ASSESSING CANADA'S REGULATORY RESPONSE TO THE *SARBANES-OXLEY ACT OF 2002*: LESSONS FOR CANADIAN POLICY MAKERS

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The article sets out to show that by adopting the Sarbanes-Oxley Act of 2002 *together with other rules of the United States corporate governance regime, Canadian securities regulators moved away from a Canadian, principles-based approach, and not necessarily for the better. It does so by first discussing the unique characteristics of the Canadian capital markets and providing a thorough background into Canada's corporate governance regime. It then highlights the main provisions of the* Act*, describes the ensuing debate in Canada, and critically examines Canada's corresponding regulatory action — the introduction of four rules and a policy. The article asserts that the* Sarbanes-Oxley Act of 2002 *was an inappropriate model to take for the regulators and recommends a re-evaluation of the perceived need to harmonize with the United States in the area of corporate governance.*

Cet article cherche à démontrer qu'en adoptant la loi Sarbanes-Oxley Act of 2002 *et autres règles régissant la gouvernance d'entreprise aux États-Unis, les organismes canadiens de réglementation de valeurs mobilières se sont éloignés d'une approche canadienne, fondée sur des principes, et pas nécessairement pour le meilleur. L'article traite d'abord des caractéristiques uniques des marchés financiers canadiens et donne une mise en contexte approfondie de la gouvernance d'entreprise au Canada. L'auteur souligne ensuite les principales dispositions de la Loi, décrivant les débats consécutifs au Canada et examine de manière critique la mesure réglementaire correspondante, soit l'adoption de quatre règles et d'une politique. L'article soutient que les organismes de réglementation avaient fait un mauvais choix en prenant la loi* Sarbanes-Oxley Act of 2002 *comme modèle et recommande une nouvelle évaluation du besoin perçu d'harmonisation de la gouvernance d'entreprise avec les États-Unis.*

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I. INTRODUCTION

The response of Canadian securities regulators to the enactment in the United States of the *Sarbanes-Oxley Act of 2002*[1] serves as an important case study of how securities regulatory policy is made in Canada. In essence, Canadian securities regulators adopted *SOX* and the related rules of the U.S. Securities and Exchange Commission (SEC) and the New York Stock Exchange (NYSE) as their model for a new Canadian corporate governance regime. Following nearly two years of protracted debate, they reached agreement. The net result was that Canada's long-standing, principles-based, stock exchange-administered corporate governance regime was replaced by a hybrid rules- and principles-based corporate governance regime modeled on *SOX* and administered by securities regulators.

It is the thesis of this article that Canada's regulatory response to *SOX* was sub-optimal for three reasons:

1. *SOX* was an inappropriate model for Canada because of the distinctly different characteristics of Canada's capital markets compared to those of the U.S.;

2. Harmonization of Canada's corporate governance regime with that of the U.S. was assumed to be a necessary or desirable policy objective and not adequately tested; and

3. Canadian securities regulators did not critically evaluate the theoretical underpinnings of *SOX*, especially its reliance on independent directors as effective monitors of management.

Part II will provide an overview of the unique characteristics of the Canadian capital markets and the Canadian securities regulatory system. Part III will discuss Canada's corporate governance regime and its theoretical underpinnings as it existed in 2002. Part IV will briefly outline the most salient corporate governance provisions of *SOX* and summarize Canada's reaction thereto. Part V will describe Canada's regulatory response to *SOX*. Finally, Part VI will assess Canada's regulatory response to *SOX* and provide recommendations for future securities regulatory policy-making in Canada.

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[1] Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.) [*SOX*].

II. CANADA'S CAPITAL MARKETS AND SECURITIES REGULATORY SYSTEM

This part provides an overview of the unique characteristics of the Canadian capital markets and the Canadian securities regulatory system, indicating how these characteristics influence the making of securities regulatory policy. This part will also briefly discuss the securities regulatory policy climate in Canada in 2002-2004.

A. CHARACTERISTICS OF CANADA'S CAPITAL MARKETS

The unique characteristics of the Canadian capital markets pose significant challenges to Canadian securities regulators in the formulation of policy. The key features of Canada's capital markets can be delineated based on: (1) the overall size of the Canadian capital markets; (2) the size (by market capitalization) of Canadian public issuers; (3) the number of Canadian public issuers with securities listed on major stock exchanges in the U.S.; (4) the number of Canadian public companies with a controlling shareholder; (5) the primary industry sectors represented by Canadian public issuers; and (6) the distinctive nature of Canada's regional capital markets.[2]

1. SIZE OF CANADA'S CAPITAL MARKETS

On a world scale, Canada's capital markets are relatively small. According to the World Federation of Exchanges (WFE), as of the end of 2006, the aggregate market capitalization of Canadian companies listed on the Toronto Stock Exchange (TSX) — Canada's senior equities market — and the TSX Venture Exchange (TSXV) — Canada's primary junior equities market — was US$1.7 trillion.[3] This is compared to the aggregate market capitalization of American companies listed on the NYSE of US$15.4 trillion, Nasdaq of US$3.9 trillion, and the American Stock Exchange (AMEX) of US$283 billion.[4] Based on the aggregate market capitalization of domestic listed companies, the Canadian publicly-listed equity market represented by the TSX and the TSXV (collectively, the TSX Exchanges) is less than 9 percent of what is represented by these three U.S. exchanges (US$19.6 trillion) and is approximately 3.3 percent of the aggregate market capitalization of domestic listed companies on all WFE-member exchanges (US$50.6 trillion).

2. SIZE OF CANADIAN PUBLIC ISSUERS

While the Canadian capital markets are small compared to those of the U.S. in terms of aggregate market capitalization, Canada has a relatively large number of public issuers. According to WFE statistics, as of the end of 2006, 3,790 domestic companies were listed on the TSX Exchanges compared to an aggregate of 5,133 domestic issuers on the three

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2 For a comprehensive overview of the Canadian capital markets, see the research study by Christopher Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to *Sarbanes-Oxley*" in Task Force to Modernize Securities Legislation in Canada (TFMSL), *Canada Steps Up: Maintaining a Competitive Capital Market in Canada*, vol. 4, 127, online: TFMSL <http://www.tfmsl.ca/docs/V4(3A)Nicholls.pdf> at 148-71.

3 See Table — Domestic Market Capitalization, online: World Federation of Exchanges <http://www.world-exchanges.org/statistics/annual/2006/domestic-market-capitalization>.

4 *Ibid.*

largest U.S. exchanges.[5] It is apparent that Canada has a large number of very small public issuers and a small number of relatively large issuers (measured by market capitalization). This "large firm/small firm bifurcation"[6] was well illustrated by Christopher Nicholls who noted (using data from December 2005) that "the 100 largest companies (by market capitalization) listed on the Toronto Stock Exchange account for over 70% of the market capitalization of all [1,535][7] TSX-listed companies."[8] He also noted that "fewer than 20% of the largest TSX companies account for almost 85% of the TSX's total market capitalization. By contrast … the 1000 smallest TSX-listed companies account for less than 5% of the total market capitalization of TSX-listed issuers."[9] On the TSXV (2,018 listed issuers),[10] he noted that "the largest 150 … companies account for just over 54% of total market capitalization, and the largest 250, more than 65%, while the smallest 1,250 account for just over 11% of total market capitalization."[11]

It is useful to compare the Canadian and U.S. capital markets based on market capitalization. For this purpose, data from the 2006 *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission*[12] will be compared to data compiled by Nicholls.[13] The U.S. Advisory Committee, in recommending a new system of "scaled or proportional securities regulation"[14] for smaller public companies, proposed to divide smaller public companies into "microcap companies" and "smallcap companies," based on their equity market capitalization.[15]

> [M]icrocap companies would consist of companies whose outstanding common stock (or equivalent) in the aggregate comprises the lowest 1% of total U.S. equity market capitalization, and smallcap companies would consist of companies whose outstanding common stock (or equivalent) in the aggregate comprises the next lowest 5% of total U.S. equity market capitalization.[16]

Applying this same classification scheme to Canadian companies, Nicholls determined that a microcap company in Canada would have a market capitalization of under CDN$36.6 million[17] (as compared to US$128 million in the U.S.[18]), and a smallcap company would have

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5 See Table — Number of Listed Companies, online: World Federation of Exchanges <http://www.world-exchanges.org/statistics/annual/2006/number-listed-companies>.

6 Nicholls, *supra* note 2 at 154.

7 *Ibid.* at 153.

8 *Ibid.*

9 *Ibid.*

10 *Ibid.*

11 *Ibid.* at 156.

12 *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission*, (23 April 2006) online: Securities and Exchange Commission <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf> [*Final Report of the Advisory Committee*].

13 Nicholls, *supra* note 2 at 159-63.

14 *Final Report*, *supra* note 12 at 4.

15 *Ibid.*

16 *Ibid.* at 5.

17 Nicholls, *supra* note 2 at 161. As the Canadian dollar and the U.S. dollar are virtually at par as of 16 April 2008 (one Canadian dollar = 0.9942 U.S. dollar), I have not converted figures in Canadian dollars to U.S. dollars.

18 *Ibid.* at 198.

a market capitalization of CDN$36.6-256.5 million[19] (as compared to US$128-$787 million in the U.S.).[20] It is evident from this comparison that small Canadian public issuers tend to be much smaller than their U.S. counterparts.

3. CANADIAN ISSUERS LISTED ON U.S. EXCHANGES

A significant number of large Canadian public issuers are also listed on U.S. exchanges. According to Nicholls, about 179 TSX issuers are inter-listed on the three largest U.S. exchanges, and "[t]he market capitalization of all TSX-listed [issuers] that are [inter]-listed on U.S. exchanges or otherwise trade in U.S. markets constitutes just over 50% of the TSX's total market capitalization."[21] According to the SEC, as of 31 December 2006, of the 1,145 foreign companies registered and reporting with the SEC, 491 (43 percent) were Canadian.[22]

4. CONTROLLED COMPANIES

A large number of Canadian public companies have controlling shareholders, which is generally considered to be a shareholder holding at least 20 percent or 10 percent of the outstanding voting or equity shares of a corporation.[23] As noted by Nicholls, "more than 1/4 of the largest 300 TSX-listed issuers have a controlling shareholder"[24] and "41 of the 100 largest Canadian corporations on the TSX have a single shareholder with at least a 10% stake; of those, 30 have a shareholder with at least a 20% stake."[25] Dual-class share structures are also a feature of the Canadian capital markets. Nicholls notes that "between 20-25% of companies listed on the TSX have some kind of dual-class share structure."[26]

The prevalence of controlled companies is not a uniquely Canadian phenomenon. Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer note that "in the rich world as a whole, dispersed ownership [meaning no shareholder owning 10 percent or more of a company's common equity] is rare."[27] However, the mere existence of a large number of controlled companies in Canada is clearly not dispositive of the public policy issue of whether securities regulatory policy should encourage the continuation and growth of controlled companies. Though not unanimous, a significant number of empirical studies

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19 *Ibid.* at 168.

20 *Ibid.* at 159.

21 *Ibid.* at 158.

22 U.S. Securities and Exchange Commission (SEC), "Number of Foreign Companies Registered and Reporting with the U.S. Securities and Exchange Commission," (31 December 2006) online: SEC <http://www.sec.gov/divisions/corpfin/internatl/foreignsummary2006.pdf>.

23 Nicholls, *supra* note 2 at 168.

24 *Ibid.*, citing Tara Gray, *Canadian Respose to U.S. Sarbanes-Oxley Act of 2002 – New Directions for Corporate Governance* (4 October 2005) PRB 05-37E, online: Parliament of Canada <http://www.parl.gc.ca/information/library/PRBpubs/prb0537-e.pdf> at 6.

25 *Ibid.*, citing Statistics Canada.

26 *Ibid.*, citing Tara Gray, *Dual-Class Share Structures and Best Practices in Corporate Governance* (18 August 2005), PRB 05-26E, online: Parliament of Canada <http://www.parl.gc.ca/information/library/PRBpubs/prb0526k-e.pdf> at 4.

27 See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, "Corporate Ownership Around the World" (1999) 54 Journal of Finance 471 at 496: "Under this definition, only 24 percent of the large companies in rich countries are widely held, compared to 35 percent that are family-controlled, [and] 20 percent are State-controlled."

support the benefits of controlled companies, particularly family-controlled companies.[28] Benjamin Maury found that in Western Europe, family control is associated with higher valuations and higher profitability as compared to firms controlled by non-family owners.[29] Maury also notes that "[a]ctive family control, in which the family holds at least one of the top two officer positions, strongly increases profitability, whereas passive family control is associated with profit rates comparable to nonfamily firms."[30] These results are "consistent with the argument that family control can reduce the classical agency problem between owners and managers."[31]

Ronald C. Anderson and David M. Reeb studied founding-family ownership of public companies over a number of years. In 2003 they published their report, which found that family firms were "on average more valuable than nonfamily firms."[32] They conclude that "family influence appears to focus the firm's investment choices, thereby lessening the moral hazard conflict with minority-equity claimants and increasing firm value."[33] They conclude that "in well-regulated and transparent financial markets, family ownership … is an effective organizational structure."[34] However, in a further study published in 2004, the authors found "a positive relation between firm performance and board independence" in firms with founding-family ownership.[35] In this later study they conclude that "independent directors potentially play an influential role in moderating the family's power and alleviating conflicts among shareholder groups."[36] Specifically, in firms with family ownership, they found that when "family control of the board exceeds independent director control," firm performance was significantly poorer.[37] They argue that their results indicate that, "at least in firms with large concentrated shareholders, independent directors act as a powerful mechanism in mitigating family opportunism."[38]

There are a number of empirical studies of Canadian family-controlled companies and companies with dual-class share structures. A study of 263 of Canada's largest public firms, which compared their performance (measured by Tobin's q[39]) against *The Globe and Mail*'s governance indices ("board composition and effectiveness, compensation policies,

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28 A strong indictment of Canadian controlled companies is found in a paper by Randall Morck & Bernard Yeung, "Some Obstacles to Good Corporate Governance in Canada and How to Overcome Them" in TFMSL, *supra* note 2, 279, online: TFMSL <http://www.tfmsl.ca/docs/v4(5)Morck.pdf>. In their paper, the authors decry the existence of controlled companies in Canada, especially families which exercise control over "business groups" through "pyramiding" ownership structures (at 296-300).

29 Benjamin Maury, "Family ownership and firm performance: Empirical evidence from Western European corporations" (2006) 12 Journal of Corporate Finance 321 at 322.

30 *Ibid.*

31 *Ibid.*

32 Ronald C. Anderson & David M. Reeb, "Founding-Family Ownership, Corporate Diversification, and Firm Leverage" (2003) 46 J.L. & Econ. 653 at 674.

33 *Ibid.* at 664-65.

34 *Ibid.* at 680.

35 Ronald C. Anderson & David M. Reeb, "Board Composition: Balancing Family Influence in S&P 500 Firms" (2004) 49 Administrative Science Quarterly 209 at 231.

36 *Ibid.*

37 *Ibid.* at 225.

38 *Ibid.* at 235.

39 Ratio comparing the market value of a company's stock with the company's equity book value.

shareholder rights and disclosure practices"[40]) found "no evidence that board independence has any positive effect on firm performance." More significantly, the study found a negative effect of board independence for family-owned firms.[41] The authors noted that

> the assumptions of agency theory may not fully apply to family firms … [where] the alignment of ownership and control is tighter, thus obviating the need for outside directors. More importantly, outside directors with less knowledge of the firm and with less of a financial stake may in this case lower company efficiency by distracting managers and by causing them to focus on short-run goals.[42]

A similar conclusion was reached in a 2006 study of dual-class share structures in Canada.[43] This study concluded that with a coat-tails provision in place, "takeovers of dual-class Canadian companies produce virtually no control benefits for holders of the supra-voting shares as compared to holders of other classes of common shares."[44] Citing the small premium attached to superior-voting shares as proof of an efficient system of legal protection for minority shareholders in Canada, the study concludes that "controlling shareholders provide substantial monitoring benefits to all shareholders."[45] Among other recommendations, the report suggests that controlling shareholders should be able to elect board members in proportion to their total voting rights to a maximum of 2/3 of the board.[46]

As will be argued below, in light of the large number of controlled companies in Canada and the evidence — though, admittedly, not unanimous — that controlled companies (and family-controlled companies in particular) are positive economic performers in the Canadian economy, Canadian securities regulators should not have changed the corporate governance regime as it applies to controlled companies in the absence of rigorous study of the application to them of the concepts of independence of directors as reflected in *SOX*.

5. KEY INDUSTRY SECTORS

The Canadian capital markets are dominated by public issuers from a few key industry sectors. According to information obtained by Nicholls, listed companies in the oil and gas, financial services, and mining sectors "collectively account for just over 65% of total TSX market capitalization."[47] On the TSXV, mining companies account for more than 50 percent of the total exchange capitalization, and oil and gas companies account for approximately 25 percent of the total exchange capitalization.[48] As noted below, each of these three key industry sectors tends to be concentrated in a particular province.

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40 Peter Klein, Daniel Shapiro & Jeffrey Young, "Corporate Governance, Family Ownership and Firm Value: the Canadian Evidence" (2005) 13 Corporate Governance 769 at 770.

41 *Ibid.*

42 *Ibid.* at 780.

43 Yvan Allaire, "Dual-class share structures in Canada: Review and recommendations" (October 2006), online: Institute for Governance of Private and Public Organizations <http://www.igopp.org/IMB/pdf/2006-11-16_Allaire-Policy_Paper_1.pdf>.

44 *Ibid.* at 11.

45 *Ibid.* at 30.

46 *Ibid.* at 24.

47 Nicholls, *supra* note 2 at 165.

48 *Ibid.*

6. REGIONAL CAPITAL MARKETS

According to a 2007 Report of the Alberta Securities Commission (ASC), public issuers headquartered in one of the provinces of Ontario, Alberta, Quebec, or British Columbia represent 86 percent of the aggregate market capitalization of all public issuers in Canada.[49] These four provinces are also home to 92 percent of all public issuers listed on the TSX Exchanges.[50] However, the distribution of publicly listed issuers differs significantly from province to province. For example, there are more public issuers headquartered in British Columbia (33 percent) than Ontario (31 percent), Alberta (19 percent), or Quebec (10 percent).[51] However, based on the market capitalization of public issuers headquartered in a province, Ontario leads with CDN$866 billion (41 percent), Alberta has $558 billion (26 percent), Quebec has $234 billion (11 percent), and British Columbia has $170 billion (8 percent).[52]

The primary provincial capital markets also vary significantly based on the industry sector within which their dominant companies operate. In Alberta, 42 percent of Alberta-based public issuers, representing 75 percent of the aggregate market capital of all Alberta-based public issuers, are engaged in the oil and gas industry.[53] In British Columbia, the capital market is dominated by mining companies, while financial services companies are the most prominent in Ontario.[54]

With these distinct regional capital markets, it is not surprising that quite different perspectives are debated in the formulation of securities regulatory policy in Canada. As home to some of the largest issuers and institutional investors in the country, Ontario represents a capital market which is closest in scale to that of the U.S. Not surprisingly, the Ontario Securities Commission (OSC) tends to treat the SEC as its primary source of new regulatory initiatives.[55] The OSC is particularly focused on Canada's large U.S.-listed issuers and wishes to ensure that the Canadian regulatory regime is comparable to that of the U.S. On the other hand, British Columbia is home to many smallcap and microcap issuers, primarily in the mining industry. As these issuers are mostly in their pre-revenue stage of development, compliance costs are of enormous concern. In the last few years, the British Columbia Securities Commission (BCSC) has advocated a new "principles-based" regulatory system.[56] The perspective of Alberta falls somewhere between that of Ontario and British Columbia. While the Alberta capital market is the second largest in Canada after Ontario and home to a number of Canada's largest issuers, Alberta has a relatively even distribution of

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49 Alberta Securities Commission (ASC), *The Alberta Capital Market: A Comparative Overview* (May 2007), online: ASC <www.albertasecurities.com/news/ASC%20Publications/6116/ASC_Cap_Market_Review.pdf> at 6 [ASC, *Comparative Overview*].

50 *Ibid.*

51 *Ibid.* at 7.

52 *Ibid.* at 6.

53 *Ibid.* at 14.

54 *Ibid.* at 11.

55 Examples abound. The genesis of *Disclosure Standards*, O.S.C. 51-201 (12 July 2002) was the SEC's *Regulation FD (Fair Disclosure)* 17 C.F.R., Part 243.

56 See British Columbia Securities Commission (BCSC), *New Proposals for Securities Regulation* (5 June 2002), online: BCSC <http://www.bcsc.bc.ca/uploadedFiles/2002_New_Proposals.pdf> at 2.

small, medium, and large companies.[57] Not surprisingly, given its capital market profile, the ASC has been a proponent of "proportionate regulation."[58]

B. CANADA'S SECURITIES REGULATORY STRUCTURE

Canada is one of the few countries in the world without a national securities regulator. This situation is the result of history — the provinces have exclusively occupied the field since the beginning of securities regulation in Canada — and the increasingly decentralized nature of Canadian federalism. However, instead of competing with each other, Canada's 13 securities regulators have traditionally co-operated and have, in the past ten years, taken enormous steps to harmonize securities laws across the country and streamline the process of regulation. Harmonization — if not complete uniformity of securities laws — is overwhelmingly preferred by market participants who express concern that any difference in laws from province to province can result in increased compliance costs.

The Canadian Securities Administrators (CSA), the council of the 13 provincial and territorial securities regulators in Canada, recently implemented a "Passport System" of securities regulation.[59] Its expressed purpose is to implement, in the areas of prospectus offerings, continuous disclosure, and discretionary exemption applications, a system that gives a market participant access to the capital markets in multiple jurisdictions by dealing solely with its principal regulator and meeting the requirements of one set of laws. The Passport System will eventually include registration provisions for brokers and dealers. The principal regulator for an issuer will usually be the regulator in the jurisdiction where the issuer's head office is located. As noted above, since 92 percent of all public issuers listed on the TSX Exchanges are headquartered in one of Alberta, Ontario, British Columbia, or Quebec, the principal regulator for almost all public issuers in Canada will be in one of these four provinces.

The Passport System is an attempt — driven by all provinces other than Ontario — to retain the current decentralized system of provincial regulation while reducing the irritant and expense of multiple regulators. It also represents a very political response of the provinces (other than Ontario) to recurring calls for the creation of a single national securities regulator.[60] Although an interface between the 12 "passport" jurisdictions and Ontario exists, Ontario has refused to join the Passport System unless the passport jurisdictions agree to take concrete steps towards the formation of a national securities commission. The relative dominance of the Ontario capital market has been noted above. However, the real influence

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57 ASC, *Comparative Overview*, *supra* note 49 at 19.

58 See ASC, *A Critical Balance* (2005 Annual Report) at 16, online: ASC <http://www.albertasecurities.com/news/ASCPublications/6116/ASC2005AnnualReport.pdf>.

59 The Passport System was implemented on 17 March 2008 by *Passport System*, A.S.C. MI 11-102 (17 March 2008); *Process for Prospectus Reviews in Multiple Jurisdictions*, A.S.C. NP 11-202 (17 March 2008); and *Process for Exemptive Relief Applications in Multiple Jurisdictions*, A.S.C. NP 11-203 (17 March 2008).

60 For example, see WPC Committee to review the structure of securities regulation in Canada, *It's Time* (December 2003), online: Wise Person's Committee <http://www.wise-averties.ca/reportsWPC%20Final.pdf>; The Five Year Review Committee to Review the Ontario Securities Act, *Final Report* (Toronto: Queen's Printer for Ontario, 2003), online: Ontario Securities Commission (OSC) <http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr_2003 0529_5yr-final-report.pdf>.

of the OSC results from the fact that the OSC is the sole regulator of the TSX, whose 1,598 issuers represent approximately 97.5 percent of the aggregate market capitalization of all issuers listed on the TSX Exchanges.[61] As all TSX-listed issuers are reporting issuers under the Ontario *Securities Act*,[62] the OSC has enormous power vis-à-vis the other provincial regulators in Canada. In reality, it is the only provincial regulator which could impose regulatory policy unilaterally. Practically, given the OSC's dominant negotiating position and size relative to the other three major provincial regulators, much of the regulatory policy in Canada is developed by OSC staff, with assistance from staff of the other regulators in Alberta, British Columbia, and Quebec.

C. THE CANADIAN REGULATORY POLICY CLIMATE IN 2002-2004

For most of this decade, securities regulators, capital market stakeholders, and federal and provincial politicians in Canada have been embroiled in a series of debates over reform of securities regulation. These debates have dealt with either *regulatory structure* or *regulatory philosophy*. As discussed in the preceding section, the provinces and territories (other than Ontario) have responded to calls for creation of a single national securities regulator by creating the Passport System. During the period between 2002 and 2004, Canada also experienced a debate on the regulatory philosophy that should apply in the regulation of the capital markets. At one end of the spectrum was the "U.S. convergence" view, advocated by Ontario. Advocates of this position believe that Canada needs a regulatory system that is highly harmonized with the U.S. system. They warn that Canada risks driving away foreign — and particularly American — investment if our system is seen as being "less robust" than that of the U.S.[63] They also cite the multijurisdictional disclosure system (MJDS)[64] as a rationale — concerned that failure to conform to the American model may negatively impact continued American acceptance of MJDS.

At the other end of the spectrum are those, like the BCSC, who advocate that Canada abandon regulation based on detailed, prescriptive rules and adopt a flexible, principles-based system which leaves market participants to determine the details of the application of general enunciated principles. This approach is supposed to reduce costs incurred by market participants by streamlining rules. The BCSC commenced public consultations in 2002 and published its proposed new legislation in October 2004. Although passed by the British Columbia legislature, the new British Columbia *Securities Act* has not been proclaimed in force. Unfortunately, the BCSC was preoccupied by its reform project and, consequently, did

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61 See TSX Group, *Annual Report* 06, online: TSX <http://www.tsx-group.ca/AnnualReport06/EN/PDFs/TSX-Group_2006_AR.pdf> at 10.

62 R.S.O. 1990, c. S.5, s. 1(1).

63 For example, see David A. Brown, "Giving Investors Reason for Confidence: A Robust Response to the Financial Reporting Scandals" (Remarks at the Board of Trade, 23 May 2003), online: <http://www.osc.gov.on.ca/Media/Speeches/2003/sp_20030523_db_investor-confidence. pdf> at 4-5: "We must introduce reforms that are every bit as robust as U.S. reforms.… The North American markets are too integrated for Canadians to think that the U.S. could adopt a new, robust set of market standards, that we could simply ignore, as though our markets have no relationship with each other."

64 The MJDS is a joint initiative by the CSA and the SEC to reduce duplicative regulation in cross-border offerings, issuer bids, take-over bids, business combinations, and continuous disclosure and other filings. MJDS was originally implemented in 1991. See *The Multijurisdictional Disclosure System*, A.S.C. NI 71-101 (1 November 1998) and SEC Releases Nos. 33-6902, 34-29354, IC-18210.

not play an influential role in the debate at CSA during 2002-2004 over Canada's response to *SOX*. In fact, the BCSC initially opted out of three of the corporate governance rules adopted by the rest of the CSA in 2004.[65] The withdrawal of British Columbia from the negotiating table at the CSA effectively left Alberta and Quebec to challenge Ontario's preference to follow *SOX*.

III. CANADA'S CORPORATE GOVERNANCE REGIME IN 2002

A. BASIC CORPORATE LAW REQUIREMENTS RELATING TO CORPORATE GOVERNANCE

The federal and provincial corporate statutes in Canada prescribe some very basic corporate governance requirements for public companies relating to the minimum number of directors, the qualifications and duties of directors, and the composition and duties of audit committees. No comparable statutory governance requirements exist for other forms of public issuers, such as limited partnerships or income trusts. In brief, these statutes require that directors "manage or supervise the management of the business and affairs of a corporation."[66] Directors' fiduciary duties consist of the duty of good faith (to "act honestly and in good faith with a view to the best interests of the corporation") and the duty of care (to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances").[67] Every corporation is required to have at least one director, although a "distributing corporation" (being, essentially, a corporation which is a reporting issuer under securities legislation) must have at least three directors, of whom at least two cannot be officers or employees of the corporation or its affiliates.[68] A distributing corporation must also have an audit committee composed of at least three directors of the corporation, "a majority of whom are not officers or employees of the corporation or any of its affiliates" unless an exemption is granted.[69] The basic duties of an audit committee are to "review the financial statements of the corporation before they are approved" by the directors and placed before the shareholders at any annual meeting.[70]

B. TSX GOVERNANCE REGIME

Beginning in 1995, as part of the TSX's listing requirements, TSX-listed issuers were required to disclose their corporate governance practices with reference to 14 corporate governance guidelines and explain any deviation from those guidelines. The TSX's corporate

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65 BCSC did not initially participate in the Auditor Oversight Rule (*Auditor Oversight*, A.S.C. MI 52-108 (27 June 2003) [MI 52-108]), the Certification Rule (*Certification of Disclosure in Companies' Annual and Interim Filings*, A.S.C. MI 52-109 (23 June 2003) [MI 52-109]), and the Audit Committee Rule (*Audit Committees*, A.S.C. MI 52-110 (30 March 2004) [MI 52-110]). Nevertheless, all British Columbia-based TSX- and TSXV-listed issuers were subject to these instruments due to their legal status as reporting issuers in Ontario and/or Alberta.

66 See *Business Corporations Act*, R.S.A. 2000, c. B-9, s. 101(1) [*ABCA*]; *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 102(1) [*CBCA*]; *Business Corporations Act*, R.S.O. 1990, c. B.16, s. 115(1) [*OBCA*].

67 See *ibid.*: *ABCA*, s. 122(1); *CBCA*, s. 122(1); *OBCA*, s. 134(1).

68 See *ibid.*: *ABCA*, s. 101(2); *CBCA*, s. 102(2); *OBCA*, s. 115(3).

69 See *ibid.*: *ABCA*, ss. 171(1), (2), (3); *CBCA*, ss. 171(1), (2); *OBCA*, ss. 158(1), (1.1).

70 See *ibid.*: *ABCA*, s. 171(4); *CBCA*, s. 171(3); *OBCA*, s. 158(2).

governance regime arose out of the December 1994 report of the TSX Committee on Corporate Governance in Canada, *Where Were the Directors?*[71] The *Dey Report*, in turn, was significantly influenced by the 1992 report of the Cadbury Committee in the United Kingdom, *The Financial Aspects of Corporate Governance*.[72] Significantly, the *Cadbury Report* contained a number of recommendations which were reflected in the *Dey Report* and the 1995 TSX governance requirements:

- U.K.-listed companies should comply with a "Code of Best Practice" that highlighted the importance of independence on the board and on the audit committee;[73]

- "Independence" meant directors who were "*independent of management* and free from any business or other relationship which could materially interfere with the exercise of their independent judgment," apart from fees and shareholdings;[74] and

- U.K.-listed companies should make an annual statement to shareholders about their compliance with the Code and give reasons for any areas of non-compliance.[75]

One of the key guidelines recommended by the *Dey Report* was that a majority of the directors of a public issuer should be "unrelated," that is, *independent of management* and free from any interest and any business or other relationship that could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding.[76] Most notably, the *Dey Report* concluded that a director who was a "significant shareholder" (a shareholder with the ability to exercise a majority of the votes for the election of the board of directors) or a director with interests in or relationships with the significant shareholder, should *not* be considered a related director.[77] The *Dey Report* expressed a number of reasons for its treatment of significant shareholders:

- Treating such a person as a related director would compromise the ability of the significant shareholder to exercise control, which ability to control through the election to the board of directors of individuals related to the significant shareholder is the *right* of the significant shareholder;

- Investors rely on the significant shareholder to exercise control and execute the strategy for the corporation; and

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71 The Toronto Stock Exchange Committee on Corporate Governance in Canada, *Where Were the Directors?: Guidelines for Improved Corporate Governance in Canada* (Toronto: Toronto Stock Exchange Committee on Corporate Governance in Canada, 1994) [*Dey Report*].

72 U.K., *Report of the Committee on The Financial Aspects of Corporate Governance* (1 December 1992), online: <http://www.ecgi.org/codes/documents/cadbury.pdf> [*Cadbury Report*].

73 *Ibid.* at para. 1.3.

74 *Ibid.* at para. 4.12 [emphasis added].

75 *Ibid.* at para. 3.7.

76 *Dey Report*, *supra* note 71 at 4.

77 *Ibid.* at 25.

- There are well-established procedures to enable the board of directors to address issues where the interests of the corporation conflict with the interests of the significant shareholder.[78]

The *Dey Report* proposed that if a corporation had a significant shareholder, in addition to a majority of unrelated directors, the board should include a number of directors who do not have interests in or relationships with either the corporation or the significant shareholder and which fairly reflects the investment in the corporation by shareholders other than the significant shareholder.[79] The expressed purpose of this constraint on the significant shareholder's ability to elect the board was to ensure, in general terms, that there is a component of the board, at least in number, generally reflecting the investment of the public or minority shareholders in the corporation that is not related to either the significant shareholder or the corporation. As will be discussed in Part V, the CSA abruptly and without real explanation veered away from this treatment of controlled companies.

IV. *SOX* AND CANADA'S REACTION

SOX represented the response of U.S. Congress to Enron and other highly publicized cases of accounting fraud involving large, prominent American public companies. Indeed, the preamble to the statute states that its purpose is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[80] This part will briefly outline the most salient corporate governance provisions in *SOX* and the implementing rules of the SEC and NYSE, and summarize Canada's reaction thereto.

A. *SOX* AND THE RELATED CORPORATE GOVERNANCE INITIATIVES OF THE SEC AND NYSE

SOX is undeniably a sweeping piece of legislation, creating the Public Company Accounting Oversight Board (PCAOB) to establish auditing standards to regulate the accounting profession;[81] providing strict rules of conduct by auditors (for example, requiring rotation of audit partners every five years and barring auditors from providing certain types of non-audit services);[82] enhancing financial disclosure by issuers;[83] mandating the SEC to adopt rules on the independence and objectivity of analysts;[84] establishing whistleblower protections;[85] requiring the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) to reimburse the issuer for any bonus-based compensation received and profits realized from the sale of the corporation's securities within any 12-month period preceding an accounting restatement resulting from misconduct;[86] prohibiting personal loans by issuers

78 *Ibid.*
79 *Ibid.* at 4.
80 *SOX*, *supra* note 1, Preamble.
81 *Ibid.*, Title I.
82 *Ibid.*, Title II.
83 *Ibid.*, Title IV.
84 *Ibid.*, Title V.
85 *Ibid.*, §§ 806, 1107.
86 *Ibid.*, § 304.

to their executives;[87] requiring disclosure regarding a Code of Ethics for senior financial officers;[88] and providing various criminal law enhancements regarding offences and penalties.[89] This article will focus on three corporate governance provisions.

1. CEO/CFO CERTIFICATION OF FINANCIAL STATEMENTS AND FINANCIAL INFORMATION

Section 302 of *SOX* requires the CEO and CFO of each reporting company to certify, annually and quarterly: (i) that the annual or quarterly report filed by the issuer "does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements … not misleading";[90] (ii) the accuracy of the financial statements and other financial information; and (iii) the design and effectiveness of internal controls.[91] It also requires the SEC to prepare rules on disclosure of internal controls.[92]

2. AUDIT COMMITTEE REQUIREMENTS

Section 301 authorizes the SEC to have stock exchanges change their listing requirements to require audit committees composed only of independent directors with full authority over outside auditors in respect of their "appointment, compensation, and oversight."[93] Under s. 407, the SEC was required to issue rules requiring each issuer to disclose whether or not (and if not, "why") the audit committee included at least one "financial expert."[94] Section 301(3)(B) of *SOX* provides that, in order to be considered independent, an audit committee member may not, other than in his or her capacity as a member of the audit committee, board of directors, or other board committee: "(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof."[95] The NYSE has expanded upon this definition of independence.

3. CERTIFICATION OF INTERNAL CONTROLS

Section 404 requires the SEC to prescribe rules requiring each issuer to prepare an annual internal control report containing an assessment of the effectiveness of its internal control structure and procedures and requiring each issuer's auditors to attest to and report on management's assessment.[96] The high costs associated with *SOX* s. 404 compliance have been well noted. According to the Committee on Capital Markets Regulation (the Paulson Committee), an independent committee formed with the endorsement of U.S. Treasury Secretary Henry Paulson Jr., the average cost of *SOX* s. 404 compliance in 2004, its first year

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87 *Ibid.*, § 402.
88 *Ibid.*, § 406.
89 *Ibid.*, Titles VIII, IX, and X.
90 *Ibid.*, § 302(a)(2).
91 *Ibid.*, § 302.
92 Disclosure controls and procedures were added by the SEC. See SEC Releases Nos. 33-8124, 34-46427, IC-25722 (28 August 2002), online: U.S. Securities and Exchange Commission <http://www.sec.gov/rules/final/33-8124.htm>.
93 *SOX*, *supra* note 1, § 301(2).
94 *Ibid.*, § 407(a).
95 *Ibid.*, § 301.
96 *Ibid.*, § 404.

of implementation, was US$4.36 million for an average company, aggregating between US$15-20 billion for all issuers.[97]

SOX represented a sort of watershed in two respects: it had the effect of transferring corporate governance from the sphere of corporate law to the domain of securities regulation and it addressed corporate governance in a very prescriptive and detailed manner.

B. CANADA'S REACTION TO *SOX*

Almost immediately after the enactment of *SOX*, Canada's low key, principles-based approach to corporate governance came under intense scrutiny from all quarters. The debate quickly divided between those who argued that Canada adopt a rules-based corporate governance regime and those who advocated that Canada retain its largely principles-based approach.

1. PROPONENTS OF A RULES-BASED RESPONSE

The principal advocates of a rules-based response by Canada were large institutional investors, the governments of Canada and Ontario, and the OSC. Large Canadian institutional investors like the Ontario Teachers' Pension Plan (Ontario Teachers') questioned the "robustness" of Canada's governance regime. Claude Lamoureux, President and CEO of Ontario Teachers', flatly rejected the then current voluntary system as inadequate to protect shareholder interests. He called for governance standards to be "set in legislation and applied to all public issuers" "irrespective of size or controlling ownership."[98]

The Government of Canada was a strong advocate for a legislative response to *SOX*. In June 2003, the Canadian Senate Banking Committee released a report of its study of Canada's corporate governance regime.[99] The report concluded that "continuing with a non-legislative approach, and perpetuating mandatory disclosure, voluntary compliance, rules and

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97 See *Interim Report of the Committee on Capital Markets Regulation* (30 November 2006), online: Committee on Capital Markets Regulation <http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportRev2.pdf> at 5, 115 [*Paulson Report*].

98 Claude Lamoureux, "Corporate Governance — Are We There Yet?" (Remarks at the 16th Annual Investor Relations Conference of the Canadian Investor Relations Institute, 26 May 2003), online: Ontario Teachers' Pension Plan <http://www.otpp.com/web/website.nsf/web/CG_CL_CIRIConference_May26_2003/$FILE/CG_CL_CIRI_May26_2003_v2.pdf> at 14.

99 Standing Senate Committee on Banking, Trade and Commerce, *Navigating Through "the Perfect Storm": Safeguards to Restore Investor Confidence* (June 2003), online: The Senate of Canada <http://sen.par.gc.ca/dtkachuk/Bankin%20-%20Investor%20confidence.pdf> at 64. Borrowing heavily from *SOX*, the Committee called for legislation: (i) requiring that a majority of members of the board of directors be independent; (ii) requiring that all audit committee members be "independent and financially literate" and that at least one member be a financial expert; (iii) prohibiting compensation committee members from being a member of management and requiring them to have a level of expertise in compensation matters; (iv) limiting the "non-audit services that auditors can provide to their audit-clients"; (v) requiring "the audit committee to oversee the auditor selected by the company's shareholders"; (vi) requiring "rotation of the lead audit partner every seven consecutive years"; and (vii) requiring an organization's CEO and CFO to "certify that the annual financial statements fairly present, in all material respects, both the results of the organization's operations and its financial condition" (at xi-xiii).

policies is … not appropriate in our view, since we believe that enhanced investor confidence in Canada requires certain legislative proposals, as was the case in the United States."[100]

In 2004, Industry Canada published a discussion paper describing a number of proposed amendments to the *CBCA* that focus on corporate governance.[101] The proposed amendments to the *CBCA* included a definition of "independence"; mandated that a majority of directors be independent; required audit committees to be composed entirely of independent directors; required auditors to be participating members of the Canadian Public Accountability Board (CPAB); required CEO/CFO certification of financial statements; and mandated separation of the roles of Chair and CEO.[102] Due to the relatively small number of federally-incorporated public companies in Canada, these proposals would have had limited impact. Although these proposals have not been acted upon, they underscore both the federal government's preference for a legislative response comparable to that of the U.S., as well as its desire to be a "player" in corporate governance.

The Government of Canada was more successful in its criminal law initiatives. On 12 June 2003, it announced the "creation of six Integrated Market Enforcement Teams (IMETs) made up of RCMP investigators, federal lawyers and other investigative experts dedicated solely to capital markets fraud cases."[103] The IMETs were part of a CDN$120 million program to combat capital markets fraud, which had been announced in the 2003 Federal Budget.[104] At the same time, the Government introduced in Parliament Bill C-13, which proposed amendments to the *Criminal Code* targeting capital markets fraud.[105]

The Government of Ontario moved even more quickly than the Federal Government in proposing legislative action. On 9 December 2002, Bill 198 was introduced in the Ontario legislature.[106] This Bill contemplated a number of significant changes to the *Securities Act*, including:

- Creating new civil liability for secondary trading (as had been previously recommended by CSA);

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100 *Ibid.*

101 Industry Canada, "Towards an Improved Standard of Corporate Governance for Federally Incorporated Companies — Proposals for Amendments to the *Canada Business Corporations Act*" (2004).

102 *Ibid.*

103 Department of Justice, News Release, "Government of Canada Announces New Measures to Deter Capital Markets Fraud" (12 June 2003), online: Prospectors & Developers Association of Canada <http://www.pdac.ca/pdac/advocacy/securities/030612-1.html>. The amendments, which received Royal Assent on 30 March 2004, made a number of changes to the *Criminal Code*, including creating a new criminal offence of improper insider trading; providing protection to employees who report unlawful conduct within their corporation from retaliation by creating a new offence to deter employment-related intimidation; raising the minimum sentences for fraud and existing market-related offences; and establishing concurrent jurisdiction that will provide federal prosecutorial authority over fraud and certain market-related offences.

104 *Ibid.*

105 Bill C-13, *An Act to Amend the Criminal Code (Capital Markets Fraud and Evidence-Gathering)*, 3rd Sess., 37th Parl., 2004 (assented to 29 March 2004), S.C. 2004, c. 3.

106 Bill 198, *Keeping the Promise for a Strong Economy Act (Budget Measures), 2002*, 3rd Sess., 37th Leg., Ontario, 2002 (assented to 9 December 2002), S.O. 2002, c. 22.

- Creating the statutory authority for the OSC to conduct continuous disclosure reviews;

- Increasing the fines for various offences under the *Act*;

- Adding the offence of fraud and market manipulation;

- Expanding the rule-making authority of the OSC in various governance areas, including composition and conduct of audit committees, internal control systems of issuers, disclosure controls and procedures, and CEO/CFO certifications.

The OSC aligned itself with the rules-based proponents. In an open letter to listed companies in Ontario and to other Ontario market participants, OSC Chair David Brown stated that the OSC's approach to its review of the U.S. initiatives was "based on the assumption that it makes … sense to harmonize with the U.S. initiatives unless there are cogent reasons for not doing so."[107] The OSC, in effect, placed a reverse onus on those who questioned adopting the prescriptive *SOX* approach in Canada. As will be described below, this *dictum* from the OSC not only placed the Canadian opponents of *SOX* in a difficult tactical position, but inhibited the very kind of thorough and analytical policy review that was needed. Interestingly, the position taken by the OSC seemed to be at odds with some of the feedback which it had received from its own extensive consultation with Ontario capital market participants in the fall of 2002.[108]

2. PROPONENTS OF A PRINCIPLES-BASED APPROACH

The case for a more principles-based response to *SOX* was made by the Canadian Council of Chief Executives (CCCE), the TSX, the BCSC, and the ASC. The CCCE argued that "much of what needs to be done to restore and enhance investor confidence in the integrity of Canadian [issuers] should be achieved within the private sector."[109] It felt that "comprehensive guidelines backed up by mandatory disclosure [were] in fact a more

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107 Letter from David Brown to All Ontario Capital Market Participants (3 September 2002), cited in Ontario Securities Commission, News Release/Communiqué, "OSC Chair Issues Open Letter to Market Participants" (3 September 2002), online: OSC <http://www.osc.gov.on.ca/Media/New/Releases/2002/nr_20020903_osc-mkt-participants-letter.jsp>.

108 In a 23 May 2003 speech to the Toronto Board of Trade (Brown, *supra* note 63), David Brown summarized his staff's findings as follows: (1) Canadians feel "entitled to a regulatory regime that is as comprehensive and dynamic as the regime established by [the U.S.]"; (2) "equal regulatory protection does not mean identical protection.… We were told … to take into account the different composition of the Canadian market … [noting the] higher proportion of small-cap public companies than in the United States and a much higher proportion of controlled companies." But, he added, "we were also told that we should avoid a two-tier market"; (3) "[W]e were told that we should take account of the fact that Canadian governance requirements have historically relied more on principles compared to the rules-based culture in the U.S." (at 3).

109 David Stewart-Patterson, "Doing What's Right: Trust and Accountability in the Public and Private Sectors" (Notes for remarks to the CGA Economic News Luncheon, 29 October 2002), online: Canadian Council of Chief Executives <http://www.ceocouncil.ca/publications/pdf/ad9807309d718 d233f851520839bdb25/speeches_2002_10_29.pdf> at 6.

effective way to improve the norms of acceptable behaviour … than any approach that relies excessively on precise but narrow rules."[110]

Perhaps the most eloquent spokesperson for the principles-based side of the debate was Barbara Stymiest, CEO of the TSX. In a letter to the OSC in September 2002,[111] Stymiest outlined her views as to why it would not be appropriate for Canada to adopt as mandatory requirements many of the new measures prescribed in the U.S.:

(1) Canada's current principles-based approach has served the Canadian capital markets well. Stymiest noted the OSC's own review earlier in 2002 of 517 Canadian listed companies, which found no serious evidence of wrongdoing. She also noted a recent McKinsey and Company Survey of Investor Opinion in 31 countries, which found that institutional investors required of Canadian securities the lowest "good governance" premium in the world (11 percent compared to 14 percent for U.S. companies).[112] She also noted the enhanced corporate governance guidelines, which the TSX had previously proposed be adopted[113] and criticized the U.S. rules-based approach as one which resulted in a regulatory "race between closing loopholes with new rules and finding new loopholes to get around the new rules."[114]

(2) Canada's capital markets have not been subject to the same problems of fraud and conspiracy as have the U.S. markets.[115] Thus, in the absence of serious problems, she questioned "what justifications exist[ed] for [introducing] similarly draconian and potentially costly measures in Canada."[116]

(3) Harmonization with the U.S. will not benefit Canadian U.S.-listed issuers as they are already subject to *SOX* and related U.S. stock exchange listing requirements. As noted by Stymiest, "Canadian companies whose securities trade in U.S. markets have been, [in effect], harmonized *de facto* by the American extra-territorial extension of their securities law."[117]

(4) Smaller companies will bear a disproportionate burden of harmonization with the U.S.[118] Stymiest noted that as Canada has proportionately more small companies than the U.S., adoption of U.S. rules would "impose a comparatively greater burden on Canadian markets than U.S. markets will have to bear."[119]

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110 *Ibid.*

111 Letter from Barbara Stymiest to David Brown (17 September 2002), online: ICSA <http://www.isacanada.org/RESOURCES/PDF/2002%20Comparison%20of%20Canaian%20Equivalents%20to%20recetn%20US%20initiatives.pdf>.

112 *Ibid.* at 4.

113 See TSX Group, Request for Proposal — Proposed New Disclosure Requirement and Amended Guidelines, 26 April 2002 [on file with author]. These amendments were not implemented as the new CSA rules superceded the TSX corporate governance guidelines which were eventually withdrawn.

114 Stymiest, *supra* note 111 at 7.

115 *Ibid.* at 6.

116 *Ibid.* at 5.

117 *Ibid.* at 8.

118 *Ibid.*

119 *Ibid.*

As noted in Part II above, in 2002 the BCSC embraced a principles-based approach to securities regulation and opposed the adoption in Canada of *SOX*. As the principal regulator of a large number of small energy companies, the ASC was especially concerned about the high compliance costs associated with *SOX*. In order to better understand the views of Alberta market participants, the ASC conducted surveys of, and focus groups involving, issuers and investors. Significantly, the ASC research revealed that although no serious problems with the current Canadian corporate governance standards were thought to exist, regulators needed to be *seen to be taking action* in order to enhance investor confidence in Canada.[120]

Feedback on specific U.S. initiatives suggested that there was little objection to the CEO/CFO certifications regarding financial disclosure. Concern was expressed, however, regarding the costs associated with the certification of internal controls. Audit Committee independence was seen as being preferable, as long as differences between large and smallcap issuers were taken account of.

The ASC was also influenced by the results of its survey of retail investors residing in Calgary and Edmonton, conducted in late 2002 and early 2003. The results suggested that Alberta investors did not lack confidence in the integrity of the Canadian capital markets as a result of the corporate accounting frauds in the U.S.[121]

V. CANADA'S REGULATORY RESPONSE

As discussed in Part IV, capital market participants in Canada expected Canadian securities regulators to take action in response to *SOX*. On 30 March 2004, three new rules came into effect in most Canadian provinces. A fourth rule and related policy followed on 30 June 2005. This part will briefly describe Canada's regulatory response to *SOX* as reflected in these four initiatives.

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120 See *Results of Survey of Corporate Governance & Accountability Issues*, online ASC <http://www.albertasecurities.com/securitiesLaw/Regulatory%20Instruments/5/3131/corp_gov_survey_-_Dec_2-02.pdf>. The other prominent theme noted was that Canada needed a "made-in-Canada" solution that recognized that: (1) one size does not fit all; (2) the unique characteristics of Canada's capital markets (including that a majority are smallcap or microcap); (3) any new Canadian rules not conflict with U.S. rules; (4) Canadian regulators should take the time to consider each U.S. initiative thoroughly before responding; (5) securities commissions — not stock exchanges — should lead a coordinated response; (6) strict detailed rules do not ensure good corporate governance — a culture of ethical behavior and critical assessment on boards needs to be promoted; (7) implications to MJDS should be considered; and (8) the U.S. initiatives would not have prevented the Enron problems (at 29).

121 See ASC, *Report on Investor Confidence Survey* (14 May 2003) [on file with author]. In brief, the ASC survey revealed that: (1) scandals in the U.S. market and concerns relating to the integrity of Canadian directors and officers *were not factors in the change in recent investment activity* of those surveyed (having been mentioned by fewer than 8% of survey participants); (2) the greatest degree of concern regarding the honesty and integrity of directors and management of public companies, the quality of the disclosure and the honesty and integrity or objectivity of the auditors was in relation to *U.S. public companies* rather than Canadian public companies; (3) in relation to Canadian public companies, the least degree of concern regarding these factors was in relation to smallcap companies; and (4) a majority of investors reported that scandals in any one segment of the market would *not* reduce their investment in that segment and would have little effect on their investment in other segments.

A. AUDITOR OVERSIGHT RULE[122]

The Auditor Oversight Rule applies to reporting issuers and the accounting firms that audit their financial statements and gives effect to the creation of the CPAB in 2003 by the federal and provincial financial and securities regulators and Canada's chartered accountants. Where a "reporting issuer … files its financial statements accompanied by an auditor's report, [the reporting issuer] must have the auditor's report prepared by a public accounting firm" that participates in CPAB's oversight program and that is "in compliance with any restrictions or sanctions imposed by the CPAB."[123] Concomitant obligations regarding participation and compliance (as well as giving notice of restrictions or sanctions) are imposed on accounting firms that prepare auditor's reports for reporting issuers. The objectives of CPAB are comparable to those of the PCAOB in the U.S. Although this rule makes no distinction between issuers or accounting firms based on size, CPAB (like the PCAOB) has adopted a proportionate or risk-based approach to its inspection process. "Firms with 100 or more reporting issuer clients are inspected [by CPAB] annually, those with between 50 and 99 … are inspected at least once every two years and those with less than 50 … are inspected at least once every three years."[124]

B. CERTIFICATION RULE[125]

The Certification Rule is clearly the most controversial provision adopted by the CSA. This rule closely parallels the SEC's certification requirements which implement s. 302 of *SOX*. Significantly, it does not require auditor attestation to, and reporting on, management's assessment of internal controls as required by s. 404 of *SOX*. As will be discussed below, this rule continues to evolve.

In brief, the rule currently requires an issuer's CEO and CFO to personally certify that, among other matters:

- They have reviewed the annual and interim filings of the issuer (including annual information form, financial statements, and management's discussion and analysis ("MD&A"));
- The issuer's annual and interim filings do not contain any misrepresentations;
- The financial statements and other financial information in the annual and interim filings fairly present the financial condition, results of operations, and cash flow of the issuer;
- They have designed (or caused to be designed) disclosure controls and procedures ("DC&P") and internal controls over financial reporting ("ICFR");

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122 MI 52-108, *supra* note 65.

123 *Ibid.*, s. 2.2.

124 See CPAB description of inspections, online: CPAB CCRC <http://www.cpab-ccrc.ca/EN/Pages/howWeWork_ overview.aspx>.

125 MI 52-109, *supra* note 65 (30 March 2004).

- They have evaluated the effectiveness of the issuer's DC&P and caused the issuer to disclose the conclusions about their evaluation in the issuer's annual MD&A;

- They have caused the issuer to disclose certain changes in ICFR in the issuer's MD&A.

Unlike *SOX*, it is not a criminal offence to provide a false certification under this rule. However, "[a]n officer providing a false certification potentially could be subject to quasi-criminal, administrative or civil proceedings under securities law."[126]

On 10 March 2006, the CSA announced that it would not proceed with proposed Multilateral Instrument 52-111 relating to officer certification and auditor attestation of internal controls.[127] In return, *all* issuers must provide CEO/CFO certificates regarding the *evaluation* of the effectiveness of the issuer's ICFR and cause the issuer to disclose in annual MD&A their conclusions regarding the effectiveness of ICFR as of the end of each financial year based on such evaluations.[128] However, on 23 November 2007, the CSA advised that the proposed amendments to effect the 10 March 2006 position would be revised to eliminate the requirement for "the CEO and the CFO of a venture issuer to certify that they have designed and evaluated the effectiveness of [DC&P] and [ICFR]."[129] These two significant departures from *SOX* — dropping *SOX* s. 404 auditor attestation and exempting venture issuers from design and evaluation certifications in respect of DC&P and ICFR — illustrate a conscious effort on the part of CSA to adapt *SOX* to the realities of the Canadian capital markets. That the most recent policy decision came after more than five years of debate within the CSA illustrates, in my opinion, the inappropriateness of *SOX* as a model in the first place. A final observation in respect of the certification rule is that it provides an exemption for issuers that comply with U.S. federal securities laws implementing s. 302(a) of *SOX* provided that they file through the System for Electronic Document Analysis and Retrieval their annual or interim certificates "as soon as reasonably practicable after they are filed with the SEC."[130]

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126 See Companion Policy 52-109CP, Part 6.

127 See *Status of Proposed MI 52-111 Reporting on Internal Control over Financial Reporting and Proposed Amended and Restated MI 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings*, O.S.C. CSA Notice 52-313 (10 March 2006) at 1: "After extensive review and consultation and in view of the delays and debate underway in the US over the rules implementing section 404 of the *Sarbanes-Oxley Act of 2002* … we have determined not to proceed with proposed Multilateral Instrument 52-111."

128 *Ibid.*

129 See *CSA Notice — Status of Proposed Repeal and Replacement of MI 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings*, O.S.C. CSA Notice 52-319 (23 November 2007). Venture Issuer is defined as an issuer that, at the end of its most recently completed financial year, "does not have any of its securities listed or quoted on any of the Toronto Stock Exchange, a U.S. marketplace [being an exchange registered as a "national securities exchange" under s. 6 of the *Securities Exchange Act, 1934* or the Nasdaq Stock Market], or a marketplace outside of Canada and the United States of America": MI 52-110, *supra* note 65, s. 1.1.

130 MI 52-109, *supra* note 65, s. 4.1(1)(b).

C. AUDIT COMMITTEE RULE[131]

The Audit Committee Rule is derived from the audit committee requirements set out in *SOX*, certain requirements of the SEC, and listing requirements of the NYSE and Nasdaq. Although the provisions of this rule are similar to those in the U.S., the CSA has made a number of changes to accommodate Canadian corporate law and the distinct profile of the Canadian capital markets, in particular, the large number of public junior issuers and controlled companies.

The rule requires every issuer to have an audit committee to which the external auditors must directly report.[132] The rule prescribes a number of responsibilities for the audit committee, including approval of "all non-audit services to be provided to the issuer" by the external auditor[133] (rather than the outright prohibition of non-audit services contained in s. 201 of *SOX*) and oversight of the work of the external auditor.[134] Every audit committee must have a minimum of three members and each member must be independent and financially literate.[135] Unlike the situation in the U.S.,[136] there is no requirement that an issuer appoint a financial expert to its audit committee.

The Audit Committee Rule sets out the definition of "independence."[137] Similar to the U.S. approach, there are general independence requirements that apply to all board members (based on the NYSE rules) and an additional set of requirements that audit committee members must also satisfy (based on s. (b)(1) of SEC Exchange Rule 10A-3). An individual is considered independent if he or she has no direct or indirect "material relationship" with the issuer, defined as "a relationship which could, in the view of the issuer's board of directors, reasonably interfere with the exercise of a member's independent judgement."[138] The rule then identifies certain categories of individuals who are considered to have a material relationship with the issuer (for example, an individual who is, or has been within the last three years, an employee or executive officer of the issuer). In determining the independence of audit committee members, the rule sets out additional categories of individuals who are considered to have a material relationship with the issuer despite any determination made under the general test (for example, an individual who is an "affiliated entity" of the issuer or any of its subsidiary entities).[139] Venture Issuers are exempted from the composition requirements (independence and financial literacy) and are subject to a slightly less detailed level of disclosure (although they must still identify each audit committee member and state whether or not the member is independent and financially literate).[140] U.S.-listed issuers are exempted from the rule provided that they are in

131 MI 52-110, *supra* note 65.
132 *Ibid.*, s. 2.2.
133 *Ibid.*, s. 2.3(4).
134 *Ibid.*, s. 2.3(3).
135 *Ibid.*, s. 3.1.
136 *SOX*, *supra* note 1.
137 MI 52-110, *supra* note 65, s.1.4.
138 *Ibid.*, s. 1.4(2).
139 *Ibid.*
140 *Ibid.*, part 6.

compliance with the equivalent requirements under *SOX* and the applicable U.S. marketplace.[141]

The Audit Committee Rule provides exemption for controlled companies. An audit committee member is exempt from the independence requirements if the member is also a director of an affiliated entity, provided that he or she is otherwise independent of the issuer and the affiliated entity.[142] (This would permit a member of the board of a parent company to sit on the audit committee of a subsidiary company if he or she were otherwise "independent" of both the parent and the subsidiary.) The second exemption allows a director to serve on the audit committee who would otherwise be independent but for his or her being an affiliated entity of the issuer or any of its subsidiaries, provided that the person is: (1) not an executive officer, or immediate family member of an executive officer, of an affiliate; (2) not chair of the issuer's audit committee; and (3) in the view of the issuer's board of directors, a person who is able to exercise impartial judgment and whose appointment "is required by the best interests of the issuer and its shareholders."[143]

D. GOVERNANCE DISCLOSURE RULE AND GOVERNANCE GUIDELINES[144]

This rule and policy were effective 30 June 2005 and were the source of considerable friction between the OSC and the rest of the CSA. Their origin is the TSX guidelines, which, as discussed above, had required listed issuers to describe their governance practices with reference to 14 guidelines and provide an explanation of any differences. The OSC had originally proposed a disclosure regime under which an issuer would have to disclose whether it complied with certain governance requirements and, if not, provide an explanation.[145] The OSC also proposed a policy which prescribed best practices "that have evolved through the confluence of legislative and regulatory reforms and the initiatives of other capital market participants."[146] The securities commissions of Alberta, British Columbia, and Quebec published their own proposed disclosure rule and governance guidelines in April 2004.[147] These three commissions objected to regulators suggesting, explicitly or implicitly, "best practices." Instead, the counter-proposal required issuers to disclose their corporate governance practices with reference to specified disclosure items, without suggesting or implying an ideal or preferred practice. In the end, the latter proposal won out and all jurisdictions adopted, effective 30 June 2005, NI 58-101 and NP 58-201. The Governance Disclosure Rule does not apply to U.S.-listed issuers. In recognition that many smaller issuers have less formal governance procedures in place, venture issuers are able to make disclosures with reference to fewer disclosure items.

While the CSA opted for a flexible, non-prescriptive approach, the treatment of controlled companies is interesting and should be contrasted with their treatment in the U.S. In the U.S.,

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141 *Ibid.*, part 7.
142 *Ibid.*, s. 3.3.
143 *Ibid.*, s. 3.3(2)(e)(ii).
144 *Disclosure of Corporate Governance Practices*, A.S.C. NI 58-101 (30 June 2005) [NI 58-101] and *Corporate Governance Guidelines*, A.S.C. NP 58-201 (30 June 2005) [NP 58-201].
145 See (Proposed) *Disclosure of Corporate Governance Practices*, O.S.C. MI 58-101 (16 January 2004).
146 See (Proposed) *Effective Corporate Governance*, O.S.C. MP 58-201 (16 January 2004).
147 See (Proposed) *Disclosure of Corporate Governance Practices*, A.S.C. MI 51-104 (23 April 2004).

the NYSE Rules (which contain requirements for board composition) explicitly recognize the legitimate interests of controlling shareholders in the governance of the companies which they control. The NYSE Rules state that: "[n]o director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no *material relationship* with the listed company."[148] In the commentary contained in s. 303A of the NYSE Rules, the NYSE states:

> Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, *as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.*[149]

This very strong statement of a policy choice can be contrasted with the following tepid statement of the CSA in s. 3.1 of Companion Policy 52-110:

> Although shareholding alone may not interfere with the exercise of a director's independent judgement, we believe that other relationships between an issuer and a shareholder may constitute material relationships with the issuer.[150]

In recognition of the fundamental interests of controlling shareholders, the NYSE Rules expressly exempt controlled companies (defined as a "[listed] company of which more than 50% of the voting power is held by an individual, a group or another company"[151]) from the requirements to have a majority of independent directors and entirely independent nominating and compensation committees, provided that the issuer indicates it is relying on these exemptions in its annual proxy statement and discloses that it is a controlled company and the basis for that determination.[152]

Although the CSA stated in NP 58-201[153] in 2005 that it intended, over the next year, to carefully consider expressed concerns about how the Governance Disclosure Rule and Governance Guidelines affect controlled companies, no proposals for change have been brought forward. In response to comments received on the treatment of controlled companies in these two instruments when first proposed, the CSA simply noted that "the guidelines are not mandatory, and so issuers are free to adopt those corporate governance practices that they determine to be appropriate for their particular circumstances."[154] This treatment of controlled companies is a significant departure from that reflected in both the *Dey Report* and the TSX guidelines. It is surprising that no explanation has been given for this apparent policy change and retreat from the principle that independence means *independent from management*.

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148 *Final NYSE: Corporate Governance Rules*, online: NYSE Euronext <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> at 4 [emphasis added] [NYSE Rules].

149 *Ibid.* [emphasis added].

150 Companion Policy 52-110CP, s. 3.1.

151 NYSE Rules, *supra* note 148 at 1.

152 *Ibid.* at 1.

153 *Corporate Governance Guidelines*, *supra* note 144, s. 1.1

154 See CSA, *Request for Comment — Proposed National Policy 58-201 Corporate Governance Guidelines and Proposed National Instrument 58-101 Disclosure of Corporate Governance Practices*, CSA Notice (29 October 2004) at C-3.

VI. ASSESSMENT AND RECOMMENDATIONS

In this part, I will assess Canada's regulatory response to *SOX* against the three criticisms noted in the Introduction and recommend a course of action to address these shortcomings in the future.

A. *SOX* WAS THE WRONG MODEL FOR CANADA

I submit that *SOX* was not the appropriate model for Canada because of the distinctly different characteristics of Canada's capital markets compared to those in the U.S. The key distinguishing features of the Canadian markets are: (1) the large number of Canadian issuers with listings in the U.S.; (2) the much smaller size of the Canadian capital markets in general and the much smaller size of Canadian public issuers in particular; and (3) the large number of controlled companies.

1. UNITED STATES-LISTED CANADIAN ISSUERS

The CSA very pragmatically exempted Canadian public issuers with U.S. listings from most of the requirements of the Certification Rule and the Audit Committee Rule. The CSA had adopted this approach before. For example, NI 51-101 *Standards of Disclosure for Oil and Gas Activities* provides that oil and gas issuers which are registered under the *Securities Exchange Act of 1934*[155] may apply for approval to substitute disclosure using the U.S. Financial Accounting Standards Board (FASB) standards and relevant requirements of the SEC.[156] This policy decision reflects the reality that these Canadian issuers, having chosen to access the U.S. capital market, are now subject to U.S. securities regulatory requirements. Thus, it makes no sense for Canadian securities regulators to require compliance with Canadian requirements if the U.S. standards are considered comparable.

2. SIZE DOES MATTER

The much smaller Canadian capital markets with their smaller issuers raised legitimate concerns about the costs of complying with the highly prescriptive provisions of *SOX*. While the CSA did make accommodation in a number of instruments for venture issuers, the key policy question is whether the division of the Canadian market into two groups — venture issuers and TSX-listed issuers — is appropriate. While distinguishing between the TSX and TSXV has the merit of simplicity and transparency, I suggest that this line of demarcation ignores the fact that many issuers listed on the TSX are smaller (when measured by market capitalization) than some of those listed on the TSXV.[157] As recommended by the Investment Dealers Association (IDA) Task Force and the U.S. Advisory Committee on Smaller Public Companies, I suggest that securities regulation in Canada be scaled according to the size of an issuer's market capitalization, with one exception discussed in the next paragraph. Market

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155 U.S.C. § 78a.

156 *Standards of Disclosure for Oil and Gas Activities*, O.S.C. NI 51-101 (25 January 2002), s. 8.3 [NI 51-101].

157 See Nicholls, *supra* note 2 at 156, where he notes that, based on data from December 2005, the 100 largest TSXV companies were larger, in terms of market capitalization, than over 500 of the TSX-listed companies (almost one third of the total number of TSX companies).

capitalization has been used as a criterion to distinguish between issuers in other regulatory initiatives in Canada, such as MJDS.[158]

I suggest that the Canadian domestic issuers should be divided into at least three tiers: large, medium, and small. A possible model for tiers would be that suggested by the U.S. Advisory Committee on Smaller Public Companies. This methodology would result in there being a very broad range of smallcap companies (CDN$36.6-256.5 million). I suggest instead that the CSA work with the exchanges and issuers to develop tiers which are realistic and workable. Adoption of proportionate or scaled regulation as an overarching policy will, I submit, eliminate much of the tension between the OSC (with its large cap focus) and the two most westerly commissions (with their small cap focus). Placing Canadian issuers that are listed in the U.S. in a separate category permits Canadian regulators to focus their policy-making efforts on Canadian domestic issuers. This focus, I submit, should be a principal mandate of the CSA.

3. CONTROLLED COMPANIES

As discussed above, the treatment of controlled companies by the CSA is perplexing and lacks any expressed policy rationale. The CSA appears to have ignored the significant (though not unanimous) empirical evidence that Canadian controlled companies — particularly family-controlled companies — perform better than non-controlled Canadian companies. The two accommodations made for controlled companies in the Audit Committee Rule appear almost as reluctant negotiating concessions. This abrupt change in the treatment of controlled companies has not gone unnoticed in Canada.[159] I suggest that the CSA address controlled companies in a direct and consistent manner. The CSA needs to conduct a thorough analysis of empirical studies of controlled companies in Canada and decide whether this feature of the Canadian capital markets is to be embraced or discouraged. Ad hoc reaction is not, I submit, sufficient.

B. HARMONIZATION WITH THE UNITED STATES

As noted above, harmonization with the U.S. was assumed — at least by the OSC — as the default policy direction. Consequently, the CSA did not undertake a thorough or deliberate analysis of whether harmonization with the U.S. in the area of corporate governance was necessary or desirable. Admittedly, the situation of Canada vis-à-vis the U.S. is very different from that of all other nations. Free trade and increasing economic integration, as well as geographic proximity, place significant pressure on Canada to conform to U.S. regulatory initiatives. Fear of loss of crucial U.S. investment in Canadian businesses and restrictions on access to the U.S. capital markets drive some in Canada to argue that Canada must be seen to be "as robust" as the U.S. in capital market regulation. Indeed, MJDS exists because of SEC satisfaction that Canadian securities regulatory requirements are comparable to those in the U.S. Nevertheless, examples abound of Canada adopting independent regulatory policy, even in the increasingly integrated capital markets of the two

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158 See MJDS where a CDN$75 million public float was required in order to be eligible to participate.

159 See Edward J. Waitzer, "Made in Canada Solutions? Responsive or Reactive Regulatory Reform" in Jay W. Lorsch & Edward J. Waitzer, 5 *One Issue, Two Voices* 9 at 14.

countries. A good example is NI 51-101 where Canada adopted an oil and gas reserves disclosure regime which is very different from that which exists in the U.S.[160]

A critical point to consider in this debate over the merits of harmonization with the U.S. is the fact that, since the advent of *SOX*, the dominance of the U.S. vis-à-vis world capital markets has diminished considerably. According to the Paulson Committee, the decline in the U.S. competitive position as compared to foreign stock markets and financial centres can be evidenced by the trend of IPOs undertaken outside a company's home country. "As measured by the value of IPOs, the U.S. share declined from 50 percent in 2000 to 5 percent in 2005. Measured by number of IPOs, the decline [was] from 37 percent in 2000 to 10 percent in 2005."[161]

The Paulson Committee notes that one important factor contributing to the loss of U.S. public market competitiveness compared to global public markets is the growth of U.S. regulatory compliance costs and liability risks compared to other developed and respected market centers:

> There should be no doubt that obtaining and sustaining competitive advantage in financial services by managing regulatory costs and burdens while maintaining the confidence of investors has become an explicit focus of government policy in competing market centers.… It is worth noting that London, for many years lacking the dominant position in worldwide capital or investment opportunities (which arguably it once held), has been able to retain its position as a leading financial center by *choice*, not necessity. It has done so, in the view of many, by providing the protection to investors of well-crafted, effective laws properly enforced without unnecessary cost and undue exposure to liability risk.[162]

The implications of this sea-change for Canadian policy-makers should be obvious. Rather than continue to emulate a regulatory regime which is apparently in competitive decline internationally, Canada should strive to forge for itself a distinct regulatory regime based on sound regulatory principles and practical, cost-effective, and enforceable rules.

C. CRITICALLY EVALUATING THE THEORY UNDERLYING *SOX*

The third criticism of the response by the CSA is that there was little critical evaluation done of the theoretical underpinnings of *SOX*, in particular the underlying premise that independent outside directors (as opposed to "affiliated" outside directors) make better monitors of management. There is little empirical evidence to support this proposition. To the contrary, some studies even suggest that boards with too many "outsiders" may negatively impact firm performance.[163] Regarding the composition of audit committees in

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160 *Supra* note 156.

161 *Paulson Report*, *supra* note 97 at x.

162 *Ibid.* at xi [emphasis in original].

163 See Sanjai Bhagat & Bernard Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance" (2002) 27 J. Corp. L. 231. The authors concluded that firms with more independent boards did not perform better than other firms and noted that there were hints in their data that they perform worse than other firms. See April Klein, "Firm Performance and Board Committee Structure" (1998) 41 J.L. & Econ. 275 at 277-78. Klein found little evidence that the "monitoring" committees of a board which are usually dominated by independent directors – audit, compensation and nominating – affect firm performance, regardless of how they are staffed. However, Klein found a

particular, Roberta Romano notes that the "compelling thrust of the literature … does not support the proposition that requiring audit committees to consist solely of independent directors will reduce the probability of financial statement wrongdoing or otherwise improve corporate performance."[164]

That the CSA may have too readily accepted the "holy grail" of director independence is illustrated by a renewed debate which has emerged among corporate governance experts in Canada. Peter Dey (of *Dey Report* fame), reflecting on his own boardroom experience, now acknowledges that "definitional independence doesn't guarantee independent-mindedness."[165] He would drop all independence requirements for the composition of the board and the audit, compensation, and nominating committees. Instead, he would add a "simple statement" recognizing the duty of directors to act independently in the best interests of the company. Dey is concerned that the result of overreacting to embrace independence is that companies are deprived of people who potentially know the most about a company and its industry.

These unintended consequences of independence are perhaps even more pronounced in the context of controlled companies. As noted in Part V, the ambivalent attitude of the CSA toward directors who have a connection to controlling shareholders marked a significant policy change. I submit that, before changing policy, the CSA should have undertaken a more thorough and rigorous consideration of the application to controlled companies of the concepts of independence reflected in *SOX*. The recommendation going forward is that the CSA undertake critical analysis of the issues to be addressed, including consideration of empirical studies and how other jurisdictions have responded to the same issue.

VII. CONCLUSION

Canada's new corporate governance regime has been described as representing a response to a *solution* rather than to a *problem*.[166] I suggest that this description accurately captures the policy approach taken by Canadian securities regulators following the enactment of *SOX*. By embracing *SOX* at the outset as the model for Canada, Canadian policy-makers thereby committed the entire Canadian capital market to an approach which, I have argued, was both inappropriate for Canada and poorly conceived *ab initio*. The continuing debate in Canada over some of the more controversial provisions of *SOX* — now in its sixth year — evidences lingering doubts over the wisdom of this initial policy decision. The diminished international dominance of the U.S. capital markets since the enactment of *SOX* — owing in part to the

positive relation "between the percentages of inside directors on finance and investment board committees and accounting and stock market performance measures" (at 277). These two board committees were selected because they are generally charged with reviewing long-term corporate strategy, financial policies, and investments — mandates which favour a director with a sophisticated understanding of the corporation's business. The suggested reason for this positive relationship is that "boards need specialized, expert-provided information about the firm's activities to evaluate and ratify the firm's long-term strategies" (at 278). Outside directors often lack both the time and firm-specific expertise to provide this insight.

164 Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2005) 114 Yale L.J. 1521 at 1533.

165 Janet McFarland, "Mr. Dey's About-Face" *The Globe and Mail* (17 July 2006) B1.

166 Nicholls, *supra* note 2 at 177.

increased regulatory burden and liability risks in the U.S. — should give Canadian securities regulators reason to reconsider the merits of harmonization with the U.S., at least for non-U.S. listed public issuers. This international disenchantment with the U.S. approach to securities regulation provides Canada with an exciting opportunity to differentiate itself from the U.S. and create a competitive advantage for its capital markets. As Canadian policy-makers ponder major structural changes to Canada's securities regulatory system, they would be well advised to bear in mind these lessons learned from Canada's response to *SOX*.