

THE CANADA INSTITUTE

# One Issue, Two Voices

## Corporate Governance in Canada and the United States: A Comparative View

Drawing on expertise from both sides of the Canada-U.S. border, the *One Issue, Two Voices* series is designed to stimulate dialogue on policy issues that have a significant impact on the bilateral relationship. This fifth issue in the series provides an up-to-date snapshot of how corporate governance practices differ between Canada and the United States. Authors Jay Lorsch of the Harvard Business School and Edward Waitzer of the Canadian law firm Stikeman Elliott are leading experts on corporate governance. Together they give us a comparison of the way our countries have responded to changes mandated by the *Sarbanes-Oxley Act* (SOX) passed by the U.S. government in 2002.

In recent years corporate governance has become a subject of debate in business, legal, and investment circles in both Canada and the United States. However, corporate governance standards and compliance vary significantly between the two countries. For example, in the United States, a strict set of rules and practices targeting top managers, board members, and the accounting and auditing professions was implemented in response to *Sarbanes-Oxley*, with steep penalties for noncompliance. In Canada the response has been reactive and frag-

mented, with no unified or concerted effort to strengthen regulatory enforcement.

Each author critically assesses the impact of *Sarbanes-Oxley* and explains why each country has tackled corporate governance differently. Lorsch states that although SOX is credited as the catalyst for reform, the new law is only part of a wider effort to focus attention on compliance. Waitzer argues that Canadian regulators lack the ability to adopt new rules for corporate governance because of Canada's highly fragmented system. Consequently, many of the recent Canadian corporate scandals have come under more vigorous regulatory scrutiny in the United States than in Canada. In his opinion, one solution to Canada's failure to implement effective reforms is to outsource Canadian securities regulation, possibly to a U.S. or U.K. body.

Both authors agree that the time has come to take direct aim at the fundamental flaws in our regulatory framework. Given the speed with which SOX was passed in the aftermath of the WorldCom and other scandals, they question whether we have carried a good idea too far. The time has come for an evaluation.

The Canada Institute thanks both authors for their contributions to our understanding of a controversial topic in the ongoing bilateral dialogue. We are grateful to the Canada Institute on North American Issues for its support.

ISSUE FIVE

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## A Progress Report on U.S. Corporate Governance

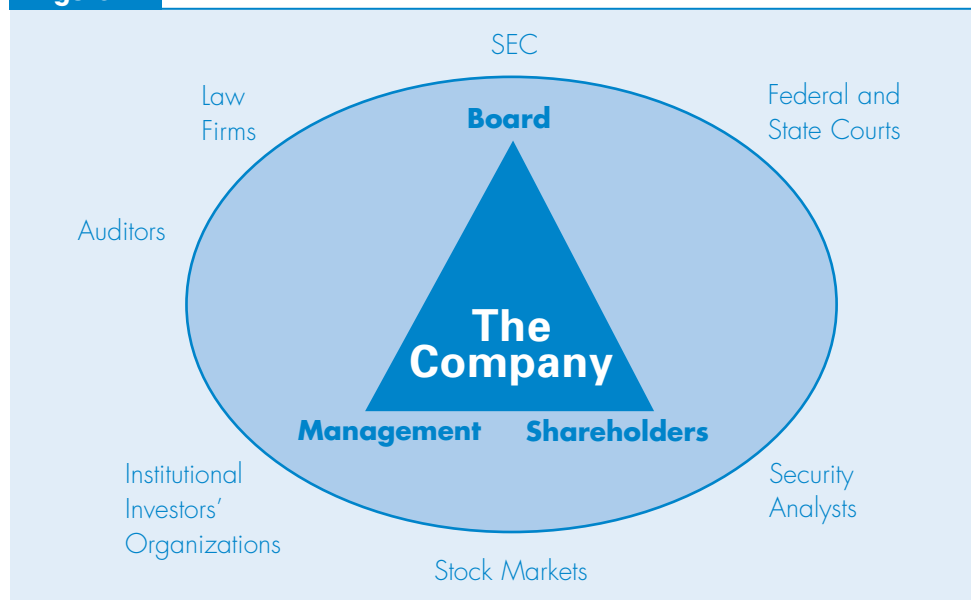
Jay W. Lorsch

In the first five years of the 21st century, one issue—compliance—has dominated discussion in U.S. board rooms. In reaction to the scandals at Adelphi, Enron, Tyco, and WorldCom, to name but the most prominent examples among huge corporations, directors are demanding assurance that companies and their management teams are acting within the rules that are intended to guarantee accurate and transparent financial reporting and to prevent self-dealing by managers. Many directors, investors, and managers directly involved, as well as journalists and members of the public, regard the *Sarbanes-Oxley Act of 2002* as the precipitating cause of this sudden preoccupation. However, important as this new law has been, it is only part of a much broader set of factors that has focused attention on compliance and, more broadly, on corporate governance.

The term “corporate governance” has become a key topic for discussion in the wider business, legal, and investment communities. It refers to the system of laws, regulations, and institutions that is intended to oversee the conduct of managers and their companies on behalf of investors, including both equity holders and lenders. At the center of this system of governance for each company is its board of directors, as well as the professional service firms responsible for audits and legal advice. And overseeing all these companies are the regulators, most notably the Securities and Exchange Commission (SEC), the state courts (of which the Delaware Court of Chancery is the most important), and the stock exchanges.<sup>1</sup>

To understand what has been transpiring in the corporate governance arena in the United States, we need to examine not only the impact of the *Sarbanes-Oxley Act* but also its relationship to longer-term trends in corporate governance as well as other responses to the recent scandals.

**Figure 1** U.S. CORPORATE GOVERNANCE SYSTEMS



### Long-Term Forces for Change

The early years of the 1990s provide the context for understanding the current state of governance in the United States. Major U.S. companies had been faltering for some time in their performance, compared to competitors in Germany, Japan, and other industrialized countries. The various pension funds for public employees, led by the California Public Employees Retirement System, were particularly concerned about this trend. Not only were the share prices for their investments depressed but, because their equity investments were “indexed” to mirror the composition of the Fortune 500 companies, they were locked into holding the entire market. In these circumstances, their leaders reasoned, the only way to improve their investment returns was to pressure major U.S. companies to improve their performance.

The pension funds decided on a strategy to create “a rising tide that would lift all the boats.” They initiated a campaign of private persuasion and public pressure to get boards of directors to become more active and demanding in overseeing management within their companies. Although the impact of this activity on performance to date has been dubious (witness the continuing struggles of Ford and General Motors), it has had an immense influence on corporate governance in general, and specifically on the conduct of boards.

These public investors and their friends (Robert Monk, Nell Minnow, and lawyers Marty Lipton and Ira Milstein, for example) created an awareness that boards need to take their duties more seriously. Directors were told to act more like the potentates they are supposed to be instead of the pawns of management they had become.<sup>2</sup> At the same time, a set of “best practices” quickly evolved, which boards of public companies began to adopt. By the end of the decade, many boards had become more active in oversight and more empowered in relation to management. Advocates of improved corporate governance were feeling bullish—and with good reason.

But the economic issues facing the country changed during the 1990s. Most notably, the dot.com boom symbolized the risk-taking and wealth creation (some would say greed) that spread to many sectors of the economy, including even prosaic industries such as telecommunications and power generation. What was not immediately apparent to advocates of good governance in both the private and the public sectors was that the improvements made in corporate governance could not contain this new economic exuberance. Hence, the scandals.

Washington reacted precipitously with the *Sarbanes-Oxley Act*. Wall Street responded with new stock exchange listing requirements.

The provisions of the *Sarbanes-Oxley Act* take direct aim at the obvious causes of the major corporate scandals of 2001–2002. They target top managers, board members, and the auditing profession.

Directors were told to act more like the potentates they are supposed to be instead of the pawns of management they had become.

**Figure 2** BEST PRACTICES

Majority of independent directors.

Leader for the board who is *not* the CEO.

Independent directors should control the process whereby directors are selected for nomination.

Three core committees—audit, compensation, and corporate governance.

Independent directors should meet periodically alone.

Boards should be as small as feasible.

Boards are expected to carry out certain activities:

- approval of their company's strategy;
- evaluation of the performance of the CEO;
- oversight of management development and succession planning; and
- evaluation of the board's own activities.

Directors should receive compensation that motivates them to focus on the interests of the shareholders.

### The Impact of *Sarbanes-Oxley*

Just 30 days before Congress passed the act on July 25, 2002, and President George W. Bush signed it into law on July 30, 2002, it seemed that the probability of these events happening was nil. Once the implosion at WorldCom occurred on July 21, 2002, however, the political pressure for a response from Washington was so great that the bill was rushed through Congress and to the president's desk. No legislation is ever flawless, but one pressed into force is especially likely to contain imperfections. Although there have been complaints about this law from managers and directors, it has, on the whole, worked better than might have been expected.

The provisions of the *Sarbanes-Oxley Act* take direct aim at the obvious causes of the major corporate scandals of 2001–2002. They target top managers, board members, and the auditing profession, especially firms that oversee the accounting and financial reporting of public companies. The chief executive officer (CEO) and the chief financial officer (CFO) of such companies are now required to certify that their financial reports accurately reflect the company's financial condition. False statements are treated as a criminal act. The law also prevents executives from receiving loans from their company. Finally, as far as management is concerned, the act's most arduous requirement, section 404, obliges managers to review the company's financial controls every year and to certify that they are adequate. This demand has caused the most complaints because of the time and the expense it entails. The cost of compliance seems to have been particularly burdensome for small firms.

The *Sarbanes-Oxley Act* has also had a significant impact on boards of directors and public accounting firms. Because it aims to cut all the ties between management and outside auditors, and to provide a coordinated audit by all the parties involved, it demands that a board's audit committee oversee all internal audits and take responsibility for the company's relationship with the external auditor. Audit committees have to be composed entirely of independent directors and include at least one "financial expert." Public accounting firms, in turn, are prohibited from doing con-

sulting work for audit clients and are limited in the non-audit work they can perform for such clients. The result of these restrictions has been dramatic: only one of the four major public accounting firms, Deloitte & Touche, still maintains a consulting practice.<sup>3</sup> In addition, the act has created the Public Accounting Oversight Board to oversee “the audit of public companies subject to security laws.”<sup>4</sup>

The reaction of business leaders to the act can best be characterized as “whiney.” Directors and managers are concerned about both the costs of compliance and the extra work required by audit committees. They worry that corporate boards spend too much time discussing issues of compliance, at the expense of due consideration of the company’s basic development. They also dislike the restrictions on company loans to executives, some of which, they argue, served a legitimate business purpose.

The accounting profession has been affected in an even more fundamental manner. In its former business model, major firms generated most of their profits from consulting, and they viewed auditing as a way to maintain and build relationships with potential consulting clients. Under the new regime, these firms have to figure out how to make auditing profitable. Not surprisingly, there has been a marked increase in fees in this area. Accounting firms also have become so risk averse that directors claim it is difficult to get them to offer firm opinions. Business leaders fret that they are paying more to their auditors and getting less in return.

In spite of these issues, real and perceived, the *Sarbanes-Oxley Act* has focused attention on transparent reporting and improved accounting controls, and has caused audit committees to take their duties more seriously. Consequently, investors feel more confident about the corporate financial reports they receive. There is also the hope among executives and directors that, once the section 404 process has gone through its initial cycle, verification will be less arduous in the future. Meanwhile, directors are seeking ways to balance their time in board rooms between issues of compliance and their other duties.

In sum, the *Sarbanes-Oxley Act* has created costs and problems, but, on the whole, it seems to have contributed to improved financial reporting and good corporate governance. Many people, including some directors and executives, attribute all the improvements they observe in corporate governance to this act alone. In truth, however, improvements in corporate governance are also the result of the continuing trend among boards to adopt the new best practices measures. These practices, in turn, have been greatly stimulated by stricter listing requirements on both the New York Stock Exchange (NYSE) and NASDAQ.



President George W. Bush signed the *Sarbanes-Oxley Act* into law on July 30, 2002.



Despite all this activity and change, one key aspect of U.S. corporate governance has not been affected by the events of the last decade: the role of shareholders.

**Figure 3** LISTING REQUIREMENTS

	NYSE	NASDAQ
Majority of independent directors	Yes	Yes
Affirmative declaration of independence	No	No
Executive sessions	Yes	Yes
Independent governance committees	Yes	Yes
Executive compensation decisions	Independent compensation committee	Either an independent committee or nomination by all independent directors
Independent committee	Yes	Compensation committee or all independent directors
Internal audit function	Yes	Yes
Corporate governance guidelines	Yes	Not required
Code of conduct for employees	Yes	Not required
Website disclosure	Yes	Yes
CEO certification of compliance with governance standards	Yes	Not required
Foreign issuers	Independent audit committee or comply with home country standards	Home country standards
Audit opinions	None	Public discloses of "qualified" opinions
Related party transactions review	Not required	Must be required and reported by the audit committee or all independent directors

Source: table compiled from information provided in Arnold and Porter LLP, "SEC Approves New York Stock Exchange and NASDAQ Revised Corporate Governance Standards," *Arnold and Porter Update*, November 2003, available at <[http://arnoldandporter.com/pubs/files/Advisory-SEC\\_Approves\\_NYSE\\_NASDAQ\\_Governance\\_Standards\(11-03\).pdf](http://arnoldandporter.com/pubs/files/Advisory-SEC_Approves_NYSE_NASDAQ_Governance_Standards(11-03).pdf)>.

### Revised Stock Exchange Listing Requirements

While *Sarbanes-Oxley* focused primarily on auditing and financial reporting, the changes in the stock exchange listing requirements aimed, more broadly, at improving board room practices. What the reforms have in common, however, is the demand for independent directors on the board. In this circumstance, directors are defined as independent if they have no conflicts of interest between their duties as directors and any other current or recent activities. *Sarbanes-Oxley* focused on independent directors on audit committees. The listing requirements go further and

mandate that boards of directors have a majority of independent directors. These independent directors must not only be on the audit committee but must also determine CEO compensation and nominate members of the board. As a result, the typical U.S. board includes only one or two members of management.

Although there are some differences between the listing requirements of the NYSE and NASDAQ, they both reflect many of the best practices measures for boards that evolved during the 1990s. For example, the NYSE requires that listed companies have, in addition to an audit committee, a compensation and a corporate governance committee, both of which must also consist of entirely independent directors. The NASDAQ requires that boards have these two additional committees of independent directors or that all the independent directors determine CEO compensation and nominate directors. In addition to the emphasis on independent directors and committees making these key decisions, both stock exchanges require that the independent directors also meet periodically without managers present. They both also mandate that boards provide CEOs with annual assessments of their performance.

These practices recognize two of the underlying factors that lead to improved governance by boards. First, independent directors are likely to be more candid with each other when they meet alone; they find it difficult to talk about issues involving management, even positive ones, when managers are present. Second, evaluation of the CEO is desirable not just to let this leader know the directors' thinking but also to provide the directors with an opportunity to share their assessment with each other. This evaluation process sends a clear signal to each CEO, as well as other managers, that the board has the power to judge the CEO's performance—that it is, indeed, the ultimate authority in the corporation.

### The Current State of Corporate Governance in the United States

Despite all this activity and change, one key aspect of U.S. corporate governance has not been affected by the events of the last decade: the role of shareholders. Sporadic attempts have been made to give them more influence in the governance process: for example, the Securities and Exchange Commission, on August 6, 2003, voted unanimously to put forth for public comment a proposed rule, which required, under certain limited circumstances, that shareholders be given access to the proxy statement to propose candidates for a company's board. Public comments were sharply divided and, to date, the Commission has not voted on any fiscal rule. As a consequence, shareholders still must accept the slate proposed by each board or enter into an expensive proxy fight to oppose it.

The reality is that U.S. shareholders participate in governance as they always have: by following the “Wall Street rule.” They sell stock when they are unhappy with a company's performance and prospects, and they buy when a company's future seems promising.

More recently, some hedge funds and similar investors have attempted to pressure boards and management to change their strategic direction so as to increase shareholder value (e.g., Carl Icahn at Blockbuster and Time Warner) and to add a director or two who favors such change. Icahn, who was a hostile raider in the 1980s, has resurfaced as a proponent of improved governance, although his underlying goal remains to create wealth for himself. Although such activities create exciting media attention, they do little to enhance shareholder power in governance. The reality is that U.S. shareholders participate in governance as they always have: by following the “Wall Street rule.” They sell stock when they are unhappy with a company’s performance and prospects, and they buy when a company’s future seems promising.

The reason is simple: over 60 percent of U.S. shareholders are institutions (hedge, mutual, and pension funds). They want to increase the value of their portfolios, and they do that by trading. The result is twofold: the average holding period for shares on the NYSE is six months, and U.S. companies focus on quarter-to-quarter earnings growth. That turnover may be good for the investment industry, but it also has limitations: it does nothing to give shareholders a greater voice in governance, and it builds a short-term focus for too many companies. So, while many observers believe that shareholders should have a greater voice in corporate governance, the reality of U.S. equity markets makes this goal unlikely in the near future.

In spite of the scandals of the early years of the 21st century, there is much that is positive to report about corporate governance in the United States. Many boards of directors are improving their oversight and guidance of their companies. The relationship between the directors and their auditors has been clarified and strengthened by the *Sarbanes-Oxley Act*, and investors can be more confident of the information they are receiving.

Of course, more progress is needed. The process of board improvement is ongoing and needs to reach even more board rooms. The public accounting professionals have to achieve a true balance between their professional responsibilities as auditors and accounting advisers and their profit-making motivations. The greatest challenge of all will be for the business community and policymakers to find a path forward which enhances the role of shareholders in the governance process, even though the majority of them seem more like short-term renters of shares than long-term owners.

## Notes

1. Under the U.S. Constitution, oversight of corporations is a duty of the states, and Delaware is the state in which a majority of public companies are incorporated.

2. See J.W. Lorsch and Elizabeth MacIver, *Pawns or Potentates: The Reality of America's Corporate Boards* (Boston: Harvard Business School Press, 1989).

3. The other three accounting firms are Ernst & Young, KPMG, and PricewaterhouseCoopers.

4. *Sarbanes-Oxley Act of 2002*, PL 107-204, section 101.



## Made in Canada Solutions? Responsive or Reactive Regulatory Reform

Edward J. Waitzer

When the U.S. Congress passed the *Sarbanes-Oxley Act* (SOX) on July 25, 2002, in just 18 weeks, the results were breathtaking to students of regulatory reform. Corporate governance standards were suddenly pre-empted by federal legislation. Accounting self-regulation was largely dismantled, and a radically new framework was implemented for regulating auditors, analysts, financial disclosure, and internal controls. The Securities and Exchange Commission (SEC) got broader enforcement powers, while certain state attorneys general also seized greater control over corporations. Amid the frenzy of political, social, and economic disturbances in the United States at the time, it seemed that this regulatory reform mirrored more fundamental shifts in the U.S. political psyche. In the aftermath of September 11, 2001, President George W. Bush's entreaties for heightened national security appeared to resonate with people whose financial security had been threatened first by the dot.com bubble and then by the corporate scandals.

How did Canada react to the new regulatory regime to the south? Perceived market crises can often be used to achieve regulatory objectives that otherwise lack sufficient political currency. The *Sarbanes-Oxley Act* presented Canada with a unique opportunity to think through responsive regulatory reform and come up with truly “made in Canada” solutions. A further inducement to an appropriate Canadian response to *Sarbanes-Oxley* should have been the relative size of our capital market and the extent to which it is integrated with that of the United States. More than half of the Toronto Stock Exchange's market capitalization, in terms of value (approximately 200 issuers), comprises interlisted SEC registrants. Canada's share of global market capitalization is less than two percent and continues to shrink. As David Brown, the immediate past chair of the Ontario Securities Commission (OSC), noted: “As a relatively small country competing internationally for capital, we could not risk the perception that our markets are less safe than those next door. Even more important, our markets are structurally very similar to those in the [United States], so if they had systemic weaknesses, chances are we shared them.”<sup>1</sup>

The *Sarbanes-Oxley Act* presented Canada with a unique opportunity to think through responsive regulatory reform and come up with truly “made in Canada” solutions.

It is worth noting, for instance, that many of the most notorious recent Canadian corporate scandals (e.g., Bre-X, Hollinger, Nortel) have attracted more attention and regulatory scrutiny in the United States than in Canada.

### The Canadian Response to *Sarbanes-Oxley*

At the outset, coordinated actions by various federal and provincial authorities and by self-regulatory organizations suggested that Canada had seized the opportunity to respond to *Sarbanes-Oxley*. Canada began to strengthen enforcement, tighten oversight of the accounting and auditing professions, implement improved standards for financial reporting, and adopt new rules for corporate governance. As events unfolded, however, the various barriers to change in Canada rapidly eroded the prospects and the impetus for reform.

Essentially, the regulatory framework for the Canadian securities industry and capital market has a unique set of systemic weaknesses. Regulators lack the ability to act, largely because of the highly fragmented system in Canada—with multiple provincial and territorial securities regulators, federal financial institution regulators, provincial and federal corporate laws, enforcement authorities at all three levels of government, and an overall lack of agency accountability or coordination. This fragmentation applies equally to the self-regulatory framework. Given the small size and geographic concentration of the market, the fragmentation has undermined confidence in the regulatory system and complicated the process of reform. It is worth noting, for instance, that many of the most notorious recent Canadian corporate scandals (e.g., Bre-X, Hollinger, Nortel) have attracted more attention and regulatory scrutiny in the United States than in Canada.

Within this context, the Canadian response to the *Sarbanes-Oxley Act* has been piecemeal and reactive. No level of government or regulatory body has seized the opportunity to fix the fundamental and universally agreed-upon flaws in the Canadian regulatory framework. What, then, has been done?

### **Strengthening Enforcement**

In keeping with a new focus on enforcement, the *Criminal Code* has been amended to restrict insider trading, endorse corporate whistle-blowing, and implement tougher penalties for those convicted of corporate crimes. Moreover, in 2003 the federal government provided additional funding for the creation of “integrated market enforcement teams.” Although these regulatory teams were launched with much fanfare, they have laid only three charges to date, all related to relatively minor cases. The response that gained most public attention concerned abuses in market-timing trades. The OSC and two self-regulatory bodies imposed settlements, respectively, on five mutual fund managers and five dealers. The penalties were all substantial, involving penal amounts and, in some cases, restitution. Significantly, the regulators did not initiate any proceedings against the actual market-timers, or even against all the “culpable” fund managers.

### **Oversight of the Accounting and Auditing Profession**

Canada is unique among mature-market countries in allowing the accounting bodies to fund and regulate standards for the profession. In addition, since a 1997 Supreme Court of Canada decision, auditors have enjoyed a high degree of immunity.<sup>2</sup> Unlike the situation in the United States, self-regulation continues to prevail in Canada, subject to the oversight of several new bodies—the Canadian Public Accountability Board (CPAB), the Accounting Standards Board (ASB), and the Auditing and Assurance Standards Oversight Council. The CPAB is modeled on the

Public Company Accounting Oversight Board (PCAOB), created by the *Sarbanes-Oxley Act* to protect investor interests, although its authority is less extensive.

Canada has adopted new auditor independence standards that incorporate the principles-based framework developed by the International Federation of Accountants. Other provisions are consistent with the auditor independence rules adopted by the SEC pursuant to the *Sarbanes-Oxley Act*. Before public company auditors can participate in the CPAB, they must comply with these standards. However, the CPAB indicated in its 2005 oversight report that, because of legal privilege, it had been constrained in its review by its lack of access to key documents. It is now seeking the same statutory authority the PCAOB enjoys to have access to privileged information without negating that privilege. Another surprising finding in the report was that, in each of the four major audit firms, more than 50 percent of the individuals reviewed had violated at least one aspect of their firm's independence policies.<sup>3</sup> The

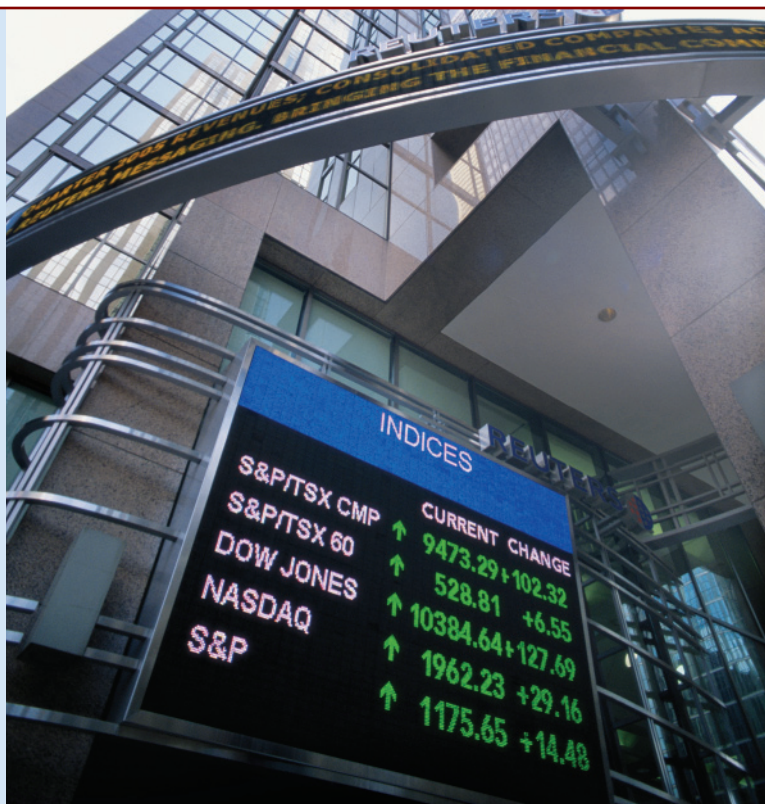
*Canada Business Corporations Act* regulations were amended in March 2005 to permit companies that have securities registered with the SEC to prepare their financial statements using U.S. Generally Accepted Accounting Principles (GAAP). Ontario has since indicated that it will amend its corporate law along these lines.

The most interesting development is a proposal adopted early in 2006 by the ASB to converge Canadian GAAP with international financial reporting standards over a transitional period, expected to be five years. At the end of that period, Canadian GAAP will cease to exist as a separate basis of financial reporting for public companies. The ASB press release indicated that it had chosen international standards over U.S. standards because "the vast majority of Canadian companies ... have little or no interest in copying the detailed, rules-oriented U.S. GAAP." Given the number of Canadian companies that are SEC registrants, this statement seems odd.

### **Improving Financial Reporting**

The ASB has implemented new standards for recognizing the expenses for all employee stock-based compensation and for dealing with the disclosure of employee future benefits and financial instruments. All these changes bring Canada more in line with U.S. and international standards.

The provincial securities regulators have implemented stronger disclosure measures. Ontario introduced a new liability-for-disclosure regime, similar to the SEC's Rule 10b-5, which facilitates lawsuits by security holders who trade in public companies that have violated continuous disclosure requirements. Under the Ontario regime, however, the plaintiffs do not have to prove that the defendants intended to deceive or manipulate, and liability for potential defendants is capped. Other protections are



The impact of the *Sarbanes-Oxley Act* is felt by companies across the border, including those listed on the Toronto Stock Exchange, pictured above.





New York Stock Exchange

designed to reduce frivolous lawsuits and stipulate that the court must approve any proposed settlement. In general, compliance issues, including reconciliation of practices between the Canadian and U.S. regimes, are proving to be substantial.

### ***Corporate Governance and Managerial Accountability***

All but one of Canada's provincial and territorial securities regulators have adopted new rules governing audit committees and certification of financial statements. The audit committee rules mirror the SOX rules in terms of the independence and responsibilities of members, but they apply only to companies listed on the Toronto Stock Exchange. Other issuers are required to disclose only those members of the audit committee who are independent and financially literate. The certification rule requires the CEO or the CFO to confirm the accuracy of the company's financial statements and other financial information.

Implementation of the SOX requirement that managers certify internal controls over their company's financial reporting has been delayed in Canada to give securities regulators time to observe their effect in the United States. The earliest that an audited internal control report could be required is for financial years ending on or after June 30, 2007. The scope of these reports is still under discussion.

Canadian securities regulators have also implemented disclosure rules for corporate governance. These rules combine a set of guidelines with a disclosure requirement, which is relaxed for smaller public issuers. The guidelines are similar in substance to the listing standards of the New York Stock Exchange and replace guidelines that had

been adopted by the Toronto Stock Exchange in 1995. In May 2004 Industry Canada published a discussion paper proposing amendments designed to entrench corporate governance “best practices” in the *Canada Business Corporations Act*, but they have not yet been implemented.

### Lessons Learned from *Sarbanes-Oxley*

*Sarbanes-Oxley* was an unprecedented intervention into the independence of the SEC and the substance of state corporate law—a response to the political need to demonize market actors and the media frenzy that fed it. We will now analyze it from two points of view—first, in general terms and, second, in terms of Canadian securities regulation and corporate governance standards.

#### ***Risk Avoidance vs. Good Governance***

The substantive reforms that *Sarbanes-Oxley* introduced are clearly having some beneficial impact on market conduct and on the quality and transparency of corporate disclosure. Few, however, would argue that the benefits outweigh the costs.

The explicit costs are significantly more than originally estimated. The SEC estimated compliance costs of US\$91,000 per company (or US\$1.24 billion in the aggregate).<sup>4</sup> The spring 2005 survey of the Financial Executives Institute stated, however, that the cost to companies was 48 times the SEC average estimate, and a December 2004 estimate by the American Electronics Association estimated aggregate costs at US\$35 billion.<sup>5</sup> Although ongoing compliance costs will decline sharply, they are likely to remain substantial. These costs have a disproportionate impact on smaller and foreign companies, and, inevitably, they are borne by shareholders who have no choice in the matter.

These explicit costs are but the tip of the iceberg. Implicit costs arise from the distraction of managers and employees from the business they should be doing. The most profound concern about SOX lies in the potential for accountants to become narrowly focused on rules, rather than engaged in exercising professional judgment, and for directors and managers to be excessively risk averse and obsessed with compliance.

The regulations introduced by the *Sarbanes-Oxley Act* in the United States and implemented selectively in Canada follow the same themes. Most are intended to reduce conflicts of interest faced by auditors and directors or to impose greater controls. What is less clear is the impact such reforms will have and whether the concerns underlying them could be addressed more effectively in other ways. For example, by making directors the “watchdogs” over management, *Sarbanes-Oxley* assumes that potential conflicts between the two cannot be dealt with through corporate law

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and other regulatory instruments. It also threatens the valuable role of boards as critical but collegial participants in the managerial decision-making process. Likewise, the focus on director “independence” ignores objective research that suggests there is little connection between more independent boards and improved corporate performance.<sup>6</sup> Ironically, this is one area where Canada, which has disproportionately concentrated ownership and control of public companies, has taken a stricter view of “best practices” than has the United States. Canada proposes that only independent directors serve on nominating and compensation committees as well as on audit committees, whereas the New York Stock Exchange has created an exception to this requirement for controlled companies.

Perhaps more disturbing are the many relevant issues that were ignored in the rush to implement *Sarbanes-Oxley*. These issues include substantive corporate law, in which duties and standards can be more nuanced and evolve over time. The development of fiduciary duties and standards of fairness cannot help but be pre-empted to some extent by highly prescriptive regulation. Similarly, little consideration was given to the division of powers and responsibilities among directors, officers, and shareholders or to the efficacy of private enforcement mechanisms.

Sadly, the follow-up commitments promised in both the United States and Canada have received scant attention. *Sarbanes-Oxley* directed regulatory bodies to carry out studies on issues such as the consolidation of accounting firms, enforcement of securities laws, and certain investment banking practices. Canada undertook to explore governance issues in controlled corporations. Given this dereliction, we should be demanding periodic reassessment of the new regulatory regimes. And, next time a major market crisis makes governance reforms politically expedient, we should hope for more responsive regulatory adjustments.

### Whither Canada?

Canada represents a small and, in relative terms, shrinking sliver of global capital markets, one firmly tied to that of our southern neighbor. In this area, as in so many others, we are subject to Lewis Carroll’s “Red Queen” principle—the need to run faster to stay in the same place. Given the disjointed state of our regulatory infrastructure, however, it is hard to be optimistic about the prospects for meeting this challenge.

Because most of our major issuers are required to be “SOX-compliant,” Canada has missed a unique opportunity to think through its regulatory reform and come up with its own solutions. First, of course, it would have to address the fundamental issues of fragmentation and capacity which continue to diminish the credibility of our regulatory framework. Unfortunately, the stream of initiatives to this end all seem to peter out, further undermining public confidence.

If we cannot get our act together, why not outsource securities regulation, at least for large public issuers?

The ASB has decided to do just that with respect to Canadian GAAP for public companies, while working simultaneously to promote the convergence of international and U.S. standards. As it says, “attempts to ‘Canadianize’ standards developed by others are considered to be a wasteful use of standard-setting resources.” They lead to “confusion among financial statement preparers and auditors,” and, given that there are few unique Canadian circumstances, “there is little need for ‘made-in-Canada’ standards.”<sup>7</sup> Rather than dedicate resources to such activities, the Canadian accounting

standard setter will now work with its international and U.S. counterparts to ensure that the Canadian perspective is taken into account in the deliberations of those bodies. In the absence of any realistic optimism for better coherence and capacity within the Canadian securities regulatory framework, perhaps the time has come to consider its continuing relevance and to seriously study “made elsewhere” solutions. The SEC may be the most obvious choice, but the United Kingdom’s Financial Services Authority might prove to be more culturally compatible. What if Canadian interlisted issuers were allowed to opt for the SEC as their sole securities regulator?

If nothing else, serious contemplation of such possibilities may encourage more discipline—and diminish the level of wishful rhetoric—in the ongoing discussions about domestic regulatory reform.

## Notes

1. David A. Brown, “The State of Corporate Governance in Canada,” remarks at McMaster University, Hamilton, Ont., March 10, 2005, available at <[www.osc.gov.on.ca](http://www.osc.gov.on.ca)>.

2. *Hercules Management Ltd. v. Ernst & Young*, [1997] 2 Supreme Court Records 165.

3. Canadian Public Accountability Board Oversight Program, *Third Public Report on Quality Inspections of Public Accounting Firms*, Toronto, Ont., December 2005, available at <<http://cpab-ccrc.ca/43a638727e764.pdf>>.

4. Securities and Exchange Commission, “Final Rule: Management’s Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,” Release No. 33-8238, N.174, June 11, 2003.

5. Available at <[www.aeanet.org](http://www.aeanet.org)> and <[www.fei.org/404\\_survey\\_3\\_21\\_05.cfm](http://www.fei.org/404_survey_3_21_05.cfm)>, respectively.

6. See, for example, Sanjai Bhagat and Bernard Black, “The Non-Correlation between Board Independence and Long-Term Firm Performance,” *Iowa Journal of Corporate Law* 27 (2002): 231. Similar issues arise over the lack of empirical support for restrictions on auditors providing non-audit services.

7. Accounting Standards Board, “Accounting Standards in Canada: Future Directions, Draft Strategic Plan,” Toronto, Ont., 2005.

## Jay W. Lorsch's Response

### Lessons from the North

Being part of a large and powerful economy, those involved in setting U.S. governance rules and practices tend to focus on what seems suitable to the U.S. situation and to worry less about our Canadian and other “foreign” friends. Further, the prevailing U.S. view always seems to be that we cannot learn much from our neighbors to the north.

However, as I read Ed Waitzer's piece, I recognize that he cites a few lessons learned by Canadians from the U.S. experience which are as relevant to the U.S. business community as they are to Canadians. For example, he points out that recent rules such as *Sarbanes-Oxley* and its Canadian counterparts have caused directors, on both sides of the border, to emphasize their job as “watchdogs.” I agree with this conclusion, and, like him, worry that this focus detracts U.S. boards from collaboratively working with management to make the significant decisions that shape their company's future.

Similarly, I worry that the increased reliance on independent directors may have gone too far. While arguing against independent directors is akin to opposing motherhood and apple pie, we may have carried a good idea too far. Certainly we want directors who have no conflicts of interest with their governance duties. Yet we must also recognize that independent directors are likely to be limited in their knowledge of the company's business and are probably operating with severe time constraints. These limitations can further impede boards' involvement in major decisions.

There is one other lesson that U.S. business leaders should learn from their Canadian counterparts—the importance of understanding the true characteristics of their shareholders. Canadians seem to be more aware of the greater concentration of ownership in many of their companies than U.S. business leaders are about their shareholders. When we discuss and consider corporate governance in the United States, we ignore the fundamental fact, as I said earlier, that in large public companies, 60 percent of shareholders are institutions, and that, while these institutions have different investment goals and strategies, the prevailing tendency is to exercise governance by following the “Wall Street rule” of buying and selling shares. These decisions are largely made on a quarterly basis, leading managers and directors to focus on short-term results.

Because we ignore this reality, we find it difficult to come up with realistic means to enable shareholders to have a stronger voice in corporate governance. There is considerable regret and discussion because shareholders are the least powerful actors in the corporate governance arena. But it will be impossible to remedy this problem unless U.S. business leaders, like their Canadian peers, realistically accept the true nature of their shareholders. We may not like this short-term focus by institutional owners, but we will have to deal with it if we are to find a way to give shareholders a larger voice in governance.

## Edward J. Waitzer's Response

### Taking Direct Aim

While robust markets have assuaged investor confidence, there has been little effort to “take direct aim,” to use Jay Lorsch’s words, at the fundamental flaws in the Canadian regulatory framework. Such inaction has become more apparent to observers, particularly those outside the country looking in. At a time when Canada could be taking a leadership role in international standard-setting processes, we seem to be stuck on domestic structural barriers.

### Importance of Ownership Structure

Contrary to the mantra of “made in Canada” solutions, in some areas Canada has tended to mimic U.S. initiatives without sufficient thought as to what adjustments are appropriate. For example, Jay Lorsch notes that *Sarbanes-Oxley*’s focus on independent directors is a response to the fact that U.S. public companies tend to be widely held. Canada has a far greater representation of controlled public companies.

It is surprising that Canada would advance guidelines advocating absolute independence for members of nominating and executive committees as well as audit committees. Even the NYSE has acknowledged that a requirement for a majority of independent board members would create “insuperable difficulties for companies controlled by a shareholder or parent company” and would “deprive a majority holder of its shareholder rights.” The excuse offered by the Canadian securities regulators is that swift action was necessary and that their policy is not prescriptive but, rather, represents “best-practice guidelines.” They undertook to study the subject further and report by April 2006.

Alternative regulatory instruments have been ignored. For example, Leo Strine, the vice-chancellor of the Delaware Chancery Court, pointed out that corporate law duties, particularly tools of equity, can be more fluid and context sensitive than prescriptive rules. Under Delaware corporate law, virtually all controlling-shareholder transactions are subject to an “entire fairness” review. This higher standard derives from the “800-pound gorilla theory” Strine has articulated—that directors and minority shareholders may be inclined to approve these transactions simply to avoid retribution. This review and the existing minority shareholder regime that apply under Canadian securities regulation are both more responsive to the underlying policy concern than is the mechanical replication of SOX independence requirements, which may well preempt or erode equitable remedies.

### Role of Owners

Few would disagree with Lorsch’s diagnosis that the role of engaged, long-term shareholders in encouraging responsive governance should produce higher sustainable returns, which in turn should attract more such investors. As outgoing Harvard University President Lawrence Summers once observed in another context, “In the history of the world, no one has ever washed a rented car.” The demographics of Canadian ownership—a significant number of controlled corporations and a concentration of institutional ownership in the hands of several large public pension plans—could auger well for achieving this long-term alignment. A contemporary debate on how best to do so has yet to occur in Canada.

### Role of Public Equity

The question of ownership leads directly to what may become a more profound concern: the role of public equity markets as a vehicle for capital allocation. Private equity firms are amassing huge pools of capital and “crowding out” the intermediation role of public equity, in part because of their ability to “arbitrage” the regulatory costs and constraints being imposed on public companies. It would be ironic if we find ourselves on the “wrong side” of an inflection point just as most of the world sees ongoing governance reforms as the route to a new stage of global capitalism and democratization.

### Accountability of Regulators

No one can accuse regulators of being ill-intentioned. What is lacking in Canada is more scrutiny and resolve to improve the efficacy of the regulatory framework and the performance of regulatory bodies. Capital market participants should be entitled to, and demand, an equal level of accountability from regulatory authorities (and their political masters) as is expected from themselves.

The excuses for fragmentation and inaction have become hollow refrains. The time has come to take direct aim at the fundamental flaws in our regulatory framework. In that respect, we can’t help but admire the boldness of *Sarbanes-Oxley*.

## Edward J. Waitzer

Chair, Stikeman Elliott LLP

Edward Waitzer is Chair of Stikeman Elliott LLP, where he has served as CEO since 1999 and as a partner in Toronto and New York since 1983. Prior to joining the law firm, he was vice president of the Toronto Stock Exchange. From 1993 to 1996 he served as chair of the Ontario Securities Commission and of the Technical Committee of the International Organization of Securities Commissions. Ranked as a leading corporate lawyer in Canada, his practice focuses on significant business transactions, governance, and public policy. He has chaired or served on several policymaking bodies, including the Strategy Working Party, which restructured the International Accounting Standards Board, the Market Design Task Force that advised on market deregulation for natural gas in Ontario, and the Independent Review Panel on the Comptrollership Function in Canada. He has served on numerous corporate boards and currently serves as a director of a number of voluntary organizations. Waitzer’s work has included assisting governments and public agencies and in 2003–2004 he spent a year in Chile advising on financial sector regulation.

Waitzer is a graduate of the University of Toronto Law School with an LL.B. (1976) and LL.M. (1981). He has written extensively on a wide range of legal and policy issues and has served as an adjunct professor of corporate and securities law at Osgoode Hall Law School. He is a contributing editor and sits on the advisory board of various publications, including *Corporate Governance Review*, *Financial Regulation*, *The Philanthropist*, and *The Valuation Law Review*.



## Jay W. Lorsch

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Professor Lorsch is the Louis Kirstein Professor of Human Relations at the Harvard Business School. He is the author or co-author of over a dozen books, including *Back to the Drawing Board: Designing Corporate Boards for a Complex World* (2003), *Aligning the Stars: How to Succeed When Professionals Drive Results* (2002), and *Pawns or Potentates: The Reality of America's Corporate Boards* (1989). As co-author with Paul R. Lawrence of *Organization and Environment* (1967), he won the Academy of Management's Best Management Book of the Year Award in 1967 and the James A. Hamilton Book Award of the College of Hospital Administrators in 1969.

Professor Lorsch has taught in all of Harvard Business School's educational programs. He was chairman of the doctoral programs, senior associate dean and chair of the executive education programs from 1991–1995, senior associate dean and director of research from 1986–1991, chairman of the advanced management programs from 1980–1985, and prior to that was chairman of the organizational behavior unit. He is currently chairman of the Harvard Business School Global Corporate Governance Initiative and faculty chairman of the Executive Education Corporate Governance Series. As a consultant, he has had a diverse array of clients, such as Ameritech, Applied Materials, the Bank of Montreal, Citicorp, Chubb and Sons, Coopers & Lybrand, Corning Glass, General Electric, Goldman Sachs, Merck Sharp and Dohme, and Petróleos de Venezuela S.A. He is a director of Computer Associates International, Inc. and a member of the advisory board of U.S. Foodservice.

He is a graduate of Antioch College (1955) with an M.S. degree in Business from Columbia University (1956) and a Doctor of Business Administration from Harvard Business School (1964). At Columbia, he was a Samuel Bronfman Fellow in Democratic Business Administration. From 1956–1959, he served as a Lieutenant in the U.S. Army Finance Corp. Professor Lorsch was recently elected as a fellow of the American Academy of Arts & Sciences.

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