

Notes for Speech at The Canadian Club Luncheon –

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I am pleased to be here to speak at this Canadian Club Luncheon. One would not have thought a few years ago that my topic "Confidence in Canadian Capital Markets – Is Good Governance Important?" would be of much general interest. Tunes change. Nevertheless, we should not take any subject too seriously. I was reminded of this late last Friday afternoon when I was flying back to Toronto from the East Coast. I was sitting beside a young banker and he told me my name had been mentioned that afternoon at a meeting he had attended. The meeting was with a group of hard driving successful, entrepreneurial businesspeople, the type who have done so much to build this country. The type who understandably have little patience for process or technical matters. Your speaker was referred to as a "poster boy for corporate governance".

1. Purpose of Private Sector Corporation

In a thoughtful article in the December, 2002 Harvard Business Review, Charles Handy states,

“In the wake of recent corporate scandals, it is again time to ask ourselves the most fundamental of questions” – namely “What’s a Business For?” I quote further from this article:

“Capitalist fundamentalism may have lost its sheen, but the urgent need now is to retain the energy produced by the old model while remedying its flaws. Better and tougher regulation would help, as would a clearer separation of auditing from consulting. Corporate governance will now surely be taken more seriously by all concerned, with responsibilities more clearly defined, penalties spelled out, and watchdogs appointed. But these will be plasters on an open sore. They will not cure the disease that lies at the core of the business culture.

We cannot escape the fundamental question, Whom and what is a business for? The answer once seemed clear, but no longer. The terms of business have changed. Ownership has been replaced by investment, and a company’s assets are increasingly found in its people, not in its buildings and machinery. In light of this

transformation, we need to rethink our assumptions about the purpose of business.

Both sides of the Atlantic would agree that there is, first, a clear and important need to meet the expectations of a company's theoretical owners: the shareholders. It would, however, be more accurate to call most of them investors, perhaps even gamblers. They have none of the pride or responsibility of ownership and are, if truth be told, only there for the money. Nevertheless, if management fails to meet their financial hopes, the share price will fall, exposing the company to unwanted predators and making it more difficult to raise new finance....The purpose of a business, in other words, is not to make a profit, full stop. It is to make a profit so that the business can do something more or better. That "something" becomes the real justification for the business. Owners know this. Investors needn't care.

In this context, it is interesting to look at some of the numbers in MacLean's Magazine year end (December 31, 2002) poll of people across Canada and I quote,

“Switch Your Focus, Boss --- Percentage saying the prime role of a company CEO should be...

Ensure products and services are the highest quality	→	20
Take care of the employees	→	19
Ensure company is a good corporate citizen	→	18
Ensure company is profitable	→	16
Provide employment for worker wherever the company operates	→	13
Increase value of company for benefit of shareholders	→	9”

You will note from this that the average public has a very different view as to what the prime role of a company is compared with the expert. In this context, a major modification to our corporate law suggested by the Broadbent-Bennett report of 2002 entitled “Canadian Democracy and Corporate Accountability” is that the fiduciary duty of directors be changed so that as long as directors take into account shareholder interests they can also take into account all other stakeholder interests, such as employees, customers, suppliers, creditors and communities.

I remind you that the current law is that directors are to manage the Company in the best interests of the company which is normally interpreted to mean the best interest of the shareholders. I suspect as a pragmatic matter the black letter of the law has to some extent been left behind by public mores. My own approach is that the purpose of the corporation is to enhance shareholder value on a long term basis. The longer term interests of shareholders will not be well served if the interests of other stakeholders are not addressed.

2. **Wealth Creation**

- (a) Wealth creation by corporations on a long term basis is very important to the success of our society. If we want to have a caring society and a society with a great quality of life, we must have the resources to help the unfortunate.

- (b) Society must also have the resources to make long term value creating expenditures on such things as health care, education (including most importantly early childhood development and other programs to make our citizens more productive), transportation systems, ports, etc.

What This Means

This means that a lot more is involved in creating confidence in our capital markets than just good corporate governance. The capital markets are just one means of participating in our broader society and in the development of our society. Canadian public policy in such areas as openness to free trade, controlling inflation, reducing public debt and in other areas is of fundamental importance to our society. Even more importance is the ability to execute such policies. This is a quality which is often sadly lacking both in government and in the private

sector. The registration of firearms may or may not be good policy but the disaster in implementation illustrates my point.

Investors, foreign investors in particular, will assess as a country as a possible place to invest by looking at these many factors at play in our society.

Corporate Governance

By my comments above, I do not mean to imply that the way our private sector corporations are managed is not important but if we want to attract more Canadian investors and world wide investors, many other important factors are involved.

Let me now turn to the governance of our profit making corporations. The accountability here is to shareholders (through the directors) and to other stakeholders and to regulators particularly securities regulators including importantly self-regulators such as the IDA and the TSX.

Let me speak first about securities regulators. On the whole, I believe our securities regulatory system, including the self regulation part of it, is as good or better than in the U.S. both in terms of the laws and the rules and the people who administer them. It used to be regularly stated by our media and that the SEC was the model regulator. We have discovered with the coming of Enron, Worldcom, etc. that the SEC has been underfunded and to some extent lacking talent.

I am not saying we do not have any problems in Canada. We do, but on the whole, we may be better. I say this with some confidence in that I have recently chaired a Committee on the Standards of Analysts in Canada and I am currently chairing a Committee appointed by the Treasurer of Ontario reviewing the securities laws of Ontario. I have also had considerable experience in the U.S. Do not misunderstand me, I am a great admirer of the U.S. society. I am merely trying to bring some balance to this matter.

There is, however, in my view, one serious deficiency with our securities regulatory system in Canada and that is the lack of one securities regulator for Canada. We have good regulators in our various provincial securities Commissions and a lot has been accomplished to make the system more efficient. The TSX represents over 90% in value of all stock market transactions in the Canadian capital markets. Some of the Provinces are concerned perhaps with some justification, that with one regulator based in Toronto, local interests will not be looked after. Quebec is also concerned about its "sovereignty". In this connection, I want to repeat some comments I made at a Special Gala celebrating the 150th Anniversary of the TSX on October 24, 2002.

I have a vision or aspiration for Canada. (Some might call it a mixed up dream.)

My vision involves one securities regulator for Canada. My vision is:

That the Premier of Ontario or the Treasurer of Ontario would state publicly (and follows through as an implementation matter) that Ontario wants one regulator, that Ontario does not care if the

regulator is a Federal regulator with Provincial delegation, or the other way around;

- That the regulator must have strong regional offices, with Vice-Chairmen in such offices and local regulation largely in such offices;
- That the Canadian Securities Administrators have a great project in developing a uniform act and it would be great if the uniformity project and the British Columbia project for more simplified regulation could, at some point, be integrated;
- That in the meantime, let's move forward with one regulator with the basic law to start being, say, the Alberta Securities Act;
- That we should not regard it as failure if one or more Provinces do not go along;
- If Ontario were to do this, or some such initiative, it would be a major positive step forward towards one regulator for Canada and a very good development for our capital markets.

Perhaps the "wise men" process recommended by Harold McKay to the Federal Finance

Minister last fall to advise on this matter will help solve the problem. The wise men are to be

appointed by the Federal government with input from the provinces. To date, they have not been appointed. I would hope that the provinces would put what is in the interest of all of Canada first. If not, then in my view, the Federal government should move ahead on its own.

Evaluation of Corporate Governance

Perhaps the Enron, World Comm and Tyco affairs have been, by hindsight, the greatest catalyst for the development of better corporate governance since the developments under President Roosevelt in 1933 – 34 (with the enactment of the *Securities Act* of 33 and the *Securities Exchange Act* of 34). There are several matters arising out of these developments, in the U.S., Canada and the U.K., that I would like to touch upon.

- (1) With the exception of many aspects of both the Saucier Report and the Higgs Report, the recent developments in the U.S. and their counterparts in Canada and the United Kingdom are designed to deal with misbehaviour, compromised accounting, fraud, etc.

They have absolutely nothing to do with creating shareholder value, other than the prevention of the destruction of shareholder value. As a matter of fact, if these laws and rules cause directors to be more conservative they may be negative to creating better performance. I was recently told by a U.S. corporate director that a C.E.O., of a U.S. company, spent over 60 hours doing the preparatory work to be able to certify the company's financial statements. The amount of time required may decrease over time but I have serious reservations about whether this is a good use of a "leader's" time. The point is, as was noted in the Economist of January 11, 2003 and I quote:

"When regulators seek to impose good governance, they may do more harm than they prevent. Some folk, such as William Allen, a respected former judge on the Delaware Chancery Court, where most big corporate lawsuits are heard, who is now a law professor at New York University, already fret that the current changes go too far, staunching the appetite for risk and innovation. Many of the proposed new requirements insist on measures that most boards ought to have met, one way or another, of their own volition."

This is not to say that these developments are not fundamentally important. They are and should be. The integrity of our capital markets requires no less. These developments have a lot to do with investor confidence.

In this connection the best thing directors can do to guard against misbehaviour, compromised accounting, fraud, etc., is to be satisfied with the values and integrity of the C.E.O. and that the C.E.O., and other leaders, have spread a values culture throughout the organization. If a director does not trust the C.E.O. then either the C.E.O. should be gone or if dumping the C.E.O. is not possible, the director should get out.

What this means to me is that if I had the responsibility of re-writing the "Dey or Saucier" guidelines I would provide that the number one responsibility of a Board of Directors is to be the guardian of corporate values. To make sure that the C.E.O. and the other leaders are people of integrity and that they "walk the talk".

(2) The holy grail of independence for Directors

There are two types of independent directors. Those who are strong minded and are able to be independent regardless of their relationships with the issuer and those who have no relationships with the issuer and still might not be able to be independent.

Perhaps psychological testing would be a better way to ascertain independence.

The requirements or proposed requirements in the U.S. would require all the directors of the Key Committees – Audit, Human Resources (or at least the compensation part of human resources) and Governance, to be independent. The proposed guidelines of the Higgs Report in the United Kingdom make the same recommendations and the TSX proposed guidelines (not mandatory rules) would do the same except for the Governance Committee where no representatives of management could be on the Committee but only a majority of independent directors would be required.

We have a very high level of corporate concentration in Canada compared to the U.S.

We have developed very sophisticated rules to deal with this in terms of transactions

between related parties, etc. Corporations that want good share performance should be

scrupulous in dealing with related party transactions and strong independent directors are

needed to properly deal with these rules. I am, however, concerned about the tendency to

disenfranchise the shareholder. Where I come from shareholders can and do add value

whether they own 20% or 40% or 60%. The U.S. rules do not go this far although major

shareholders are treated as non-independent for audit committee purposes. This I can

understand but it does mean, if the controlled subsidiary is significant, that some other

means must be found to satisfy the fiduciary responsibilities of the audit committee and

the board of the parent company of the integrity of the financial results of the subsidiary.

This probably means a pragmatic relationship between the two C.F.O.s and perhaps the

respective audit committees. I am not sure if this result solves the mischief that the non-representation of an officer or director of the parent was designed to deal with i.e., to prevent non-independents from pressing the auditor or financial management of the controlled subsidiary.

Under the recent Ontario legislation, the OSC has power to enact rules relating to audit committees and I suspect its compromise might be that the officers of the major shareholder cannot be on the audit committee of the controlled public subsidiary but independent directors or other independent representatives of the major shareholder could be so represented.

- (3) I cannot pass this subject without saying a word about the combined role of the Chairman of the Board and the C.E.O. because of the conflicts of interest inherent in the two jobs. I have come to the view over time that the role of the Chairman and the C.E.O. should be

split. I am however, prepared to compromise where the Chairman is the C.E.O. by having a strong independent director as "Lead Director". The practice in the U.K. has been to split the functions and the Higgs Report recommends that this be a guideline.

The Saucier Report opted for either splitting the job or having an independent Board leader (or lead director).

In the U.S., there has been great resistance to the idea of splitting the roles of the Chairman and C.E.O. The C.E.O. must be the "monarch". Recently a Committee of the Conference Board of the U.S. co-chaired by John Snow, the new secretary of the Treasury, recommended that where the jobs are combined then there should be a "presiding director" to lead the boards outsiders. This is starting to happen in the U.S. Disney, GE, H&R Block, Interpublic Group, Tyco and others have named or are in the process of naming presiding directors.

The Higgs Report recommends that there be both a non-executive Chairman (who would be independent at least at the start of his or her term) and a senior independent director.

The clear implication of the requirement for a senior independent director in addition to a non-executive chair seems to be that you cannot be a Chairman without losing your independence. This perhaps relates more to the traditional situation in the U.K. where the separate Chairman was sometimes a Co-C.E.O., not necessarily in name but in fact.

Bill Dimma a distinguished Canadian thinker in this area suggested in a recent article in the publication of the Institute of Corporate Directors that a non-executive Chairman should be a full time job. What you do if you are full time Chairman other than getting involved in running the Company and thereby compromising your independence is hard for me to understand.

To the other extreme is Fairvest (now part of the U.S. based Institutional Shareholder services) which appears to be concerned that a non-executive Chairman may not be independent if he or she is paid more than twice as much as other independent directors.

These are all illustrations of chasing the concept of independence. I hope we do not get too distracted in the process from the importance of a Board of Directors as being a valuable asset to the Company in creating positive value.

- (4) I should mention that I regard the recent formation of the Canadian Coalition for Good Governance by various institutional investors as a very positive development for creating better corporate governance in Canada. Properly organized and well operated, this organization which is representative of major shareholders of our private sector corporations can do much to strengthen Boards of Directors and make our corporations perform well. This organization can contribute more than any laws or rules.

- (5) The initiative by the Institute for Corporate Directors to create director education programs is also a very positive initiative. We need directors of diverse backgrounds and this means that people with such diverse backgrounds need their particular strengths broadened to other areas so that their contributions as directors will be strengthened.
- (6) Based upon a lot of experience, I believe that we have on the whole better corporate governance in Canada than in the U.S. The C.E.O. is less a "monarch" in Canada. We in Canada have a long way to go in improving corporate governance but probably not as far as in the U.S.
- (7) With some pushing and pulling between the TSX and the OSC or Canadian securities administrators about how far the rules should go and to what extent they should be guidelines or mandatory, a system will evolve in Canada that will be a reasonable

compromise. I regard the debate between the TSX and the securities regulators as healthy for the system.

- (8) We probably need a somewhat different regime for small public businesses. There are a great many of these in Canada. This regime might apply to companies listed on the ventures exchange. The regime should move the goal post forward with respect to governance requirements but not as far as for the larger corporations. One possible approach would be to create a new regime for existing small business with a requirement to meet the higher standards within, say five years. New companies coming to the public market would have to meet the higher standards from day one.

- (9) Compensation is a troublesome issue. This is exacerbated by the integration of our economy with the U.S. economy where compensation tends to be much higher.

(Incidentally, a recent experience of mine would indicate that, at least for the petroleum industry, compensation is also higher in the United Kingdom than in Canada).

I am not in favour of doing away with stock options but I would suggest:

- (a) Strong independent compensation committees that receive independent advice from consulting firms;
- (b) Options that vest over a long period of time, say over a minimum of four years with performance conditions as to vesting. In creating performance conditions, I think we should move away from the "noise" of the market and have performance conditions relate to performance of the business;
- (c) We should use more restricted stock with performance conditions qualifying the right to receive the stock; and

- (d) We should try to avoid the ratcheting up effect that can come from compensation surveys.

The bottom line however is that it is fundamentally important to recruit, develop and retain outstanding people. Companies that do this well have better results over a long period of time.

All of this leaves open a fundamental question as to whether good governance adds value. It is perhaps self-evident that it does. However, many studies would indicate that it is not possible to demonstrate that there is any correlation between good corporate governance and performance, at least from the perspective of good governance which is measured by filling in all the appropriate blanks.¹ As a matter of fact there has been an analysis by two Montreal professors, Yvan Allaire and Mihaela E. Firsirotu which shows, among other things, that the 25 firms with

1. See "Second Thoughts on Board Independence" by James D. Westphal – September/October 2002, The Corporate Board and "What Makes Great Boards Great" by Jeffrey A. Sonnenfeld, September 2002 Harvard Business Review.

the best governance scores in the Globe and Mail rankings underperformed the 25 firms with the worst scores.

On the other hand, a recent survey by McKinsey & Company found that 76% of institutional investors said they would pay a premium price for effective corporate governance. If financial institutions are prepared to put their money where their mouth is then good governance will add value. In this regard, I quote again from the Economist of January 11, 2003:

“For years, investors have had a good reason to ignore good governance. Academic research found no clear causal link with financial performance. New research, however, threatens to change that. Paul Gompers of Harvard Business School and two colleagues looked at 1,500 firms in the 1990s and found those that were most responsive to shareholders would have enjoyed returns 8.5% a year higher than those run as management dictatorships.”

Let me close by saying that if we get our public policy reasonably positive in Canada (including our corporate governance rules) and we are prepared to demonstrate this to the rest of the world, we in this country will have great tomorrows.

Thank You.