canada approach." The Ontario Securities Commission likewise indicated to us that "[a]s responsible regulators, our job is to learn from the U.S. experience. This does not imply that we graft the Sarbanes-Oxley Act in its entirety onto our market. We need to determine the exact regulatory remedies that are right for the Canadian market."

KPMG Canada suggested that "Canadian market participants are effectively addressing the Enron crisis. The [chartered accounting] firms, the standard setters and regulators are working cooperatively and collectively to introduce made-in-Canada measures that are fair, reasonable, effective and aligned with similar reforms in the U.S. … . [W]e will need mutual recognition and acceptance by Canada and the U.S. of each other's regulatory systems."

From another perspective, however, Mr. Peter Dey urged "only one standard of governance for all public companies" in Canada and the Ontario Securities Commission said that "good governance is important to all investors in all companies, regardless of size."

Some witnesses were mindful of the requirements that must be met by Canadian companies that are listed on exchanges in both countries … or are listed exclusively in the United States.

Some witnesses were mindful of the requirements that must be met by Canadian companies that are listed on exchanges in both countries – referred to as interlisted – or are listed exclusively in the United States. The Advisory Group on Corporate Responsibility Review told the Committee of "how difficult it is for an interlisted company to work out all the different regulations and rules to which one must comply. In the longer term, it does not make sense. It is not sustainable. If this schism between the two jurisdictions is not addressed, the efficiencies we have been seeing between the capital markets will be driven out one way or the other." From this perspective, interlisted companies "would like to see Canada move to help create an environment with compatible requirements – if not exactly the same – which would allow Canadian corporations to be deemed compliant on the U.S. side."

A number of the Committee's witnesses mentioned a national securities regulator.

A number of the Committee's witnesses mentioned a national securities regulator. In comparing the Canadian and U.S. situations, Professor Thornton suggested that companies would probably find the U.S. Securities and Exchange Commission to be "far tougher" to deal with, with a lot more hoops to jump through. Nevertheless, it is only one entity, whereas in Canada a company might have to contend with many different securities commissions, each with a different

agenda, although perhaps fewer hoops to jump through, in aggregate.

Support for a national securities regulator was also voiced by the Canadian Coalition for Good Governance and by Rosen & Associates Limited; Caldwell Securities Ltd. argued that "[a] national regulator is needed now. The regional argument for separate commissions does not exist any more … . We are competing internationally and one securities voice is needed to deal with the SEC and other regulators." Furthermore, according to the Centre for Corporate & Public Governance, "Canada has 13 different securities jurisdictions, a fractured model unique in the G-7 – and one in dire need of reform." The Investment Dealers Association suggested two options: a comprehensive, harmonized provincial regulatory system; or a single national regulator under federal or provincial jurisdiction. The Ontario Securities Commission told us that "[h]armonization of regulation among the securities commissions has become our number one priority."

Support for a national securities regulator was … voiced by [a range of witnesses].

The British Columbia Securities Commission shared the view that "[a]ll of the securities regulators have the same objectives. We are all in favour of and striving toward effective regulation that protects investors from abusive conduct and fraud. We are also trying to have a system that does not overburden the industry and allows Canada's markets to be competitive. We are all striving to have better disclosure by our publicly traded companies. We are all in favour of better governance of Canada's companies. We are all looking for our brokers and advisors in the securities industry to provide honest advice that is untainted by self-interest. These are the fundamental objectives we are all striving toward." It also said, however, that while "[w]e should not overstate the difference in views among securities regulators [i]t is also important not to understate the differences in regulatory philosophy among securities regulators. … There are arguments in favour of [a national securities commission], certainly in terms of efficiency, but there are concerns. … [M]any of the proponents of a national commission overstate the potential benefits."

The Committee's current study did not focus on the issue of securities regulation per se …

We believe that a national securities regulator would also contribute to our nation's prosperity and growth.

… we believe that enhanced investor confidence in Canada requires certain legislative proposals as was the case in the United States.

The Committee's current study did not focus on the issue of securities regulation *per se*, but we are aware of the March 2003 establishment of a Wise Persons' Committee on securities regulation by the Department of Finance, which implements a November 2002 recommendation made by Mr. Harold MacKay. In 2002, he had been asked to recommend a process to determine the best securities regulatory system for Canada as well as the key issues to be addressed in that process. The Wise Persons' Committee, which is expected to report by 30 November 2003, will review the current regulatory system and recommend an appropriate securities regulation model for Canada, as well as a governance model and accountability framework. We look forward to the Committee's report, and are hopeful that it will recommend a national securities regulator, as was advocated by the majority of our witnesses who commented on the issue. We believe that a national securities regulator would also contribute to our nation's prosperity and growth.

Having completed our study, the Committee is confident that the approach we have taken, and the recommendations we have made, are correct. Simply importing the *Sarbanes-Oxley Act of 2002* into Canada would not be appropriate, since doing so would not recognize the strengths and initiatives that currently exist and might not be appropriate to our needs. On the other hand, continuing with a non-legislative approach, and perpetuating mandatory disclosure, voluntary compliance, rules and policies is also not appropriate in our view, since we believe that enhanced investor confidence in Canada requires certain legislative proposals, as was the case in the United States.

From this perspective, and fully recognizing that the ethical behaviour we are seeking by the board of directors, senior corporate officers and all employees cannot be legislated, the Committee has advocated the introduction of legislation in some areas. The question might be raised: would implementation of these initiatives preclude an Enron-type situation in Canada? While that is an impossible question to answer in any categorical way, we are convinced that our recommendations will, at a minimum, reduce the probability.

The Committee is reminded of our meeting with Dr. Alan Greenspan, Chair of the U.S. Federal Reserve Board, who suggested to us that instances of "fever" – where major increases in market value provide people with an opportunity to satiate their greed – occur in cycles. In his view, while the *Sarbanes-Oxley Act of 2002* probably is not needed now – and in the view of some Americans may not have prevented the Enron scandal in any event – it may be needed ten to fifteen years from now, when the "fever" begins to build again. We believe that the real value in the initiatives that have been or will be taken to restore investor confidence may be realized in the future, when the lessons of Enron, WorldCom and others in the United States are forgotten and another cycle of greed begins again. Action must, however, be taken now, when the political will exists.

… the real value in the initiatives that have been or will be taken to restore investor confidence may be realized in the future, when … another cycle of greed begins again.

Canada, too, has experienced significant declines in investor confidence, as a result of what has occurred in the United States but also because of circumstances at Nortel, Bre-X, Livent, Cinar and Laidlaw, among others. The Committee believes that the implementation of the recommendations made by us in this report will contribute to the restored investor confidence needed for the proper functioning of our capital markets and the accumulation of personal wealth that contribute to our prosperity as a nation.

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APPENDIX A:

REPORT ON THE FACT-FINDING TRIP BY THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE TO NEW YORK, N.Y. & WASHINGTON, D.C. (31 MARCH – 2 APRIL 2003)

CORPORATE GOVERANCE

- the New York Stock Exchange (NYSE) has long had an interest in corporate governance, and in the late 1860s began to impose requirements on companies as a condition for listing, including annual reporting of financial information to shareholders

- in some sense, the *Sarbanes-Oxley Act of 2002* "broke the mold" since prior to this legislative initiative, corporate governance occurred largely at the state level

- with what has been described as "the perfect storm" occurring in June 2002 with the exposure of widespread corporate malfeasance at WorldCom, a legislative initiative became inescapable; in the view of some, corporate governance requires a rule of law that includes the notion that fraud is a crime and should be a felony

- the *Sarbanes-Oxley Act of 2002* contains a requirement regarding independent directors on audit committees; it might be noted that although the NYSE has had a requirement for independent directors for a number of years, only the majority of audit committee members are required to be independent directors

- it is the view of some that when an individual becomes a member of a board of directors, it is inevitable that after a period of time personal relationships will develop with management, which has the effect of diminishing the independence; it cannot be legislated that personal relationships will not develop; nevertheless, the importance of independent directors was repeatedly stressed and it was suggested that the "acid test" of independence is an affirmative response to the question "As a director, could you fire the CEO or deny the CEO his or her bonus?"

- also indicated as important by some was a balance of power between an independent board of directors and the Chief Executive Officer, which may be difficult since the CEO is generally a member of the board of directors of various companies represented on its board; a separation of the Chair and CEO positions was mentioned

- a number of initiatives are likely to be of assistance in avoiding future problems, including the internal audit function, whistleblower protection and "perp walks"; given the range of measures, it is hard to separate the independent effects of each action, rule and regulation

- in commenting on the difference between Canada and the United States with respect to audits selection, whereby the audit committee selects the auditor in the United States while the shareholders select the auditor in Canada, Canada was characterized as being "more advanced in its thinking" from a corporate governance perspective

- there is some speculation that increased obligations and liabilities on directors may lead to "director chill," in the sense that directors will have to evaluate whether they have the substantial time commitment now required; in that sense, the "deal breaker" with respect to whether one becomes a director, or takes on another directorship, is time; others indicated that there is no lack of interest among people wishing to be directors but a wide pool is needed because of reductions in the number of boards on which any particular director sits

- it has been argued that, over the past decade, research has become "tainted" as a result of the merging of the research and investment functions, with organizations giving bad advice in order to generate investment banking fees; the solution to resolving this structural issue is to unravel the two functions and to develop rules about independence, the flow of independent research for investors, improved disclosure, etc. to re-establish the "firewalls" between the different functions of investment banks

- a mechanism to compare analysts' projections to reality in an effort to assess analyst accuracy was noted

- in the same way that an absence of personal relationships cannot be legislated, a system of rules may be insufficient for ensuring the ethical conduct that is needed; in the view of some, what is needed is a systemic approach that begins at the top with the board of directors and the CEO; ethical conduct must pervade corporate action, and the organization needs people who are willing to do the right thing and who are backed up when they do so; laws and penalties should ensure that the CEO acts with integrity in his or her business dealings, or pays the consequences

- training for corporate directors was noted, with particular mention made of board structure, board oversight of risk, corporate ethics, audit committee and compensation committee issues, etc.

AUDITING AND ACCOUNTING STANDARDS

- in the United States, accounting is very industry-specific, and U.S. Generally Accepted Accounting Principles (GAAP) are tailored sector-by-sector; given this diversity, audit committee members that require information should receive any "tutoring" they might need and should receive training regarding the questions that they should ask; however, it is perhaps the case that not everyone on the audit committee should have an accounting background, since someone without such a background would probably let his or her intuition take over

- there is some desire to see the harmonization of accounting standards globally, and it was noted that efforts are underway between the U.S. Financial Accounting Standards Board and the International Accounting Standards Board in this regard, with the standards-setting agencies in other countries also involved; while the European Union wants this globalization completed by 2005, it is unlikely to be completed by this time

- it was suggested that, to date, accounting standards in the United States have been supply-side driven, with the accounting profession, the corporate community and the SEC driving the standards, rather than the users of the information; means should be found to involve users and the public

- the SEC is expected to report by July 2003 on the issue of principles-based versus rules-based standards; harmonization would likely lead to a more principles-based system, which may be advantageous from the perspective that many companies operate internationally, and institutional investors want to compare "apples with apples"; however, it was noted that we must not "crush" smaller companies as we work toward solutions; in light of Enron, Tyco, WorldCom, etc., it may be difficult for the United States to dictate solutions to other countries; moreover, the Financial Stability Board of the G-30 has encouraged international standards across major capital markets

- some believe that the internal audit function should be enhanced, with more forensic auditing undertaken

- commenting on the issue of self-regulation, it was suggested that while this concept is not popular at this time and may not work particularly well, there may not be another model available

- in the view of some, part of the excess is the result of the move by some to "push the envelope" of accounting standards; you will always have "bad apples," and bad apples make good press

- many believe that investors need full, clear disclosure of corporate information in a manner that is meaningful and easily understood by them; investors need to know that more than just the rules have been followed

- it was indicated that, in the past, audits were underpriced, and were used as a loss leader in order to access non-audit consulting work

EXECUTIVE COMPENSATION

- some believe that the genesis of the abuses of executive compensation and corporate governance problems was stock options

- regarding the pricing of stock options, which is not addressed by the *Sarbanes-Oxley Act of 2002*, the Black-Scholes option pricing model was identified as the most popular approach; on the issue, it was also noted that there may be difficulties with pricing stocks that are not actively traded, and that flexibility may be needed between different industries that have different characteristics

SARBANES-OXLEY ACT OF 2002

- it was indicated that Senator Sarbanes, for some time, had wanted many of the provisions found in the *Sarbanes-Oxley Act of 2002;* Enron and other scandals provided him with a window of opportunity; moreover, when the legislation was being considered by the U.S. Senate, many provisions were added to the bill by other Senators

- some believe that the Securities and Exchange Commission has been moving rapidly in all aspects of implementation required by the Act, and that the SEC is being very accommodating with respect to foreign countries

- regarding enforcement, it was noted that one consequence of the *Sarbanes-Oxley Act of 2002* is the creation of increased criminal law to be enforced; it was predicted that many judges around the United States will make many judgments in the months and years ahead; while case law will be developed over time, there is likely to be some lack of consistency around the country

- regarding future changes that are likely to occur to the *Sarbanes-Oxley Act of 2002*, it was noted that although there is some discussion of a technical corrections bill, there is a leariness toward re-opening the legislation because of fears of what might be added; technical correction is perhaps not surprising, given the view expressed that the *Sarbanes-Oxley Act of 2002* served a political rather than a technical agenda; since its passage, people have found a way to "live with" the *Sarbanes-Oxley Act of 2002*; exemptions and interpretive guidance is available from the SEC

- on the issue of exemptions from the *Sarbanes-Oxley Act of 2002*, it was noted that Canada has achieved three of six exemptions sought; in particular, Canada has obtained the exemption it desires in terms of the definition of pro forma reporting, the definition of financial expertise and attorney responsibilities; Canada is still seeking exemptions with respect to loans to employees, auditor independence, and registration with and oversight by the Public Company Accounting Oversight Board

- whistleblowing protection was highlighted as a tool that might be used to promote ethical conduct

- in assessing jurisdictional issues, it was argued that jurisdiction is an elastic concept, and jurisdiction exists until the elastic snaps; in the State of New York, the *Martin Act* gives statutory jurisdiction for prosecution and the downside risk of being charged is so large that the parties really have no choice but to negotiate; some fear that the Act is too powerful, which leads to some reluctance to test its limits; with prosecution opportunities available at the federal, state and city/county level, jurisdictions may compete for securities prosecution cases although early on they may decide who will take the lead, and then may work together

- of the $1.4 billion in fines collected annually by the state of New York, the Attorney General receives nothing; about $900 million is remitted to the SEC or the state revenue fund, and the remainder is given to the federal government (of which $50 million is used for investor education by the SEC and approximately $450 million is used for research)

- in assessing whether the *Sarbanes-Oxley Act of 2002* is a "good thing," a number of perspectives were voiced; it was suggested that, at this point, it is hard to tell whether the legislation will attain its core objectives and hard to predict what the unintended consequences might be, although they may include the dampening of risk-taking, particularly in the short-run, as well as reduced capital spending and a limited number of IPOs

- in commenting on whether the Enron debacle would have happened had the *Sarbanes-Oxley Act of 2002* existed five years ago, some said "maybe" and suggested

that people will always be tempted when there is lots of money to be made; many of the legislation's provisions were in response to the very particular circumstances of Enron, Tyco, WorldCom, etc. and, in any event, many of the types of provisions found in the legislation had already been in place for some time; while the *Sarbanes-Oxley Act of 2002* may not prevent problems, it may make any outcome less destabilizing

- in the view of some, corporate corruption happens in a ten- to fifteen-year cycle, with bad behaviour leading to a scandal, leading to a cleanup, leading to bad behaviour, etc.; from this perspective, the main benefit of the *Sarbanes-Oxley Act of 2002* is that it will be available when it is needed in the future, since if it had not been passed now when the political will existed, it might not be available when required

- the *Sarbanes-Oxley Act of 2002* was also identified as being important for backstopping some of the rules developed by self-regulating organizations, and for the implementation of the Public Company Accounting Oversight Board, with provisions regarding Chief Executive Officer and Chief Financial Officer certification of financial statements, insider-trading prohibitions, pro forma reporting, the reporting of off-balance-sheet transactions, code of ethics disclosure, enhanced enforcement tools, whistleblower protection, etc.

- on the issue of whether investor confidence has improved since the legislation's passage, it was argued that investors are likely to be out of the market for a long time since a huge amount of wealth has been lost and they continue to expect – unrealistically – double-digit rates of return, although they are likely to come back more quickly than was the case in the 1970s; in the view of some, what is needed to restore investor confidence is the continued absence of additional scandals, a pattern of enforcement (including "perp walks") and – importantly – rising stock values; the SEC is likely to focus more on enforcement than it is on additional rule-making, although some suggest that until trust is re-established, more rules – rather than fewer – are needed

- about 100 of the anticipated 300 employees that work for the Public Company Accounting Oversight Board will be involved in inspections, and the Board is funded by fees on public companies, with the fees proportional to a company's market capitalization; the frequency of inspection is related to the number of public firms that are audited by registered accounting firms

- it was noted that since the *Sarbanes-Oxley Act of 2002* has increased the cost of accessing capital markets in the United States, the key question may be whether the legislation's benefits exceed its costs; in the view of some, even if the legislation prevents only one failed audit, then success will be achieved

APPENDIX B:

Witnesses and Submissions:

Accounting Standards Board of the Canadian Institute of Chartered Accountants
- Paul G. Cherry, FCA, Chair (Wednesday, May 28, 2003)

Accounting Standards Oversight Council
- T.I.A. (Thomas) Allen, Chairman (Wednesday, June 12, 2002)
- Paul Cherry, Chair, Accounting Standards Board (Wednesday, June 12, 2002)

Advisory Group on Corporate Responsibility Review
- David McAusland, Senior Vice-President, Merger and Acquisitions and Chief Legal Officer, Alcan (Wednesday, February 12, 2003)
- John Kazajian, Partner, Osler, Hoskin & Harcourt LLP (Wednesday, February 12, 2003)

Anand, Anita (Submission)
- Assistant Professor, Director, Torys Business Law Workshop, Faculty of Law, Queen's University

Aon Consulting
- Pierre Geoffrion, Vice-President (Wednesday, February 26, 2003)

Association de protection des épargnants et investisseurs du Québec
- Jocelyne Pellerin, President (Wednesday, November 20, 2002)
- Robert Cournoyer, Vice-President (Wednesday, November 20, 2002)
- Réjean Belzile, Member of the Board of Directors (Wednesday, November 20, 2002)
- Rachel Didier, Corporate Secretary (Wednesday, November 20, 2002)

Association for Investment Management and Research (Fact-Finding Mission to New York and Washington)
- Rebecca Todd McEnally, CFA,Vice-President, Professional Standards and Advocacy
- Raymond J. DeAngelo, Senior Vice-President, Stakeholder Services and Global Relations

Bevilacqua, The Honourable Maurizio, P.C., M.P.
- Secretary of State (International Financial Institutions) (Thursday, October 24, 2002)

British Columbia Securities Commission
- Douglas M. Hyndman, Chair (Thursday, October 31, 2002)

Brookings Institution (Fact-Finding Mission to New York and Washington)
- Robert E. Litan, Vice-President and Director Economic Studies Program

Caldwell Securities Ltd.
- Thomas S. Caldwell, Chairman (Thursday, May 30, 2002)

Canadian Bar Association (Submission)

Canadian Embassy to the United States (Fact-Finding Mission to New York and Washington)
- His Excellency Ambassador Michael F. Kergin
- Bertin Côté, Minister (Economic) and Deputy Head of Mission
- David Sévigny, Finance Counsellor

Canadian Coalition for Good Governance
- Stephen Jarislowsky, Chairman and Chief Executive Officer, Jarislowsky Fraser Limited (Thursday, November 7, 2002)

Canadian Consulate General to New York (Fact-Finding Mission to New York and Washington)
- Pamela Wallin, Canadian Consul General to New York
- David Murchison, Finance Counsellor
- Zahir Lalani, Consul and Senior Representative, Bank of Canada

Canadian Council of Chief Executives
- Thomas Paul d'Aquino, President and Chief Executive Officer (Wednesday, November 6, 2002)
- David Stewart-Patterson, Senior Vice-President, Policy (Wednesday, November 6, 2002)
- Sam T. Boutziouvis, Vice-President, Policy and Senior Economic Advisor (Wednesday, November 6, 2002)

Canadian Institute of Chartered Accountants
- David Smith, FCA, President and Chief Executive Officer (Wednesday, June 12, 2002 & Wednesday, October 30, 2002)
- Gérard Caron, FCA, President and Chief Executive Officer and Secretary General, Ordre des comptables agréés du Québec (Wednesday, June 12, 2002)
- Brian Hunt, FCA, President and Chief Executive Officer, Institute of Chartered Accountants of Ontario (Wednesday, June 12, 2002)

CATO Institute (Fact-Finding Mission to New York and Washington)
- William A. Niskanen, Chairman

Center for Financial Research & Analysis, Inc. (Fact-Finding Mission to New York and Washington)
- Dr. Howard M. Schillit, CPA, President

Centre for Collaborative Government
- Donald G. Lenihan, Director (Wednesday, February 12, 2003)

Centre for Corporate & Public Governance
- J. Richard Finlay, Chairman (Wednesday, May 28, 2003)

Certified General Accountants Association of Canada
- Guy Legault, President and Chief Operating Officer (Thursday, May 30, 2002 & Thursday, February 6, 2003)
- James Gaa, Professor of Accounting, Department of Accounting and Management Information Systems, University of Alberta (Thursday, May 30, 2002)

CMA Canada (Certified Management Accountants of Canada)
- Bill Langdon, Vice-President, Knowledge Management (Wednesday, November 6, 2002)

Collenette, Penny
- Senior Fellow, Centre for Business and Government, Kennedy School of Government, Harvard University (Thursday, February 13, 2003)

Conference Board (Fact-Finding Mission to New York and Washington)
- Chris Plath, Senior Corporate Governance Consultant
- Alan A. Rudnick, Counsel to the Conference Board's Commission on Public Trust

Council of Institutional Investors (Fact-Finding Mission to New York and Washington)
- Sarah A. B. Teslik, Executive Director

Crawford, Purdy
- Counsel, Osler, Hoskin & Harcourt, LLP (Thursday, December 5, 2002)

Dey, Peter
- Partner, Osler, Hoskin & Harcourt LLP (Wednesday, February 19, 2003)

Dimma, William A.
- Chairman, Home Capital Group Inc. (Thursday, February 6, 2003)

Ernst & Young LLP
- Christine Sinclair, Partner, Financial Services Group (Wednesday, February 19, 2003)

Deloitte & Touche Canada (Submission)

Finance Department
- Timothy Bishop, Senior Project Leader, Financial Sector Division, Financial Sector Policy Branch (Wednesday, March 26, 2003)
- Bob Hamilton, Assistant Deputy Minister, Financial Sector Policy Branch (Thursday, October 24, 2002)
- Charles Seeto, Director, Financial Sector Division, Financial Sector Policy Branch (Thursday, October 24, 2002 & Wednesday, March 26, 2003)

Financial Standards Accounting Board (Fact-Finding Mission to New York and Washington)
- Robert Herz, Chairman

Fridman, Josef J. (Submission)
- Doctoral Student, Faculty of Law, McGill University

GPC International (Submission)

Grant Thornton Canada
- Alex MacBeath, Chief Executive Officer (Wednesday, February 19, 2003)
- Michel Lavigne, Chair of the Board (Wednesday, February 19, 2003)
- Don Thomson, National Director of Professional Standards (Wednesday, February 19, 2003)

Higgs, Derek
- Author, "Review of the role and effectiveness of non-executive directors" (Thursday, March 27, 2003)

Houghton, Representative Amo (Fact-Finding Mission to New York and Washington)
- Congressman, United States House of Representatives

Investment Dealers Association
- Joseph J. Oliver, President and Chief Executive Officer (Thursday, November 21, 2002)
- Ian C.W. Russell, Senior Vice-President, Industry Relations and Representation (Thursday, November 21, 2002)

KPMG LLP Canada
- Bill MacKinnon, Chief Executive Officer (Wednesday, February 19, 2003)
- Axel Thesberg, Partner in Charge, Professional Standards (Wednesday, February 19, 2003)
- Peter Sahagian, General Counsel (Wednesday, February 19, 2003)

Long, Richard
- Professor, College of Commerce, University of Saskatchewan (Thursday, February 27, 2003)

Market Regulation Services Inc. ("RS")
- Tom Atkinson, President and Chief Executive Officer (Thursday, November 7, 2002)

Mercer Human Resource Consulting
- Ken Hugessen, Canadian Compensation Practice Head, Managing Director (Thursday, February 27, 2003)

New York State – Office of Attorney General Eliot Spitzer (Fact-Finding Mission to New York and Washington)
- Eliot Spitzer, Attorney General
- Eric R. Dinallo, Bureau Chief, Investor Protection and Securities Bureau
- David Nocenti, Counsel to the Attorney General, Executive Bureau
- Joseph R. Palozzola, Esq., Deputy Chief of Staff, Executive Office
- Bruce Topman, Assistant Attorney General, Investor Protection and Securities Bureau

New York Stock Exchange, Inc. (Fact-Finding Mission to New York and Washington)
- James L. Cochrane, Senior Vice-President, Strategy and Planning
- Elizabeth V. Montz, Account Manager, International

Office of the Superintendent of Financial Institutions
- Nick Le Pan, Superintendent (Wednesday, October 30, 2002)

Ontario Securities Commission
- David A. Brown, Q.C., Chair (Wednesday, October 30, 2002)
- John A. Carchrae, CA, Chief Accountant (Wednesday, October 30, 2002)

Ontario Teachers' Pension Plan Board
- Brian J. Gibson, Senior Vice-President, Active Equities (Wednesday, May 29, 2002)

Oxley, Representative Michael G. (Fact-Finding Mission to New York and Washington)
- Chairman, House of Representatives Committee on Financial Services

PricewaterhouseCoopers Canada
- Kevin J. Dancey, Chief Executive Officer, Canadian Senior Partner (Thursday, February 13, 2003)

Rich Rotstein Chartered Accountants (Submission)

Rosen & Associates Limited
- L. S. (Al) Rosen, President (Wednesday, May 8, 2002)

Sarbanes, Senator Paul S. (Fact-Finding Mission to New York and Washington)
- Ranking Member, United States Senate Banking, Housing and Urban Affairs Committee

Securities Industry Association (Fact-Finding Mission to New York and Washington)
- Frank A. Fernandez, Senior Vice-President, Chief Economist and Director, Research
- Scott C. Kursman, Vice-President and Associate General Counsel
- David G. Strongin, Vice-President, Vice-President and Director, International Finance

Shareholder Association for Research and Education
- Gil Yaron, Director of Law and Policy (Thursday, November 21, 2002)

Smith, Sir Robert
- Chairman, Weir Group PLC (Thursday, February 27, 2003)

Social Investment Organization
- Eugene Ellmen, Executive Director (Wednesday, November 6, 2002)

Stearns, Representative Cliff (Fact-Finding Mission to New York and Washington)
- Chairman, House of Representatives Subcommittee on Commerce, Trade & Consumer Protection of the Committee on Energy and Commerce

Stearns, Office of Representative Cliff (Fact-Finding Mission to New York and Washington)
- Jack Seum, Chief of Staff
- Ramsen V. Betfarhad, Counsel – Policy Coordinator, Committee on Energy and Commerce
- David Cavicke, Counsel, Committee on Energy and Commerce

Thornton, Daniel B.
- Professor, Queen's School of Business, Queen's University (Wednesday, May 29, 2002)

TSX Group
- Barbara Stymiest, Chief Executive Officer (Wednesday, June 5, 2002)

United States Federal Reserve Board (Fact-Finding Mission to New York and Washington)
- Alan Greenspan, Chairman, Board of Governors

Unites States Securities and Exchange Commission (Fact-Finding Mission to New York and Washington)
- William H. Donaldson, Chairman