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# CANADIAN RESPONSE TO THE U.S. SARBANES-OXLEY ACT OF 2002: NEW DIRECTIONS FOR CORPORATE GOVERNANCE

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# CANADIAN RESPONSE TO THE U.S. SARBANES-OXLEY ACT OF 2002: NEW DIRECTIONS FOR CORPORATE GOVERNANCE

## INTRODUCTION

This paper discusses the Canadian response to the U.S. Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and the related rules adopted by U.S. exchanges and securities regulators.

Sarbanes-Oxley introduced sweeping changes to the corporate governance and disclosure obligations of publicly traded companies on U.S. markets. The need to maintain compatibility and competitiveness with the United States has forced Canadian regulators to adopt similar provisions. However, the Canadian response has been shaped by the unique conditions of the domestic market. Canadian regulators have also been able to benefit from the U.S. experiences since 2002, allowing regulators to avoid many of the pitfalls encountered by their U.S. counterparts. In Canada, most new rules and regulations arising from the reforms came into force in mid-2005, with the remainder to be phased in over the following few years.

## RECENT CORPORATE GOVERNANCE REFORMS IN THE UNITED STATES

### A. Overview of the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 was introduced in the aftermath of a series of major corporate scandals involving, among others, Enron, WorldCom, Global Crossing, and Tyco, as well as several major auditing firms including Arthur Andersen. These scandals resulted in hundreds of billions of dollars in corporate and investor losses in the United States. Corporate defaults and plunging stock prices were followed with stories of excessive executive compensation, insider dealing, and systematic failures in management and board oversight that eventually led to a series of high-profile criminal prosecutions of executives and senior management.

In response, Sarbanes-Oxley introduced far-reaching and significant changes to the corporate governance and disclosure obligations of publicly traded companies in the United States. Its objectives were first, to quickly restore investor confidence in the markets; and second, to prevent further occurrences of corporate fraud. To this end, Sarbanes-Oxley introduced provisions designed to: enhance the accountability of corporate officers; improve corporate disclosure; introduce new audit committee standards and responsibilities; improve auditor oversight and limit conflicts of interest; strengthen accountability for wrongdoing; and address analyst conflicts of interest. While the Act set the broad outlines for reform, it was left to the U.S. Securities Exchange Commission (SEC) as well as U.S. security exchanges themselves to implement many of the details by regulation.

One of the most important provisions of Sarbanes-Oxley establishes the Public Company Accounting Oversight Board, designed to prevent auditing abuses such as those seen at Enron. The accounting board is responsible for registering, overseeing, investigating, and disciplining all accounting firms that audit public companies, and setting auditing standards to be used by those firms. Some other key related requirements include major restrictions on the auditors of public companies. As an example, Sarbanes-Oxley imposes new auditor independence standards in response to concerns that Arthur Andersen's audits of Enron may have been compromised by the fact that the accounting firm was providing both consulting and auditing services to Enron.

The auditing profession was not the only target of Sarbanes-Oxley. The Act also includes a broad range of provisions dealing with corporate governance. These include an expansion of the role and responsibilities of audit committees of the board of directors of public companies, and the introduction of safeguards to ensure that audit committee members are not controlled by top management. Under the Act, at least one member of the audit committee must be designated as a qualified financial expert.

Many of the reforms were controversial. One of the more contentious provisions requires chief executive officers (CEOs) and chief financial officers (CFOs) of public companies to personally certify the accuracy of various financial reports, with significant criminal penalties for false certifications. In addition, if a public company makes an accounting restatement, that company's CEO and CFO could be forced to forfeit any bonuses or profits gained from selling company stock for a one-year period. The Act also prohibits new loans to directors and executive officers. Another controversial provision – known as Section 404 – considered as the Act's most financially onerous, requires public companies to document and test their financial accounting processes to ensure that their financial reports are accurate.

In addition to reforms aimed at strengthening the corporate governance regime, Sarbanes-Oxley introduces a new set of disclosure requirements. For example, material changes to a company's financial condition must be reported on a "rapid and current basis." Sarbanes-Oxley also creates new or broader federal crimes for obstruction of justice and securities fraud. The maximum sentence for some securities law violations was doubled from 10 to 20 years, and the maximum fine against a company for the same offence was increased from $2.5 million to $25 million. To further deter corporate fraud, the law extends protection for whistleblowers: no company may "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee" because of any lawful provision of information about suspected fraud.(1)

In all, the provisions of Sarbanes-Oxley and the related rules and regulations adopted by the SEC and the exchanges contain more than 100 major provisions.(2)

## B. Assessing the Effectiveness of Sarbanes-Oxley

Three years after the passage of Sarbanes-Oxley, U.S. regulators and market observers have only just begun to assess its effectiveness. Clearly a work in progress, many observers feel that it still may be too early to evaluate whether or not the reforms have met their objectives, or whether the benefits of the reforms will exceed the costs.

One of the early criticisms that emerged was that Sarbanes-Oxley was designed in haste and implemented too rapidly. This resulted in confusion and uncertainty as firms sorted out their new obligations. In some cases, these were unclear, as the rules were often made binding before the SEC or the exchanges had issued detailed interpretation of them. For example, in the case of CEO/CFO financial statement certification, CEOs and CFOs were incurring personal liability for certifications whose exact meaning and interpretation was yet to be clarified by the SEC. In 2005, the SEC responded by issuing clarifications of the original regulations and promised further consultations aimed at improving them.

One ongoing concern has been the excessive regulatory burden imposed by the reforms. According to the Financial Executives International (FEI), in a survey of

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(1) Sarbanes-Oxley Act of 2002, s. 806.

(2) For a more detailed discussion, see Margaret Smith, *The U.S. Sarbanes-Oxley Act of 2002: Reforming Corporate Governance and Disclosure*, PRB 02-42E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, 4 November 2002.

217 companies with average revenues above $5 billion, the cost of compliance averaged $4.36 million. The FEI survey also indicated that the actual costs associated with compliance were approximately 39% higher than companies had expected. Another study put the cumulative cost of compliance for the private sector at $1.4 trillion.(3) Compliance with Section 404 (internal controls) alone has been estimated to have cost U.S. business more than $30 billion.(4)

Some expenses were one-time implementation costs. However, the costs of compliance with the Act are important and imposed a significant financial burden that fell disproportionately on smaller and emerging firms. Some of these burdens are being reduced as calls for a less rigid interpretation of the rules are being heeded by regulators. The SEC is also discussing reforms aimed specifically at easing some of the regulatory and paperwork burden imposed on smaller companies.

The hidden costs of Sarbanes-Oxley are only now becoming known. Evidence suggests that foreign firms, including many Canadian companies, are delisting or choosing not to list on American stock exchanges as a result of Sarbanes-Oxley. The New York Stock Exchange (NYSE) reports that it has seen a slowdown in foreign listings since Sarbanes-Oxley, from 50 to 60 per year (about one-third of them European) before the Act was passed to 16 in 2003 (of which only 2 were European).(5) In other instances, firms are deciding not to go public in order to avoid compliance costs.(6) Many market observers also believe that the new rules and regulations, chiefly those aimed at increasing the personal accountability of directors and officers, are serving to discourage risk-taking and other entrepreneurial behaviour.

On the other hand, the benefits of the reforms are also becoming more evident. Section 404, aimed at improving internal controls, is laying the groundwork for sounder financial reporting and better investment decisions, improvements noted by Moody's rating agency. Nevertheless, academics and economists say they need to see more concrete evidence that Sarbanes-Oxley is working before they will weigh in on its merits.

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(3) "A price worth paying?" *The Economist*, Vol. 375, Issue 8427, 21 May 2005, pp. 71-73.

(4) Amey Stone, "SOX: Not So Bad After All?" *BusinessWeek Online*, 1 August 2005.

(5) On 15 December 2005, Air China, a Chinese company, chose to list on the London Stock Exchange rather than the New York Stock Exchange. Industry observers believe this decision was made in order to avoid the burdens imposed by Sarbanes-Oxley.

(6) "404 Tonnes of Paper," *The Economist*, Vol. 373, Issue 8406, 18 December 2004, p. 116.

## THE CANADIAN RESPONSE

While the changes that have been adopted in Canada largely emulate the Sarbanes-Oxley Act of 2002 and related rules, the Canadian response has been shaped by the significant structural and philosophical differences between the two countries' financial markets. Taking a more measured approach to implementation has also allowed Canadian regulators to learn from, and build upon, U.S. experiences.

### A. The Canadian Context

In 2002, Canadian securities regulators found themselves under considerable pressure to adopt similar reforms in order to maintain investor confidence in the Canadian regulatory system and protect the integrity of the Canadian capital markets. However, there was less sense of urgency in Canada since, at the time, Canada had yet to experience corporate fraud on the same scale as in the United States. Nonetheless, Canadian regulators seized the opportunity provided by Sarbanes-Oxley to introduce desired and long-delayed corporate and securities law reform.

Additionally, regulators were strongly motivated by the belief that mirroring U.S. reforms was vital to preserving Canada's preferential access to U.S. markets.(7) This was of crucial importance to large Canadian issuers. Canadian firms make up the single largest group of foreign firms listed on U.S. stock exchanges, with approximately 15% of Toronto Stock Exchange (TSX) listed firms having a U.S. listing. In all, more than 180 Canadian firms were cross-listed on the NYSE, the American Stock Exchange, or the NASDAQ at the end of 2003.(8)

Cross-listed firms are, for the most part, already subject to the new U.S. requirements. Canadian regulators therefore found themselves faced with the need to simultaneously accommodate the conflicting needs of large Canadian issuers listed on American markets and the greater number of smaller, exclusively domestic, issuers. Contradictory

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(7) The Canada-U.S. Multi-jurisdictional Disclosure System allows eligible Canadian public companies to access the U.S. public markets using Canadian disclosure documents (which are subject to review only by Canadian securities regulators) and without becoming subject to the U.S. domestic registration and reporting system.

(8) Scott Hendry and Michael R. King (Research Director and Assistant Director, respectively, Financial Markets Department), "The Efficiency of Canadian Capital Markets: Some Bank of Canada Research," *Bank of Canada Review*, Summer 2004.

requirements would be intolerable for cross-listed companies, except where U.S. rules provide appropriate exemptions for foreign private issuers. Duplicative requirements, if waived for smaller Canadian issuers, would be largely redundant.(9)

When considering which U.S. reforms to adopt, Canadian regulators also had to take into account the significant disparities between U.S. and Canadian financial markets. First, unlike the United States, Canada does not have a national securities commission. Securities regulation is the responsibility of the provincial and territorial governments, each of which has its own legislation and regulatory authority. Uniformity across Canada, necessary for harmonization with U.S. reforms, would therefore require the agreement of and action by all 13 authorities.(10) This situation was further complicated by the fact that provincial authorities often hold very divergent views on market regulation, further delaying the implementation of national reforms.

The second difference is that a much greater percentage of Canadian public companies have a controlling shareholder compared to U.S. companies. According to the TSX, over 25% of the largest 300 companies that it lists have a controlling shareholder, and about one-quarter to one-fifth of Canadian companies issue restricted or subordinated voting shares.(11)

Critics strongly opposed the suggestion that Canada adopt reforms that would raise the required proportion of independent directors on the boards of Canadian public companies and restrict the membership on audit committees. Such measures, critics said, would be unworkable in Canada, since controlling shareholders have a desire either to be represented on a corporation's board or to name representation to the board. Mandated audit committee independence would be especially impractical if it prevented directors associated with a public company's controlling shareholder from serving on the board of directors. Smaller Canadian public companies would be especially disadvantaged, since the pool of qualified directors willing

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(9) Christopher C. Nicholls, *The Canadian Response to Sarbanes-Oxley*, Capital Markets Institute, Toronto, January 2003.

(10) Regulatory authorities coordinate their activities through the Canadian Securities Administrators, a forum for developing a harmonized approach to securities regulation across the country. Given the pre-eminence of the TSX, the Ontario Securities Commission is generally regarded as the lead securities regulatory authority in Canada and normally leads any reform efforts.

(11) For a further discussion, see Tara Gray, *Dual-Class Share Structures and Best Practices in Corporate Governance*, PRB 05-26E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, 18 August 2005.

to serve on their boards is already limited. As a result, there were calls for significant relaxation of these rules for small issuers.

The third difference is that many Canadian public corporations have relatively low market capitalization. Canadian companies commonly go public at an earlier stage in their development than U.S. companies. Thus many Canadian companies are very small by U.S. standards. Critics of Canadian/U.S. harmonization feared that the economic interests of these small companies were at risk of being sacrificed for regulatory harmonization. For smaller companies, complying with rules modelled on Sarbanes-Oxley would impose an overwhelming and untenable financial and administrative burden.

Market participants and regulators debated over adopting a U.S.-style, rules-based system. In many cases, Canadian regulators have been reluctant to impose regulations, choosing instead to encourage good corporate governance through voluntary best standards and guidelines. Many participants felt that an American rules-based approach to regulation has engendered an unhealthy, "find the loophole" mentality that militates against the development of a culture of compliance that, in their view, more aptly describes Canada's principles-based regulatory environment.(12) It was felt that Canadian regulators should establish general principles of disclosure, accountability and transparency that would allow companies room for judgment in determining what they have to do to meet those principles. The argument was that specific regulations could not take into account the circumstances of every company and could result in unnecessarily burdensome requirements.

### B. Regulatory Reform: An Ongoing Process

The Canadian Securities Administrators (CSA), together with the Ontario Securities Commission (OSC), embarked in 2003 on an extensive consultation process, publishing for comment a series of draft instruments designed to cover most major provisions of Sarbanes-Oxley. By doing so, regulators wished to avoid the confusion and uncertainty that had characterized the U.S. experience.

Following this process, the CSA introduced a series of national instruments and policies (CSA rules, called multilateral instruments or MIs, and national instruments or NIs).(13) To a great extent, these rules closely follow Sarbanes-Oxley and the rules and guidelines

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(12) Nicholls (2003).

(13) Multilateral instruments are securities rules in force in all Canadian provinces and territories; national instruments are securities rules in force in each Canadian province and territory that elects to adopt those instruments.

established by the SEC and U.S. stock exchanges, but strive to accommodate the unique nature of the Canadian financial market. Most provinces published the amended draft MIs and NIs for comment prior to adopting the new rules and regulations.

The first set of rules proposed by Canadian regulators requires CEO/CFO certification of annual and quarterly reports (MI 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings*). Canadian companies will also have to adopt disclosure controls and procedures with regard to financial reporting. Apart from some minor differences related to how information is disclosed in Canada, the proposed national instrument for Canada is very similar to s. 302 of Sarbanes-Oxley, both in form and implementation.

The second set of rules (MI 52-110, *Audit Committees*) proposes new standards and an expanded role for the audit committee. Major Canadian public companies will be required to have fully independent and financially literate audit committees. Certain exemptions are provided for venture issuers, controlled companies and U.S.-listed issuers.

The third set of rules (MI 52-111) relates to internal controls. Companies will be required to perform detailed tests of all their internal accounting processes, and their external auditors will have to examine and give an opinion on those tests. In addition, MI 52-108 proposes establishing a new accounting supervision body, the Canadian Public Accountability Board.

MIs 52-109 and 52-110 were adopted by all jurisdictions in Canada with the exception of British Columbia.(14) Most provisions are now in force. The CSA has delayed for one year the introduction of MI 52-111, which will now be phased in over four years, starting with financial years ending on or after 30 June 2007. According to Steve Sibold, Chair of the CSA and of the Alberta Securities Commission, the net result of these rules is that investors will receive more consistent disclosure on a more timely basis, and that they can be more confident in the quality of the information they receive.

On 16 January 2004, the OSC published proposals that describe best corporate governance practices and require issuers to make disclosures relating to these best practices. The proposals include:

- National Instrument 58-101, *Disclosure of Corporate Governance Practices*
- National Policy 58-201, *Effective Corporate Governance*

These best practices include measures related to the composition of a board, its mandate and its committees; director education and assessment; and codes of business conduct and ethics.

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(14) A reporting issuer in British Columbia that also reports in other jurisdictions must comply with the rules.

The purpose of the Policy is to provide guidance on corporate governance practices; the purpose of the Instrument is to provide greater transparency for the marketplace regarding issuers' corporate governance practices. While the policy is not mandatory, reporting issuers are required to disclose the corporate governance practices they adopt. However, in recognition of the fact that many smaller issuers may have less formal procedures in place to ensure effective corporate governance, the policy provides for lesser disclosure for venture issuers. In order to avoid regulatory duplication and overlap, the TSX intends to revoke its corporate governance guidelines and related disclosure requirements when the proposals become effective across all provinces.

Other rules that came into force (or will do so shortly) include:

- National Instrument 51-102, *Continuous Disclosure Obligations*(15)
- National Instrument 52-107, *Acceptable Accounting Principles, Auditing Standards and Reporting Currency*
- Multilateral Instrument 52-108, *Auditor Oversight*
- National Instrument 71-102, *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*(16)

In addition to the CSA rules, the Ontario government recently amended Ontario's securities laws to increase the maximum penalties for securities law offences.(17) The new measures also provide for new statutory offences such as fraud and market manipulation, tougher penalties for violations of the Ontario *Securities Act*, greater rule-making authority on the part of the OSC, and civil liability for continuous disclosure.

The federal government also amended the *Criminal Code* to: prohibit and impose criminal penalties for insider trading (insider trading is also regulated under provincial securities laws); prohibit and impose criminal penalties for threatening or retaliating against whistleblowers; and increase the penalties for public market-related offences and establish aggravating factors to assist courts in imposing penalties that reflect the seriousness of the crime. Most of these provisions came into force on 15 September 2004.(18)

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(15) NI 51-102 came into force on 30 March 2004, but different provisions have different effective dates. Venture issuers are subject to less onerous requirements.

(16) NI 71-102 provides broad relief from NI 51-102 for SEC foreign issuers and other designated foreign issuers.

(17) *Keeping the Promise for a Strong Economy Act (Budget Measures), 2002* (the "Budget Measures Act"; formerly Bill 198).

(18) McMillan Binch Mendelsohn, *Corporate Governance in Canada*, Toronto, 2005.

## CONCLUSION

The gradual approach favoured by Canadian regulators may have allowed them to avoid many of the pitfalls encountered by their U.S. counterparts in implementing a Sarbanes-Oxley type of governance regime. Certainly, it has allowed them to better reflect the fundamental differences between the Canadian and U.S. capital markets.

The principal difference between many of the Canadian and U.S. requirements is the non-prescriptive nature of many of the Canadian reforms, reflecting the nature of the Canadian financial marketplace. Over the next few years, market participants will be following these reforms closely to determine whether or not Canadian regulators have been able to strike the correct balance between the conflicting needs of a small number of large cross-listed Canadian issuers and the greater number of smaller domestic issuers.