UPDATE ON CORPORATE GOVERNANCE: RESPONDING TO ENRON AND OTHER CORPORATE SCANDALS

In the wake of the recent corporate scandals in the United States, including the bankruptcy of Enron Corp. in December 2001, and the massive losses sustained by shareholders as a result, corporate governance has been subjected to intense scrutiny in Canada, the U.S. and elsewhere. We discussed the legal framework for corporate governance in Chapter 19. How public corporations are governed in practice, however, is not just a function of legal rules. A variety of other factors may be identified, including those set out in the section that follows.

Business Practices: How boards are organized and the practices they adopt have an impact on how well they function. Practices that may improve the functioning of boards include:

1. practices designed to enhance the ability of the board to monitor and supervise management such as
   (a) having a chair of the board of directors who is not also the chief executive officer (CEO), the most senior manager in the corporation,
   (b) having truly independent board members who have no other relationship with management or the corporation (e.g., directors who are not also lawyers or bankers for the corporation),
   (c) enhancing role to independent board members by
      (i) giving them control of important committees, like the audit committee, which oversees financial reporting by the corporation,
      (ii) giving them responsibility to choose the CEO, nominate new directors and hire and fire auditors; and

2. adopting incentive schemes for directors and senior officers which appropriately align their financial interests with the interests of shareholders.

Business Ethics: The ethics and values of the officers and directors responsible for corporate decision making will have an impact on how diligently they seek to maximize the value of shareholders’ investment as opposed to benefiting themselves, and whether they are likely engage in fraud, insider trading, and other illegal activities.

Criminal Rules Dealing with Corporate Fraud: Where ethics fail, the effectiveness of the criminal law and its enforcement to punish and deter fraud and other illegal activities will be an important determinant of corporate behaviour.

Independence of Auditors from Management: Auditors are responsible to shareholders for reviewing the financial statements prepared by management and reporting on whether they fairly present the financial condition of the corporation. Where the independence of auditors from management is compromised, the risk that management will be able to engage in fraud and manipulation in the presentation of financial information is
increased. Independence of auditors from management may be compromised where management is in a position to determine if the auditing firm receives lucrative consulting work, such as providing advice on tax planning in addition to its auditing work.

**Effectiveness of Accounting Rules:** Shareholders will be able to monitor what management is doing only if accounting rules are effective to ensure that the financial condition of the corporation is fairly presented in its financial statements.

Following the corporate scandals in the United States, concern has been expressed that corporate governance must be improved. Changes have been initiated in many areas in an effort not only to avoid the kind of serious fraud alleged in the Enron case but also to strengthen corporate governance with a view to restoring investor confidence in the market.\(^1\) One important question is whether the Canadian legal framework for corporate governance discussed in Chapter 19 is adequate.

One could expand the legal framework by making mandatory some of the best corporate governance practices identified above. Some argue, however, that no such legal changes are needed or desirable. They claim that the market exerts its own discipline on management that fails to act in the interests of shareholders by driving down the price of shares of companies with poor governance practices. The prospect of crashing share prices should encourage management to do their best for shareholders. Lower share prices hurt management’s reputation and reduce aspects of management compensation tied to share prices, such as some bonuses. Low share prices also make corporations into takeover targets. They lower the cost of acquisition and create an opportunity for a bidder who successfully acquires control of a corporation to increase the value of its investment by improving management. Inevitably, this means getting rid of existing management. Managers can protect themselves against a takeover bid and the loss of their jobs by managing effectively and, in this way, keep share prices up. Proponents of these market-based disciplines also argue that, notwithstanding the pain caused by the dramatic fall in some share prices, only the market can be relied on to encourage enduring improvements to corporate governance in practice. Changes to legal rules, they claim, will involve significant costs and encourage only technical compliance and searching for loopholes.\(^2\) By contrast, only true improvements in governance practices will be rewarded by the market.\(^3\)

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1. Outside of the legal framework for corporate governance, some changes have already taken place. In July 2002, for example, the Canadian Securities Administrators, the Office of the Superintendent of Financial Institutions and The Canadian Institute of Chartered Accountants (CICA) announced the creation of a new Canadian Public Accountability Board responsible for promoting auditor independence and overseeing the work of auditors of public companies. The CICA has also issued proposed new guidelines on auditor independence.


3. McKinsey & Company issued a report in July 2002 entitled *Global Investor Opinion Survey: Key Findings*, which found that 57% of institutional investors felt that corporate governance was as important or more important than financial issues as a criterion for investment. Investors would be prepared to pay a premium for shares of corporations with good governance (11% for Canadian corporations).
Some major corporations have already engaged in significant reforms to their corporate governance systems beyond what is required by law in the interests of maintaining the confidence of their shareholders. Improvements have been made in accounting disclosure, for example, and more and more corporations are installing as the chair of the board of directors a person who is not also the chief executive officer, in order to enhance the effectiveness of board oversight of management.\footnote{Lexpert, citing securities lawyer Laura Sabia; TSX Letter.} Institutional shareholders, like pension and mutual funds, are the most significant investors in the stock market and increasing numbers of them are becoming more actively involved in ensuring that the corporations in which they own shares have strong corporate governance practices.\footnote{In February 2003, one of the largest institutional investors in Canada, the Canada Pension Plan Investment Board released its new guidelines, \textit{Proxy Voting Principles and Guidelines} indicating a much more aggressive approach to how it will vote its shares on a range of corporate governance issues (<http://www.cppib.ca/who/policy/Proxy_Voting_Guidelines.pdf>). Some U.S. institutional investors are adopting a similar approach (see C. H. Deutsch, “Revolt of the Shareholders: At Annual Meetings, Anger will Ratchet Up a Notch,” The New York Times, February 23, 2003, Section 3, at 1).}

Despite these responses from the marketplace, however, most doubt that relying on the market alone is a feasible solution. The dramatic collapse of a number of major U.S. corporations suggests that even if reliance on markets is the best approach to ensuring effective corporate governance, it can have great costs. Perhaps more fundamentally, many have asked why the markets did not do a better job of pricing in the risk of collapse of a business like Enron? Why, for example, was the market price of Enron’s shares not reduced to reflect the risk that the auditors of Enron, Arthur Andersen, would be compromised in fulfilling their responsibilities to shareholders by their interest in retaining lucrative consulting business from Enron and that their audit of the financial information provided by the corporation was therefore not reliable?\footnote{J. N. Gordon, “What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections,” (2002) 69 U Chicago L R 1233, at 1235-1240.}

The U.S. Congress has responded to Enron and other corporate scandals by substantially expanding the legal framework for corporate governance through the enactment of the so-called “Sarbanes-Oxley” Act in 2002.\footnote{PUB L No. 107-204, 116 Stat. 745 (2002).} Sarbanes-Oxley mandates an array of best practices in corporate governance and creates a number of new criminal offences relating to corporate fraud. Detailed rules to implement these changes have been developed by the U.S. Securities and Exchange Commission (SEC). New listing requirements approved by the New York Stock Exchange in August 2002 contain a variety of additional mandatory requirements relating to corporate governance. Key features of these new rules are set out in the section that follows.

\section*{Key Features of New U.S. Corporate Governance Rules}

- Corporations must have corporate governance, audit, and compensation committees, each with a written charter containing prescribed content.
• Audit committees must discharge certain prescribed responsibilities, including appointing, discharging, and supervising the corporation’s auditors, and have a certain level of financial expertise.
• A majority of board members and all members of the corporate governance, audit and compensation committees must be independent, meaning that they have no material relationship with the corporation, apart from their roles as directors.
• Corporations must adopt a code of business conduct; and adopt and disclose corporate governance guidelines.
• Loans to directors and officers are prohibited.
• Disclosure documents, including annual and quarterly financial statements, must be certified by senior officers.
• A lawyer who reasonably believes that a material violation of securities law, breach of fiduciary duty or similar violation has occurred, is occurring, or is about to occur must report evidence of the material violation to the CEO, chief legal officer or other appropriate officer within the company (called “up-the-ladder reporting”).

If an outside lawyer believes that the board or a board committee has not appropriately responded within a reasonable period of time to evidence of such a material violation that is ongoing or about to occur and is likely to result in substantial injury to the company or investor, the lawyer must: (i) withdraw from representing the company, indicating that withdrawal is based on “professional considerations,” and (ii) within one business day of withdrawing, notify the SEC in writing of this withdrawal for “professional considerations” (called a “noisy withdrawal”).

In Canada, there is an emerging consensus on the need for a similar strong rules-based response to perceived problems in corporate governance. This marks a significant departure from the approach followed in Canada since the mid 1990’s which has relied on voluntary compliance. Based on a study for the Toronto Stock Exchange (TSX), in 1995, the TSX established a number of best practices benchmarks for corporate governance. The TSX requires listed corporations to report each year on the consistency of their corporate governance practices with these benchmarks. Such a voluntary “principles-based” approach to corporate governance is similar to the approach followed in Europe, the United Kingdom, and Australia. The recent changes in the legal rules in the United States made mandatory many of the TSX’s benchmarks.

Following the enactment of Sarbanes-Oxley, some in Canada remain in favour of a voluntary principles-based approach. The head of the securities commission in British Columbia, the CEO of the TSX, and the Canadian Council of Chief Executives have argued in favour of retaining the present system with some enhancements, including a

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9 TSX Company Manual, s 473.
10 Lexpert.
11 TSX Letter.
few new mandatory requirements. In rejecting the detailed rules-based approach being pursued in the US, they emphasize the differences in the scale of public corporations in Canada as compared to the United States, arguing that the application of rigid rules of the Sarbanes-Oxley type would be too onerous in Canada, where many public corporations are significantly smaller than those in the US. As well, given the small pool of potential independent directors and the inability of many Canadian businesses to pay significant directors’ fees, it is argued that compliance with Sarbanes-Oxley type rules would be impossible. Supporters of this view claim that the relatively small number of large Canadian corporations that could comply with such rules have shares listed in the United States and so are obliged to comply with US rules in any event. While some additional mandatory obligations may be acceptable, the core of the Canadian corporate governance rules should be voluntary compliance with principles accompanied by mandatory disclosure of the extent to which benchmarks for governance are met and reasons for any non-compliance.

Most securities regulators, including the Chair of the Ontario Securities Commission (OSC), now doubt the adequacy of a voluntary principles-based approach. A recent study supports their concerns. The study found that 35% of corporations listed on the TSX were not fully in compliance with even the relatively soft obligation to disclose the extent to which they met the suggested benchmarks. The authors of the study concluded that this level of non-compliance was inviting the imposition of mandatory requirements. The federal and provincial governments have begun to do so.

In December 2002, Ontario passed Bill 198, which amended the Ontario Securities Act. Among other things, the Act gives the OSC the power to make rules governing the composition and conduct of audit committees, requires corporations to adopt systems of internal controls, as well as disclosure controls and procedures, and directs chief executive officers and chief financial officers to provide certifications related to internal controls and to disclosure controls and procedures.

In June 2003, the OSC, along with all the provincial securities regulators, except the British Columbia Securities Commission, released for comment draft provisions relating to the quality and reliability of public disclosure by corporations and the role and composition of audit committees. The draft provisions require CEO’s and Chief Financial Officers to certify their corporation’s financial statements and annual information filings, and set standards for auditor independence, and the operation of audit

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13 The TSX board of directors approved new, more rigorous disclosure requirements and amended corporate governance guidelines on March 26, 2002. Further revisions were issued in November, 2002. These changes address many of the same issues as Sarbanes-Oxley and the New York Stock Exchange Listing Requirements.
16 Keeping the Promise for a Strong Economy Act (Budget Measures), 2002, SO 2002, c 22 (2002 OSA Amendments), Part XXVI.
committees. These provisions are to be implemented as rules\textsuperscript{17} or regulations in each province. Once the provisions are finalized, it is anticipated that implementation will occur in stages beginning in January 2004, with full implementation to be completed by January 2005.

The December amendments to the Ontario \textit{Securities Act} also provide that new securities fraud offences are to be created and civil liability is to attach for misrepresentations made by corporations in their disclosures to the public and where a required disclosure has not been made. As of June 2003, the securities fraud amendments had been proclaimed in force but the amendments to establish the civil liability regime had not been.\textsuperscript{18}

On June 12, 2003, the federal government introduced two bills to enhance the criminal law rules relating to securities market activities. Bill C-46 creates new criminal offences related to insider trading, which complement offences created under corporate and securities laws. A new offence is also created for corporations that retaliate against whistle blowers who provide information regarding an offence to law enforcement authorities.\textsuperscript{19} As well, the Bill contemplates stiffer criminal penalties for capital market fraud. The penalty for defrauding the public or any person of property, money or valuable securities, or engaging in intentionally fraudulent acts that affect the public market price of shares will be increased to a maximum sentence of 14 years imprisonment from the current maximum of ten years. A companion bill, Bill C-45, broadens the category of persons whose behaviour may result in criminal liability for the corporation.\textsuperscript{20} The Bill provides that a corporation may be deemed to be a party to a criminal offence committed by one of its representatives if a senior officer was knowingly involved in the offence or was aware of the offence and knowingly failed to take all reasonable measures to stop the representative’s participation in the offence. Unlike the common law standard discussed in Chapter 19, the senior officer need not be a “directing mind” of the organization. The bill also enhances the investigatory powers of law enforcement officials and sets new and tougher sentencing guidelines for capital markets offences and offences committed by corporations. These new rules have not yet been passed by Parliament.

Thinking on corporate governance in Canada has been dramatically affected by the major corporate scandals in the US and the rules-based American response in the Sarbanes-Oxley legislation. Some changes to aspects of corporate governance in Canada have been introduced already and others are actively under consideration. This marks the beginning of what may be a dramatic transformation in the legal framework for Canadian

\textsuperscript{17} Some securities regulators, such as the Ontario Securities Commission, have been given the power by statute to make legally binding rules. Other provinces must pass regulations. The new rules on certification, auditors and audit committees will be enacted by the OSC pursuant to the \textit{2002 OSA Amendments}, ibid., s 187(3).

\textsuperscript{18} In the federal budget announced by Finance Minister John Manley on February 18, 2003, the government indicated that it intended to introduce changes to the \textit{Canada Business Corporations Act}, RSC 185, c C-44, to improve corporate governance standards.

\textsuperscript{19} Bill C-46, \textit{An Act to amend the Criminal Code (capital markets fraud and evidence gathering)}.

\textsuperscript{20} Bill C-45, \textit{An Act to amend the Criminal Code (criminal liability of organizations)}. The common law rules regarding criminal responsibility are discussed in chapter 19.
corporate governance. Whether it leads to significant improvements in corporate governance in Canada remains to be seen.\textsuperscript{21}

\textsuperscript{21} This update draws on J. A. VanDuzer, \textit{The Law of Partnerships and Corporations} 2d ed (Toronto: Irwin, 2003) at 258-265.