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Notes for an Address

by

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**"The Role of Government in Improving and
Enforcing Corporate Governance"**

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The Role of Government in Improving and Enforcing Corporate Governance

The hasty enactment of the *Sarbanes-Oxley* legislation by the United States Congress in the summer of 2002 has had wide-ranging effects, not only in the US, but also here in Canada as well as in the United Kingdom and the European Community. Among other things, it has brought into sharp focus the long-debated question of how far, in market-driven economies, is it appropriate for government to get involved in regulating business, in this case as regards the governance of corporations. The issues range from whether or to what extent honesty, integrity and good commercial judgment can be legislated, to the degree of severity of sanctions and penalties for corporate fraud and related abusive conduct by corporate managers causing significant loss to shareholders.

Mr. Emerson has just provided us with a key, albeit as he says “sanitized”, case in point with his analysis of the Ontario Government’s initial response to *Sarbanes-Oxley* via the *Securities Act* amendments contained in *Bill 198* and the amendments proposed in *Bill 41*. My Firm’s Toronto office partners are on record stating *Bill 198* would be better named “*Another Avenue for Shareholders to Sue Corporations and their Directors and Officers Act*”. Other observers have suggested that the OSC, led by its activist Chairman, Mr. David Brown, has pushed the Legislature into delegating to OSC sweeping new rule-making powers which will enable it to reach into Canada’s boardrooms in a way which will not improve corporate performance, but rather will hamper performance and reduce the ability of Canadian corporations to increase investor wealth.

This debate has evolved to its current level as a direct result of the perceived urgent need to restore investor confidence in public corporations, mutual funds, hedge funds and other financial products trading in the major capital markets.

This perception has, of course, been driven by the series of corporate scandals involving in most cases illegal, corrupt, sleazy and avaricious behaviour by corporate managers. These scandals came into high public profile with the shocking revelations about Enron Corporation and WorldCom. They have, sadly, been ongoing and lately, with the disclosures about major abuses and illegal behaviour at certain well-known mutual and hedge funds, seem to be on the increase. In most cases, the illegal behaviour has been made possible by weak or even non-existent corporate governance. Often, in the more serious debacles, there has been little or no effective Board supervision of management and sometimes questionable independence of the Boards from management. As well, there has been a serious lack of transparency, poor or incomplete disclosure of material information, including financial, a disturbing propensity to grant grossly excessive compensation packages to senior managers not in any way aligned with performance or shareholder reward. There have also been many instances of misleading and improper accounting practices, all of which has led to a strong focus on auditors, audit committees and accounting standards.

The overriding and common factors present in all of these corporate debacles have been dishonesty, lack of integrity and a breach of trust by corrupt individuals. In some of the cases under review, even Enron, the corporate governance, on its face, has been "up to par" and the Boards comprised largely of reputable, intelligent, independent citizens not particularly beholden to or otherwise linked to or in cahoots with the evil elements of management. As well, there quite often existed proper and well-functioning Board committees, including audit, human resources and compensation, and corporate governance. The reality is that in large multi-million or billion dollar corporate organizations, there is plenty of scope for corrupt management to "pull the wool over the eyes" of well-meaning "outside" directors.

We should also keep in mind that, based on statistics currently available, for every corrupt and scandalous situation involving abuse of shareholders' rights and "theft" of their money, there are hundreds of "clean" corporate enterprises involving honest and hardworking management, working flat out in the best

interests of their shareholders, supervised by largely independent Boards practicing good corporate governance and also working in good faith for the benefit of the shareholders. Too much generalization usually leads to bad public policy and ultimately to bad law.

There is another caveat I wish to highlight before getting into the pros and cons of government intrusion into the boardrooms of the nation. I speak of “Caveat emptor” – Let the Buyer Beware. In the so-called “good old days”, prudent investors carefully sought out corporations that had sound and trustworthy management, a record of solid earnings and healthy cash flow, transparency and a reputation for being fully accountable to shareholders. In recent years, it seems, these time-tested investment standards were often honoured in the breach. During the “Raging Bull Market”, pre-Enron and the bursting of the “tech bubble”, many investors, managers, directors and executives quite literally – as evidenced by their investing in and operating enterprises with ZERO earnings, ZERO cash flow and ZERO tangible assets – came to believe that “Yes, money does grow on trees”. As well, it seemed that investors were overly complacent about known corporate excesses such as obscenely high compensation packages for greedy CEOs and stock option programs that had a significant dilutive effect on the shareholders at large. Former Federal Reserve Bank Chairman Paul Volker, referring to the obvious greed of many senior executives, declared “Traditional norms did not exist. You had this whole culture where the only sign of worth was how much money you made!” Current Fed Chairman Alan Greenspan has employed numerous pungent epithets, including “irrational exuberance”, to describe the phenomenon ... that aura of unreality that seemed to envelop the investment and corporate world during the period mid-1997 to mid-2000! In other words, the poor deprived shareholders may themselves, by their lack of due diligence and complacency, have been part of the problem investors’ rights groups are now asking governments to resolve by increased regulation of corporate governance.

Yes, investors need to be protected! Yes, they need transparency! Yes, they require and deserve accountability! Yes, they should be able to believe the

numbers, the financial data fed to them! And finally, yes, they did – at least for a time – lose confidence! But have the circumstances been such as to justify a massive government legislative and regulatory onslaught designed to improve and enforce the governance of our publicly traded corporations? The answer, I believe, is “No, there is not a need for a massive legislative and regulatory program”, but “Yes, we do require a focused legislative approach in certain carefully-defined areas to reinforce present rules, regulations and guidelines and to sharpen the teeth of existing criminal and related laws by criminalizing behaviour such as insider trading and providing for more stringent enforcement and compliance and for much tougher, more onerous penalties”. However, if our governments (federal and provincial) go too far with a legislative solution, the negative effects could well outweigh the positive. A measured approach is what is needed.

In the immediate wake of Enron and WorldCom, allegations of fraud, greed, obscene compensation packages, conflicts of interest and generally abominable corporate governance were rampant. No one was immune. Directors, senior management, outside auditors, analysts, all were swept up in a maelstrom of accusations and recriminations. Poor corporate governance was a prime culprit and the light began to shine brightly on the urgent need to put an end to corporate fraud by improving and enforcing better corporate governance through rigid new regulations coupled with a vigorous new regime for punishing those guilty of non-compliance with much more than simple raps on the knuckles.

President Bush and his colleagues in the White House were under intense criticism for being too soft on business, especially the high profile supporters of the Republican Party in Texas. The “knee-jerk” reaction was a call for sweeping new penalties to root out executive corruption, the doubling of prison terms for executives convicted of cooking the books and by increasing the SEC’s investigative budget by US \$100 million. The President also called for the immediate introduction and rapid passage of a very tough new corporate accountability law – the *Sarbanes-Oxley Act*, which was indeed enacted in record

time and has had a dramatic effect on the corporate governance landscape ever since its basic provisions came into force July 30, 2002, followed by its various sets of regulations on a staggered schedule since. Most of us have, I am confident, been affected in one way or another by *Sarbanes-Oxley* and know what an impact it has had in the North-American corporate world, even here in Canada. Similar legislation has been introduced in the United Kingdom following the Biggs Report and we have just had an excellent insight from Mr. Emerson as to some of the Canadian legislative initiatives on the subject.

What is rather less known or discussed these days is the possibility that *Sarbanes-Oxley*, its regulations and similar legislative provisions may be having certain negative effects. As an example, it has been suggested that competent directors are becoming more difficult to find; directors' and officers' insurance has become prohibitively expensive and, in some cases, impossible to find; audit fees are skyrocketing; directors are becoming overly cautious and conservative, frequently refusing or demonstrating reluctance to accept bold and creative, albeit perfectly reasonable, strategies and projects recommended by management; otherwise excellent directors with sound judgment and a wealth of experience are being removed from audit, compensation and governance committees because they don't fit the new SOX technical definition of "independent"; and finally, numerous medium and smaller sized companies are apparently complaining about the high costs and time commitment involved in complying with all the so-called new red-tape around what they consider as unproductive governance matters. They argue that they are well-run, well-governed companies with a strong culture of ethical conduct, a focus on shareholder reward and the sound judgment of their directors. Why should they pay the price of a few "rotten apples in the barrel"? A key element of this price is the increased cost of accessing capital markets and a dampening of the risk-taking spirit which is so crucial to productive entrepreneurship in Canada.

It was against this background that the Canadian Senate's Standing Committee on Banking, Trade and Commerce recently concluded a major study on corporate governance issues with a view to determining what lessons for Canada

and Canadian business practices can be learned from the Enron/WorldCom affairs and the subsequent and consequential legislative initiatives undertaken in the United States. This study was concluded last spring and the Committee's 77 page Report entitled "*Navigating Through 'The Perfect Storm': Safeguards to Restore Investor Confidence*" was released mid-June. The Committee heard from some 75 witnesses, including our good friend and fellow panellist, Purdy Crawford, received and considered numerous excellent and often provocative briefs and traveled to New York and Washington in an effort to understand better both the nature of the problems giving rise to the high profile instances of corporate corruption and the solutions being considered or already implemented. During this exercise, we were fortunate to meet some of the well-known key players such as Eliot Spitzer, William Donaldson, Alan Greenspan, Senator Paul Sarbanes and Representative Michael Oxley, plus representatives of the Board and senior management of the New York Stock Exchange.

Our meeting with Mr. Greenspan was understandably "unofficial", but his views were very interesting indeed, being insightful, practical and down to earth. I don't believe it would be out-of-school to report that, in his view, it is not strict and complex legislation which will restore investor confidence, but rather two or three quarters of good earnings and a sharply rising Dow Jones Index. As to *Sarbanes-Oxley*, he pointed out that corporate corruption tends to occur in a ten to fifteen year cycle, with bad behaviour leading to a scandal, leading to clean up, leading to bad behaviour again. From this perspective, the main benefit of new regulatory rules like *Sarbanes-Oxley* is that they will be available when needed in the future, since if they had not been passed now when the political will existed, they might not be available when required.

Based on its findings during this illuminating study, the Banking Committee made some fourteen detailed and specific recommendations for legislated rules which, in its view, would appropriately supplement existing (federal) legislation regulating corporate behaviour. Such current legislation includes rules on subjects like directors' liability, insider trading and financial disclosure. The Senate recommendations, if accepted by Government, would in the view of the

Committee help considerably to improve and enforce corporate governance standards in Canada. And yet, in the Committee's view, they would not constitute an undue intrusion into the nation's boardrooms. They would rather add some legislative clout to the rules and guidelines already deemed acceptable in the marketplace. Although the Committee was cognizant of the negative fallout from *Sarbanes-Oxley* and reluctant to unnecessarily "hand-cuff" efficient corporate practice, it decided to abide by the age-old principle of "not necessarily regulation, but regulation where necessary!"

The overwhelming evidence disclosed to the Senators was to the effect that the vast majority of these corporate scandals was due to the obscene greed and dishonesty of the senior managers of the corporations in question. Therefore, it was not surprising that one prominent witness interviewed on the Banking Committee's trip to New York and Washington candidly asserted: "The one thing that will really restore investor confidence is five or ten executives in orange suits and handcuffs on the evening TV news!!" Clearly, there is a pressing need for tougher penalties and stricter enforcement of the criminal and corporate fraud statutes already on the books. As well, these laws require fine-tuning to fit the contemporary corporate environment, together with tougher punitive provisions for those found guilty of breaking the law. Finally, in this regard, governments at all levels need to commit more resources in the way of manpower, money and investigative tools to the regulatory bodies and enforcement agencies so the investigators will be able to do their jobs more thoroughly and those tempted to commit corporate fraud will think twice in the future.

In addition to the scandalous criminal activity at the expense of corporate shareholders, situations such as Enron served once and for all to illuminate the major flaws in the governance systems prevailing in our public corporations. Guidelines and administrative directives are clearly not enough to obviate the risks of unscrupulous managers paying lip service to the guidelines, but acting in a contrary way. Thus, the Banking Committee Members opted for a measure of government regulation, albeit well-balanced and not overly onerous and

impractical for SMEs and major family-controlled corporations. Their recommendations include a call for carefully crafted rules capturing the spirit of *Sarbanes-Oxley* in the following areas:

- Board composition and comportment for large public companies;
- Audit committee composition and procedure;
- Compensation committee composition and procedure;
- Special rules for auditors;
- Special rules for financial analysts;
- Whistleblower protection for employees reporting financial irregularities and failed corporate governance;
- Splitting the roles of Chief Executive Officer and Chair of the Board for large public companies;
- Certification of a corporation's financial statements by the CEO and the CFO.

The Committee also recommended that:

- The federal government review current legislative and regulatory provisions dealing with fraud, insider trading and other offences, including the adequacy of penalties, with a view to implementing needed changes as expeditiously as possible; and
- The federal government take a leadership role and work with Canadian shareholders in undertaking discussions with the US Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB) and other key players to encourage an expeditious agreement on global uniform accounting standards.

During last February's Budget Address, federal Finance Minister John Manley laid the groundwork for some initial Canadian legislation in the corporate fraud area. He emphasized the pressing need to restore investor confidence in the integrity of Canada's capital markets and promised early legislation "to strengthen the corporate governance standards in the *Canada Business*

Corporations Act and in financial institutions statutes". Such legislation, he said, will take into account what is being done elsewhere, particularly by the provincial governments, securities commissions and stock exchanges. True to Minister Manley's word, the Minister of Justice on June 12, 2003 introduced *Bill C-46*, being proposed amendments to Canada's Criminal Code aimed at strengthening measures to investigate, prosecute and deter capital markets fraud by:

- Creating a new Criminal Code offence of improper insider trading;
- Providing whistleblower protection to employees who report unlawful conduct;
- Increasing the maximum sentences for existing fraud offences and establishing a list of aggravating factors to aid the courts in sentencing;
- Allowing the courts to issue production orders to obtain data and documents from persons not under investigation; and
- Establishing concurrent federal jurisdiction to prosecute certain capital market fraud cases.

Along with these legislative measures of *Bill C-46*, the federal government announced that it will create a number of Integrated Market Enforcement Teams (IMETs) composed of RCMP officers, federal lawyers and other investigators such as forensic accountants to deal with capital markets fraud cases. Located in Toronto, Vancouver, Montréal and Calgary, these teams, which are scheduled to become operational over the next two years, will work with securities regulators, as well as provincial and local police forces. I am not sure where this initiative presently stands.

The reaction to *Bill C-46* has been generally positive, although some observers feel the penalties prescribed in the Bill are not tough enough. Anyway, perhaps it is not too late to change this going forward. The bad news, however, is that *Bill C-46* died on the House of Commons Order Paper not yet having reached the Senate, when Parliament was prorogued last week. Let's hope Mr. Martin considers it a priority when Parliament gets back to work in Ottawa early next

year. Maybe he will even deem it appropriate to expand the Bill by incorporating some or all of the Banking Committee's useful recommendations.

Whatever the future holds for C-46, Ladies and Gentlemen, the regulatory environment surrounding corporate governance in Canada is presently active and highly charged. Let us hope that a sane regulatory framework emerges, one with sharp and effective teeth to get the bad guys, as well as one which strikes a reasonable balance of moderation, reality and good sense so the good guys can continue to operate efficiently and corporate risk taking will not be dampened and our fine corporations not diminished or forced out of business by excessive regulation of corporate governance.

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