DOING WHAT'S RIGHT

TRUST AND ACCOUNTABILITY IN THE PUBLIC AND PRIVATE SECTORS

Notes for remarks
to the CGA Economic News Luncheon

By David Stewart-Patterson
Senior Vice President, Policy
Canadian Council of Chief Executives
Ottawa, October 29, 2002

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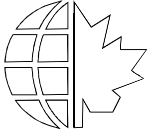

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Democracy cannot function in the absence of public trust. Neither can free markets. Today, though, public trust seems to be at a low ebb: in business leaders, in corporations and in market-based policies, but equally in elected leaders, in our democratic institutions and in the political process. If not addressed effectively, this loss of trust will have serious consequences for our economy and for our society.

Today, I want to look at how Canada's business leaders are addressing the challenge of rebuilding public trust through the process of corporate governance. Then I will offer a few personal thoughts by way of comparison on what governments are doing. And I will conclude with what I see as some common themes in terms of what needs to be done in both the public and private sectors if Canada is to rebuild public trust and move forward as a country.

Let me begin with the corporate challenge. Here, I think that public trust has been undermined on two levels. First, corporate scandals such as Enron and WorldCom have defrauded investors of billions of dollars and undermined confidence in the integrity of markets. Second, more subtly, there seems to be a perception that the culture of greed has run rampant, that too many people have been cashing in on short-term performance that proves to be short-lived.

In the United States, the response to Enron and other major scandals involving breaches of the law has been driven by the political process. Legislators facing mid-term elections this fall scrambled to pull together a tough-looking package of new laws to add to the ones that had already been broken. The result, the Sarbanes-Oxley Act, imposes stacks of new rules and penalties that affect boards of directors, senior

executives, accountants, lawyers and others involved in the corporate governance process.

It also creates a significant gap between the legal and regulatory framework in the United States and that in Canada. How then should this country respond?

According to the Ontario Securities Commission, there is no choice but to harmonize. According to this argument, adoption of any regulatory regime less comprehensive and rigid than Sarbanes-Oxley is a recipe for disaster, a loss of confidence that would send capital fleeing from Canada's markets.

Other key players are sending a different message. Barbara Stymiest, President and Chief Executive Officer of the Toronto Stock Exchange, has pointed out that the implementation of Sarbanes-Oxley is likely to be long, complex and messy, causing considerable uncertainty in the United States and certain to involve numerous mistakes that will have to be fixed. Her question: why would we want to impose all of that uncertainty on Canadian markets, especially on smaller companies that may be ill-equipped to handle a vast new regulatory burden.

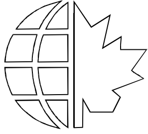
Then last week, Hardwick Simmons, chief executive of NASDAQ, the world's second-largest stock exchange, urged Canadians not to get swept up in the American regulatory wave. He approves of measures to increase transparency, but suggests that the pile of new restrictions on directors, auditors, investment bankers, analysts and others threatens to strangle the capital formation that is essential to economic growth.

And sure enough, the Financial Times of London has reported that dozens of publicly traded American companies are now looking for ways to delist their stocks and go private because of the burden being imposed by all the new regulations. Lawyers quoted in the article point out that all the new rules will add to the liabilities of directors and to compliance costs. They also could hurt smaller companies in particular by making it more difficult to get analyst coverage and therefore by decreasing the liquidity of their shares.

Many of Canada's largest public companies are directly affected by Sarbanes-Oxley. For them, the issue of its costs and benefits is moot. And even companies that may not be legally required to comply with Sarbanes-Oxley recognize that effective compliance with the new United States rules may be necessary to ensure competitive access to liability insurance, credit or analyst coverage.

More broadly, though, Canadian chief executives understand that good governance matters. Compliance with United States law may be necessary for some. But for any company, compliance with the highest standards globally is a way to create an important competitive advantage.

At the same time, Canadian chief executives recognize that in matters of governance, one size does not always fit all, that while some principles are universal, the way they are applied should be shaped by the circumstances. In particular, many of the members of the Canadian Council of Chief Executives are worried that wholesale adoption of the new American rules could hurt rather than help the ability of thousands of smaller public companies in Canada to attract capital and to grow.



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A few weeks ago, the Council unveiled a comprehensive set of recommendations on corporate governance in Canada. Despite the fact that our membership includes four distinct corporate structures -- widely held public companies, public companies with a controlling shareholder, privately held Canadian companies and wholly owned subsidiaries of multinational enterprises -- the Council achieved what I think is a remarkable degree of consensus through two months of intense personal engagement by member CEOs.

Our first recommendation focused on CEO accountability. Our members have always signed off on their financial statements. And they have said they also are ready and willing to put their word on the line in terms of a comprehensive personal certification comparable to that required by Sarbanes-Oxley.

In addition, we called for more vigorous enforcement and tougher penalties for breaches of the law, as well as faster and more comprehensive disclosure of insider trading. And we suggested that boards take a look at CEO compensation in two key areas.

First, based on the principle that executive pay should be linked strongly to performance, we suggested that legal and regulatory sanctions could be supplemented by employment agreements. In addition to offering rewards for good performance, boards could ensure that these agreements include provisions that would reduce or even require repayment of bonuses if, for instance, the company was forced to restate its financials.

Second, we addressed the broader concern about whether too many executives have been able to cash in too quickly for corporate performance that proves to be unsustainable. Here, we suggested that boards consider a greater emphasis on compensation linked to longer-term performance.

As two examples of ways to achieve this goal, we mentioned the payment of a significant portion of bonuses in the form of stock that must be held until departure or retirement, or a requirement that a significant portion of the after-tax proceeds from the exercise of stock options remain invested in company stock for a minimum period.

More broadly, though, our members believe that the key to good governance is more a matter of values than of rules, and we recognize that a fundamental responsibility of the chief executive is to live those values. That is why our second and third recommendations dealt with the expression of a company's values -- internally through a comprehensive code of ethics and conduct, and externally through good corporate citizenship and stakeholder relationships.

We went on to recommend in considerable detail a wide range of good governance practices that should lead to stronger, more independent boards of directors, reinforce the integrity of the audit process and enhance the degree and extent of public disclosure.

And while our formal recommendations were limited to actions that could be taken within the company by shareholders and boards, we also discussed the vital roles to be played by institutional shareholders, accountants, analysts, investment dealers, educational institutions and the media in addition to governments and regulators.

Through it all, we emphasized that much of what needs to be done to restore and enhance investor confidence in the integrity of Canadian companies and markets can and should be achieved within the private sector. Individually and collectively, it is business leaders who must earn the public trust that they need to build their enterprises and strengthen the economy. No government can legislate that trust. No regulator can restore it. Businesses must earn it.

The Council's emphasis on voluntary action has been portrayed by some people as a "laissez-faire" attitude, a go-slow approach that is out of touch with today's market realities. It is true that the Council favours a principles-based rather than rules-based approach to improving governance practices. But that is because we believe that comprehensive guidelines backed up by mandatory disclosure are in fact a more effective way to improve the norms of acceptable behaviour and prevent future abuses of public trust than any approach that relies excessively on precise but narrow rules. Canada needs to do better than Sarbanes-Oxley, and that does not mean simply going further down the same path as the United States.

In making this case, there are three points I want to emphasize. First, no country relies exclusively on either a rules-based or principles-based approach. Canada's approach includes a mix of both rules and principles and always will. But in looking at how to move forward, we have to remember that rules define the minimum that is acceptable. Principles move personal and corporate behaviour beyond that legal minimum. The question then is whether and to what extent investor confidence will be increased by raising the minimum rather than by enhancing the norms of actual practice.

My second point is that too many rules can limit good governance and hurt investor confidence just as easily as too few rules. Rules have their strengths, but also their downsides. Let me offer a couple of examples.

Canada defines what constitutes an independent or unrelated director with a broad statement of principle: such directors must be “free from any interest and any business or other relationship which could, or reasonably be perceived to, materially interfere with the director’s ability to act with a view to the best interests of the company.”

In the United States, on the other hand, new rules will determine independence through a long list of very specific tests. For companies listed on NASDAQ, for instance, a director may receive up to $60,000 (U.S.) a year from the company in addition to directors’ fees without compromising his independence.

It is not clear to me why $59,999 would not compromise someone’s independence while $60,001 would. And while I would agree that for the CEO of a Fortune 500 company, $60,000 is unlikely to be material enough to compromise his ability and willingness to ask tough questions of management, would the same necessarily be true for a semi-retired executive sitting on only a couple of boards, where an extra $60,000 in consulting income on top of directors’ fees could be a significant proportion of total income?

Take another of the NASDAQ tests. A director is deemed to lose his independence if he is an executive officer of a charity that receives more than $250,000 from the company. How will this affect the eligibility of most university presidents as independent directors?

This spills over into another area of concern for those interested in improving corporate governance. Earlier this month, Senator Donald Oliver made an eloquent argument for improving governance through diversity, through enlargement of the pool of potential directors to include employees, academics and leaders in the non-profit sector.

Yet new highly specific rules and definitions could rule out many of the people he recommended. Indeed, one reason the New York Stock Exchange resisted a requirement that audit committee chairs have specific financial qualifications is that it would have had a disproportionate gender impact on women then serving as audit chairs.

To take another example in this area, consider the recent *Globe and Mail* ranking of governance practices at 270 Canadian public companies. To win top marks by the newspaper's benchmarks, companies had to require that directors own shares worth at least three times their annual retainers, and were prohibited from lending directors money, even to buy those shares. If these two benchmarks became regulatory requirements, would we and should we exclude as directors anyone unable to finance that scale of investment on their own?

My third and final point with respect to the relative merits of rules and principles is that the latter are fundamentally more effective. There have been a number of suggestions recently that Canada cannot hope to restore investor confidence without a host of new rules that are enforceable by law. I would agree that rules deal very precisely with known circumstances and make life easier for regulators and prosecutors seeking to win cases. But surely the goal here is not just conviction, but prevention.

Rules are not always the best deterrent. As respected shareholder activist Stephen Jarislowsky put it, an excessive reliance on rules can lull the ordinary investor into a false sense of complacency. Nor do rules necessarily lead to what the Joint Committee on Corporate Governance referred to as moving beyond compliance in order to build a culture of good governance.

Even in the absence of specific rules, strong investor expectations coupled with peer pressure can have a powerful impact. Just look at how Canada's performance stacks up against that of the United States on some key issues.

First, many experts consider that one important element in building a stronger, more independent board is to separate the positions of chair and chief executive officer. In the United States, only a quarter of the largest public companies split these positions, and yet Sarbanes-Oxley does not even address the issue. In Canada, by contrast, last year's survey of boards by Spencer Stuart found that 70 percent of the top widely held companies have split the two positions, and another 20 percent have appointed independent lead directors.

Second, Spencer Stuart found that Canadian companies were far more likely than their American counterparts to formally evaluate the performance of the board of directors as a whole (by 76 percent to 52 percent) and more than twice as likely to evaluate the performance of individual directors (50 percent to 21 percent).

Third, Sarbanes-Oxley, the New York Stock Exchange and NASDAQ have all moved to strengthen the independence of audit committees with a new requirement that the committee have access to outside advisors. Yet existing Canadian guidelines already give that authority

to all directors, not just members of the audit committee. And even though it is just a guideline, Spencer Stuart said this practice is actually in place in nine out of ten of the boards it surveyed and is "well on its way to becoming universal in Canada".

To illustrate the power of a principles-based culture, put yourself in the shoes of a person contemplating a particular action. In a rules-based culture, you just have to ask: "Is this against the rules? If not, or if my lawyer can make a good argument that it's not, I'm okay." In a principles-based culture, on the other hand, you must ask: "Is this right? Or is it wrong?" And whatever your answer, you have to be prepared to explain it publicly and live with the consequences.

To put this another way, a principles-based culture replaces definitions and rules with the smell test. And in today's highly skeptical marketplace, even a whiff of impropriety can trigger an abrupt and dramatic response. By using disclosure to give power to investors rather than to lawyers, a principles-based culture can punish actions that fail the smell test far faster and often more effectively than any regulatory and legal process.

This power is not limited to markets. Just last week, Lawrence MacAulay resigned his post as solicitor-general. Both he and Prime Minister Jean Chrétien insisted that he had not broken any rules or indeed done anything wrong. But both of them acknowledged, in effect, that according to the public's nose, his actions had failed to pass the smell test -- and that alone required his departure from Cabinet.

As long as people know what is going on, as investors or as citizens, they have significant power to impose judgment, to reward and to

sanction the behaviour of corporate executives and political leaders alike.

In the public sector, current discussion is centred on two issues related to governance: ethics and institutional reform. Last week, the federal government released a major ethics package for members of the House of Commons and Senators. The most significant element in the draft bill is the creation of an independent ethics commissioner who will report directly to Parliament and who will administer a new code of conduct for parliamentarians.

This change in effect puts ethics on the same plane as financial probity. The government of the day will retain the power to override the advice of the new commissioner just as it can ignore that of the Auditor General. However, any parliamentarian will be able to request the Ethics Commissioner to look into the conduct of a minister, and the resulting report will be made public. Regardless of the decisions any prime minister may make in a particular circumstance, the actions of ministers will be subject to more rigorous scrutiny and disclosure, and therefore be subject to public judgment. This is an important step forward.

The creation of the Ethics Commissioner and the drafting of the code of conduct come on top of new guidelines released in June covering the actions of ministers and secretaries of state, in particular with respect to dealings with Crown corporations and to activities for personal political purposes. Still to come in the weeks ahead are new rules for financing political parties and strengthening public service accountability.

There has been much talk, but less action, when it comes to institutional reform. There have been numerous proposals over the years for reforms to the Parliamentary process that might restore public faith in our democratic institutions. As Tom d'Aquino and I discussed in our book last year, *Northern Edge: How Canadians Can Triumph in the Global Economy,* measures to this end could include:

- stronger Parliamentary committees, with chairs elected by a double majority of government and opposition members;
- a commitment by ministers to participate personally in all committee meetings on bills for which they are responsible;
- consideration by committees of more bills at the draft stage, to enable more collaboration across party lines;
- public review of key appointments, to the courts, the Bank of Canada, regulatory bodies and the boards of directors of Crown corporations; and
- making confidence votes in Parliament the exception rather than the rule, so that MPs would in most cases be free to vote according to the wishes of their constituents and the dictates of their conscience.

In one way or another, broader engagement of citizens through their elected representatives is critical to restoring public trust and to making Parliament and provincial legislatures more effective institutions.

This leads me to what I see as four key themes that must drive any effort to restore and enhance public trust in business and government alike.

The first is the issue of *checks and balances*. While strong and visionary leadership is important to the success of enterprises and of governments, no leader's power should be unchecked.

In the private sector, the check on the power of the chief executive officer must be a strong, independent and engaged board of directors, able and willing to work closely with the CEO, but also to assess his or her performance and act accordingly.

In the public sector, the primary check on executive branch power must come from the legislature. These powers are not formally split in Canada as they are in the United States. But I would argue that Canadian MPs and their provincial counterparts should have more power both to contribute to the development of legislation and to question and focus public attention on the actions of the prime minister and premiers and of the members of their respective cabinets.

The second common theme is the need for *greater personal accountability* on the part of decision-makers. As I mentioned earlier, one of the key elements of the Sarbanes-Oxley Act is the personal certification by chief executive officers and chief financial officers of every significant aspect of their annual and quarterly reports.

Under the new American rules, corporate executives must certify personally not only that their financial statements are accurate and fairly represent the condition of the company, but also that every material statement in the report is true, that nothing has been left out

that might make what is said misleading, that processes are in place to make sure that the CEO is aware of all material facts and that the CEO has checked these processes and reported any deficiencies. The CCCE's work suggests that a comparable certification here is widely accepted by Canadian chief executives as a useful means of reassuring investors of the integrity of the information companies provide.

It seems to me that the same argument could be made with respect to the public sector in Canada. Since governance structures are different, the forms of accountability might not be identical, but surely the principles remain the same.

This still leaves open a number of key questions. For instance, should ministers personally certify that the financial statements of their departments are accurate and complete, that all material facts in their reports to Parliament are true, that nothing has been left out that might make them misleading, and that they have put in place and monitored the processes necessary to make sure that they are fully aware of all material actions by their departments? Or should deputy ministers be the ones made directly accountable through such a certification, in which case, would there have to be a provision like that in the United Kingdom allowing ministers to override their deputies only if they do so publicly and in writing?

In either case, should this accountability be administered through regulation or guidelines? In other words, should such certifications be subject to sanctions determined by regulators or the courts? Or should we continue to rely primarily on guidelines, ones that require full disclosure of relevant facts, advice and decisions but leave the power to decide sanctions with the Prime Minister?

I have put these ideas on the table as questions rather than answers, but I believe that one way or another, the public is demanding greater accountability from leaders in government as well as in business. And I believe that leaders in either sector ignore such demands at their peril.

This leads to my third theme, the *power of disclosure*. In today's society, more than ever, knowledge is power. Give people information and they will use it. Try to withhold information and they will find out anyway.

In the corporate sector, what this means is that anything a company does anywhere in the world can have an immediate and real impact on its reputation everywhere in the world. In effect, the globalization of information and personal networks means that, far from engaging in a race to the bottom, companies are being held to the highest common denominator. And their performance against this benchmark affects everything from their licence to operate and their relationships with customers to their ability to recruit and retain employees.

Perhaps most significantly, a company's actions in any area -- its environmental performance, its human rights record, the treatment of its labour force, the safety of its products, and so on -- can significantly affect investor perceptions of risk. And this in turn can have an abrupt impact on the price of a company's shares, which in turn affects both the compensation and job security of top executives.

To take a single practical example, the recent decision by the *Globe and Mail* to compile a ranking of corporate governance practices is likely to generate significant action by Canadian corporations before

the bulk of the regulations needed to implement Sarbanes-Oxley are even drafted, much less implemented and tested in the courts.

Disclosure is a powerful tool for improving governance and for enhancing public trust, and it can work just as well in the public sector. I would suggest in particular the need to strengthen rather than weaken Access to Information legislation: to speed up the processing of requests; to reduce the number of exemptions; perhaps even to insert an element of personal accountability for deliberate delays or unwarranted deletions from responses to access requests. While there will always be a duty to protect the privacy of certain information supplied to governments, in principle citizens have a right to know what is being done in their names and with their money. And greater transparency is critical to more effective accountability.

This leads me to my final theme: the *value of values*. Without the right tone at the top, without a real commitment to ethical principles by those in charge, all the rules in the world will not restore public confidence in either business or government.

Restoring public trust requires more than the adoption of new governance practices or codes of ethics. In the public and private sectors alike, leaders are going to have to show that they mean what they say, that they practice what they preach. There is simply no possible substitute for honesty and for personal integrity.

In an age of information overload, character matters more than ever. In the drive to restore public trust, we need to do a better job of catching and punishing those who break the rules and abuse that trust. But we also need to make sure that our governance processes help

both private enterprises and public institutions to attract and retain leaders with a high degree of both competence and character.

On the whole, Canada has a good reputation. Our corporate governance practices and the integrity of our business environment and leadership are highly regarded by investors around the world. Similarly, Canada's public sector -- its governments, public service, judiciary and police forces -- are models of competence and honesty for many other parts of the world. This combination is an important advantage for Canadian companies as they try to grow their businesses globally. And it is an important advantage for our country as we try to attract talented immigrants and international investors.

So we start from a strong base. But we have to admit that public trust has been badly shaken. And leaders in business and government alike are each going to have to do their bit in living the values and delivering the actions that are needed to restore the confidence of citizens and of investors, and then take that confidence to new heights. Good governance, in the public and private sectors alike, can and must be one of Canada's competitive advantages. And in addressing this formidable challenge, we all have to be part of the solution.