

THE IMPORTANCE OF GOOD GOVERNANCE FOR CONFIDENCE IN CANADIAN CAPITAL MARKETS

Purdy Crawford

In the wave of corporate scandals that followed the burst of the bubble on the stock market, confidence in the business community has been badly shaken across North America. And in the subsequent wave of recriminations, business has been confronted with unprecedented scrutiny from government and regulators. Business leaders have been forced to ask about the nature, purpose and value of their enterprises beyond their bottom lines. Purdy Crawford, former chairman of Imasco and Canada Trust, was an advocate of corporate governance long before it became a flavour of the month. He looks beyond the recommendations of the Bennett-Broadbent Report and the Saucier Report in Canada, as well as the Higgs Report in the UK, and offers some simple rules for corporate governance, particularly for enhancing the independence of corporate chairs and directors.

La vague de scandales financiers consécutive à l'éclatement de la bulle spéculative du marché boursier a rudement ébranlé dans toute l'Amérique du Nord la confiance à l'égard du monde des affaires. Et la vague de récriminations qui en a découlé a incité gouvernements et autorités de réglementation à soumettre les grandes entreprises à un examen d'une rigueur sans précédent. Lequel a forcé les grands patrons à s'interroger, au-delà des résultats financiers, sur la nature, la mission et les valeurs de leur entreprise. Ancien président d'Imasco et de Canada Trust, Purdy Crawford était partisan de la gouvernance d'entreprise bien avant que l'idée ne soit en vogue. Au-delà des recommandations des rapports Bennet-Broadbent et Saucier, et du rapport Higgs au Royaume-Uni, il énonce quelques simples règles de gouvernance visant notamment à renforcer l'indépendance des dirigeants et administrateurs de sociétés.



In a thoughtful article in the December 2002 *Harvard Business Review*, Charles Handy wrote, “In the wake of recent corporate scandals, it is again time to ask ourselves the most fundamental of questions,” namely, “What’s a Business For?” He concludes: “The purpose of a business, in other words, is not to make a profit, full stop. It is to make a profit so that the business can do something more or better. That ‘something’ becomes the real justification for the business. Owners know this. Investors needn’t care.”

In this context, it is interesting to look at some of the numbers in the Maclean’s annual year-end readers’ poll in 2002. Respondents were asked what the primary role of the CEO should be. The answers, in percentages, can be seen in table 1.

The public has a very different view as to what the prime role of a company is compared with the expert. A major

modification to our corporate law suggested by the Broadbent-Bennett report of 2002, entitled *Canadian Democracy and Corporate Accountability*, is that the fiduciary duty of directors be changed so that as long as directors take into account shareholder interests they can also take into account the interests of all other stakeholders such as employees, customers, suppliers, creditors and communities.

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

if the interests of other stakeholders are not addressed.

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

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

As to the governance of corporations, they are accountable to shareholders (through the directors) and other stakeholders and to regulators, particularly securities regulators

represents over 90 percent in value of all stock market transactions in the Canadian capital markets. Some of the provinces are concerned that with one regulator based in Toronto, local interests will not be looked after. Quebec is also concerned about its "sovereignty."

Perhaps the "wise men" process recommended by Harold McKay to the federal finance minister last fall to advise on this matter will help solve the problem. The wise men have been appointed by the federal government with input from the provinces. I would hope that the provinces would put what is in the interest of all of Canada

Our securities regulatory system, including the self-regulation part of it, is as good or better than in the US, both in terms of the laws and rules and the people who administer them. There is one serious deficiency with our securities regulatory system in Canada and that is the lack of one securities regulator for Canada.

creating expenditures on such things as health care, education, and most importantly, early childhood development and other programs to make our citizens more productive.

This means that a lot more is involved in creating confidence in our capital markets than just good corporate governance. The capital markets are just one means of participating in our economy and in our broader development of society. Canadian public policy in such areas as openness to free trade, controlling inflation, reducing public debt and others is of fundamental importance to our society. Even more important is the ability to execute such policies. This is a quality that is often sadly lacking both in government and the private sector. The registration of firearms may or may not be good policy, but the disaster in implementation illustrates the point.

and, importantly, self-regulators such as the Investment Dealers' Association and the TSX.

I believe our securities regulatory system, including the self-regulation part of it, is as good or better than in the US, both in terms of the laws and rules and the people who administer them. It used to be regularly stated by our media that the Securities and Exchange Commission was the model regulator. We have discovered with the coming of Enron, Worldcom, and others, that the SEC has been underfunded and lacking human resources.

There is one serious deficiency with our securities regulatory system in Canada, and that is the lack of one securities regulator for Canada. We have good regulators in our various provincial securities commissions, and a lot has been accomplished to make the system more efficient. The TSX

first. If not, then the federal government should move ahead on its own.

The Enron, WorldCom and Tyco affairs have been, in hindsight, the greatest catalyst for the development of better corporate governance since the enactment under President Franklin Roosevelt of the *Securities Act* of 1933 and the *Securities Exchange Act* of 1934. There are several matters arising out of these recent developments in the US, Canada and the UK that merit our attention.

With the notable exceptions of the Saucier Report in Canada and the Higgs Report in Britain, recent developments in the US and their counterparts in Canada and the United Kingdom are designed to deal with misbehaviour, compromised accounting, fraud, etc. They have absolutely nothing to do with creating shareholder value, other than the prevention of the destruction of shareholder value. As a matter of fact, if these laws and rules cause directors to be more conservative they may not be conducive to creating better performance. I was recently told by a US corporate director that a CEO of an American company spent over 60 hours doing the preparatory work to be able to certify the company's financial statements. The amount of time required may decrease over time but I have serious reservations about whether this is a

TABLE 1. WHAT THE PRIMARY ROLE OF THE CEO SHOULD BE

Roles	Responses (Percent)
Ensure products and services are of the highest quality	20
Take care of the employees	19
Ensure company is a good corporate citizen	18
Ensure company is profitable	16
Provide employment for workers wherever the company operates	13
Increase value of company for benefit of shareholders	9

Source : *Maclean's* annual year end readers' poll 2002



The Gazette, Montreal

Before confidence can be fully returned to the floor of the stock exchange, there must be confidence in the culture of corporate values, writes Purdy Crawford, former chairman of Imasco and Canada Trust.

good use of a leader's time. The point is, as noted in the *Economist* of January 11, 2003: "When regulators seek to impose good governance, they may do more harm than they prevent."

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

In this connection the best thing directors can do to guard against misbehaviour, compromised accounting, fraud, etc., is to be satisfied with the values and integrity of the CEO and

that the CEO, and other leaders, have spread a values culture throughout the organization. If a director does not trust the CEO, then either the CEO should be gone or, if dumping the CEO is not possible, the director should get out.

What this means to me is that if I had the responsibility of rewriting the guidelines I would provide that the number one responsibility of a board of directors should be to act as the guardian of corporate values, to make sure that the CEO and the other leaders are people of integrity and that they "walk the talk."

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

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

The requirements or proposed requirements in the US would require all the directors of the key committees — audit, human resources (or at least the compensation part of human resources) and governance, to be independent. The

proposed guidelines of the Higgs Report in the United Kingdom make the same recommendations and the TSX proposed guidelines (not mandatory rules) would do the same except for the Governance Committee where no representatives of management could be on the Committee but only a majority of independent directors would be required.

We have a very high level of corporate concentration in Canada compared to the US. We have developed very sophisticated rules to deal with this in terms of transactions between related parties, and so on. Corporations that want good share performance should be scrupulous in dealing with related party transactions, and strong independent directors are needed to properly deal with these rules. I am, however, concerned about the tendency to disenfranchise the shareholder. In my experience, shareholders can and do add value, whether they be a widow voting 100 shares at the annual meeting or a fund manager voting one million shares. The US rules do not go this far, although major shareholders are treated as non-independent for audit committee purposes. I can understand this but it does mean that, if the controlled subsidiary is significant, that some other means must be found to satisfy the fiduciary responsibilities of the audit committee and the board of the parent company of the integrity of the financial results of the subsidiary. This probably means a pragmatic relationship between the two CFOs and perhaps the respective audit committees. I am not sure if this result solves the mischief that the non-representation of an officer or director of the parent was designed to deal with, for example, to prevent non-independents from pressing the auditor or financial management of the controlled subsidiary.

In my own experience as the head of a management holding company, we

were very careful to maintain an appropriate distance from our operating companies on financial transactions. For example, Imasco owned Canada Trust, but never took office space in the CT Tower in Montreal. And CT never banked Imasco. Royal Bank did. It was more than a question of appearances. It was simple common sense. By the same rule of common sense, an accounting firm doing a company's audit should never do significant management consulting with that company. It is no accident that Arthur Andersen did both with Enron and WorldCom, nor is it any accident that Andersen, once one of the largest accounting firms in the world, no longer exists. Its demise is a

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reminder to us all that integrity and reputation are the ultimate guarantors of trademark value.

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

A word about the combined role of the chair of the board and the CEO because of the conflicts of interest inherent in the two jobs. I have come to the view over time that the role of the chair and CEO should be split. I

am, however, prepared to compromise where the chair is the CEO, by having a strong independent director as "Lead Director." The practice in the UK has been to split the functions, and the Higgs Report recommends that this be a guideline. The Saucier Report opted for either splitting the job or having an independent board leader (or lead director).

In the US, there has been great resistance to the idea of splitting the roles of the chair and CEO. The CEO must be the "monarch." A committee of the Conference Board in the US, co-chaired by John Snow, now secretary of the Treasury, recommended that where the jobs are combined, there should be a "presiding director" to lead the board's outsiders. This is starting to happen in the US: Disney, GE, H&R Block, Interpublic Group, Tyco and others have named or are in the process of naming presiding directors.

The Higgs Report recommends that there be both a nonexecutive chair, who would be independent at least at the start of his or her term, and a senior independent director. The clear implication of the requirement for a senior independent director in addition to a nonexecutive chair seems to be that you cannot be a chair without losing your independence. This perhaps relates more to the traditional situation in the UK where the separate chair was sometimes a co-CEO, not necessarily in name, but in fact.

At the other extreme is Fairvest (now part of the US-based Institutional Shareholder Services), which appears to be concerned that a nonexecutive chair may not be independent if he or she is paid more than twice as much as other independent directors.

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

I regard the recent formation of the Canadian Coalition for Good Governance by various institutional investors as a very positive development for creating better corporate governance in Canada. Properly organized and well operated, this organization, which is representative of major share-

We probably need a somewhat different regime for small public, businesses. There are a great many of these in Canada. This regime might apply to companies listed on the ventures exchange. The regime should move the goal post forward with respect to governance requirements, but not as

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

The recent formation of the Canadian Coalition for Good Governance by various institutional investors is a very positive development for creating better corporate governance in Canada. Properly organized and well operated, this organization, which is representative of major shareholders of our private sector corporations, can do much to strengthen boards of directors and make our corporations perform well.

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

holders of our private sector corporations, can do much to strengthen boards of directors and make our corporations perform well. This organization can contribute more than any laws or rules.

The initiative by the Institute for Corporate Directors to create director education programs is also a very positive step. We need directors of diverse backgrounds, and this means that people with such diverse backgrounds need their particular strengths broadened to other areas so that their contributions as directors will be strengthened.

far as for the larger corporations. One possible approach would be to create a new regime for existing small business, with a requirement to meet the higher standards within, say, five years. New companies coming to the public market would have to meet the higher standards from day one.

Compensation is a troublesome issue. This is exacerbated by the integration of our economy with the US economy, where compensation tends to be much higher. (Incidentally, a recent experience of mine would indicate that, at least for the petroleum industry, compensation is also higher in the UK than in Canada).

All of this leaves open a fundamental question as to whether good governance adds value. It is perhaps self-evident that it does. However, many studies would indicate that it is not possible to demonstrate that there is any correlation

between good corporate governance and performance, at least from the perspective of good governance that is measured by filling in all the appropriate blanks. As a matter of fact there has been an analysis by two Montreal professors, Yvan Allaire and Mihaela E. Firsirotu, which shows, among other things, that the 25 firms with the best governance scores in the *Globe and Mail* rankings underperformed the 25 firms with the worst scores.

On the other hand, a recent survey by McKinsey & Company found that 76 percent of institutional investors said they would pay a premium price for effective corporate governance. If financial institutions are prepared to put their money where their mouth is, then good governance will add value.

Based upon a lot of experience, I believe that we have, on the whole, better corporate governance in Canada than in the US. The CEO is less a “monarch” in Canada. We in Canada have a long way to go in improving corporate governance, but probably not as far as in the US.

With some pushing and pulling between the TSX and the OSC or Canadian securities administrators about how far the rules should go and to what extent they should be guidelines or mandatory, a system will evolve in Canada that will be a reasonable compromise. I regard the debate between the TSX and the securities regulators as healthy for the system.

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

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

Purdy Crawford, a leading authority on corporate governance, is Counsel to Osler, Hoskin & Harcourt in Toronto and Chairman of Allstream Inc. A graduate of Harvard Law School, he was chairman and CEO of Imasco Ltd. until 1995 and nonexecutive chairman of Imasco and Canada Trust until 2000. He is a Fellow of the Institute of Corporate Directors and a member of the Canadian Business Hall of Fame. In 2000, he was named Ivey Business Leader of the Year, and has just been named the Conference Board of Canada’s Honourary Associate for 2003.