

Forcing Canada's Hand? The Effect of the Sarbanes-Oxley Act on Canadian Corporate Governance Reform

SUKANYA PILLAY*

"Sarbanes-Oxley is becoming the global benchmark for internal best practices in corporate governance." Dr. Carolyn Kay Brancato, Director, Global Corporate Governance Research Center¹

"For many non-U.S. corporations, the fit is alien, superfluous or conflicting. In exporting corporate norms by fiat, SOX threatens other nations bearing competing concepts of corporate performance and ways to manage, measure, and supervise it." Lawrence A. Cunningham, Professor of Law and Business, Boston College²

I. INTRODUCTION

Stringent, sweeping corporate governance reforms in the U.S. were introduced in July 2002 by the *Sarbanes-Oxley Act*,³ enacted in response to a series of corporate scandals beginning with Enron and ending with five of the biggest bankruptcies in U.S. corporate history.⁴

* LL.M. in International Legal Studies, (NYU), LL.B., B.A. (Windsor). The author was formerly in-house counsel for a leading Hong-Kong based multinational corporation, responsible for corporate governance, M&A, and IPO issues in India, and has significant international legal field experience from missions conducted worldwide. The author currently teaches at the Faculty of Law, University of Windsor. This article was made possible through a grant from the Law Foundation of Ontario. The author is grateful to Ryan Fritsch for his excellent assistance with citation, and to Kyle Armagon for valuable initial research.

¹ See *Corporate Governance in U.S. undergoes radical change*, Economic Times, The Times of India, 1 August 2003: <http://economictimes.indiatimes.com:80/cms.dll/html/uncomp/articleshow?msid=105403> (last visited 2 Aug. 2003).

² Lawrence A. Cunningham, Speech Made to the Federation of European Securities Exchanges Convention at the Guildhall in London (12 June 2003), at http://www.fese.be/efmc/2003/report/efmc_cunningham.htm.

³ The Public Company Accounting Reform and Investor Protection Act [*Sarbanes-Oxley Act*], 18 U.S.C. §§ 1514A(a) (2002), [hereinafter SOX], available at http://www.sarbanes-oxley.com/pcaob.php?level=1&pub_id=Sarbanes-Oxley

⁴ Between 2001 and 2002, Enron, WorldCom, Adelphi, Global Crossings, and Arthur Anderson (an auditing company) were implicated in corporate accounting scandals result-

Because many of the damning corporate actions were not prohibited under the black-letter of then-existing laws, SOX now expressly prohibits these actions and attaches administrative, civil and criminal penalties. SOX applies to all publicly traded companies listed on U.S. stock exchanges, including foreign issuers. This extraterritorial application of SOX imposes significant corporate governance obligations on Canadian issuers listed in the U.S., and is the thematic issue at the heart of this paper.

Notwithstanding vigorous corporate governance reform measures undertaken in Canada pre-SOX,⁵ the U.S. enactment of SOX has ignited fierce debate in Canada about the future direction of Canadian corporate governance reform over the following issues:

- Should Canada harmonize its securities laws with SOX?
- Given that Canada does not have a federal securities regulator like the U.S. Securities Exchange Commission ("SEC") but rather has 13 provincial securities regulators, can Canada even achieve domestic harmonization let alone external harmonization with SOX?
- Since Canada has traditionally employed a principles-based model of corporate governance, is it necessary for Canada to now shift its corporate governance culture to adopt a rules-based model in order to harmonize with SOX?
- Recognizing that Canadian companies are typically much smaller and more closely-controlled than their U.S. counterparts, and these Canadian companies must remain nimble in order to compete for capital in today's globalized capital markets, can a SOX-inspired rules-based model accommodate the particular needs of Canadian companies?
- Does the extraterritoriality of SOX, combined with the pressure (perceived or real) to adopt SOX-inspired legislation inside Canada amount to U.S. legal hegemony?

Perhaps all of the above questions will be rendered moot by the realities of today's globalized marketplace. Because of the dominant position enjoyed by the U.S. and its capital market on the global stage coupled with the extraterritorial provisions of SOX, the U.S. has effectively placed corporate governance and the restoration of investor confidence at the top of the global corporate-

ing in their demises. See *U.S. Bankruptcies Break Records*, BBC WORLD NEWS, 30 December 2002, at <http://news.bbc.co.uk/2/hi/business/2616135.stm>.

⁵ For example, in the spring of 2002, Canada had already a public accounting board with regulatory oversight of the accounting profession, See discussion *infra* Part II. Also, in the field of corporate governance reform, Canada has not been idle but rather has embarked upon several major studies in past years resulting in greater responsibilities for officers, directors and accountants. See Dey and Saucier Reports, *infra* note 55.

economic agenda.⁶ Countries and IGOs are revisiting their corporate governance legislation and guidelines in the wake of SOX.⁷ In this climate of heightened competition among capital markets, can Canada even afford to entertain discussion about not harmonizing with SOX and remain competitive?

At the time of writing, interim resolutions to these questions are seemingly being played out. Canada's largest provincial securities market, Ontario, passed legislation in December 2002⁸ enabling the Ontario Securities Commission to issue new "robust"⁹ rules governing corporate, director, officer, audit committee, and auditor accountability with attached civil and criminal penalties which are inspired by SOX. The proposed rules have been adopted throughout Canada by 12 of the 13 securities commissions,¹⁰ suggesting that the extraterritorial reach of SOX inside Canada has been very powerful indeed.

Just how far Canada's hand has been forced by SOX in terms of abandoning its traditional practices and adopting new rules-based corporate governance reforms will be addressed in this paper as follows: Part I will (a) provide an overview of the misdeeds of Enron leading to its demise and the eventual enactment of SOX, (b) briefly overview the general provisions of SOX, and (c) set out the extraterritorial provisions of SOX which will apply to Canadian public issuers listed on U.S. exchanges. Part II will (a) identify the significant characteristics of Canadian capital markets and public companies, (b) consider the legal issues

⁶ But see Philip Anisman, formerly of the Capital Markets Institute, who has questioned the assumption of whether investor confidence is really at stake. Professor Anisman has suggested that investor confidence may be synonymous with 'investor optimism', or perhaps investor greed, as evidenced by the dot.com bubbles in the late 1990s. Professor Anisman also questions the role of securities regulators over whether their mandate is only to create fair and efficient markets, or also to foster investor confidence. As a resolution of this debate is beyond the scope of this paper, see Philip Anisman, *Regulations of Lawyers by Securities Commissions: Sarbanes-Oxley in Canada*, Capital Markets Institute (March 2003) (on file with the author).

⁷ International Bar News, June 2003, vol. 57, no.2. See also websites for the OECD and the World Bank available at [http://www.oecd.org/home/](http://www.oecd.org/home/http://www.oecd.org/home/) and <http://www.worldbank.org>.

⁸ See Keeping the Promise for a Strong Economy Act (Budget Measures), S.O. 2002, c. 22 [Bill 198, 2002], [hereinafter Bill 198], at Part XXVI "Securities Act".

⁹ See the comments of David Brown, Chair of the Ontario Securities Commission, who has described the new rules as robust. *New Securities Rules Unveiled*, CBC NEWS, 27 June 2003, at http://www.cbc.ca/stories/2003/06/27/securitiesrules_030627.

¹⁰ The province of British Columbia does not back Ontario's corporate governance reforms, and proposes instead to continue with a principles-based approach to corporate governance. See Douglas Hyndman, Chair of the B.C. Securities Commission, Remarks to the Economic Club of Toronto (9 October 2002), at http://www.bsc.bc.ca/Publications/Hyndman_EconomicClub.pdf, and see discussion in Part III *infra*.

surrounding the debate in Canada over whether to harmonize corporate governance legislation with SOX domestically, and (c) consider the legislative reforms being enacted throughout Canada in response to SOX. Part III will draw conclusions on the effects of SOX in Canada, and more generally, on global corporate governance.

II. THE U.S. SARBANES-OXLEY ACT

Some of the criticisms of the extraterritoriality of SOX revolve around the legislation being a largely “populist response”¹¹ to the distinctly American corporate scandals of Enron et al. Others have suggested that we must wait to see how effective SOX will prove to be in the U.S.¹² before exporting its approach to other domestic jurisdictions.¹³ While both comments may be valid, the important thing to remember is that SOX has prescribed rules applying to corporations and their officers, auditors, and lawyers, and in so doing has raised the bar for what is perceived as rigorous and effective corporate governance. If investor confidence is a prerequisite to investment, then countries without standards as stringent as the U.S. may by comparison appear to be ‘soft’ on corporate governance and investor protection, which may in turn detrimentally affect the attractiveness of their domestic capital markets in the eyes of investors.

This Part of the paper will overview the corporate actions leading to the demise of Enron and the other U.S. corporate scandals, and set out the general provisions of SOX including those provisions with extraterritorial reach that will affect Canadian issuers listing in the United States.

A. Enron’s Demise

The U.S. corporate scandals beginning with the energy giant Enron, and expanding to include the bankruptcies of WorldCom, Adelphia, Global Crossings,

¹¹ Barbara Stymiest, Chief Executive of the TSX [Toronto Stock Exchange] Group, finds that SOX is a response to issues in U.S. markets and legislation that can not adequately account for the Canadian context. See Christopher C. Nicholls, *Policy Comment: Canadian Responses to Sarbanes-Oxley*, Capital Markets Institute, January 2003, at 11–12, at <http://www.rotman.utoronto.ca/cmi/news/Canadian%2520Response%2520to%2520SOX.pdf>.

¹² MSNBC articles one year later note that the effects of SOX are not clear, although costs of doing business post-SOX have risen drastically. See Consuelo Mack and Wally Griffith, *The Downside of Sarbanes-Oxley*, MSNBC.COM, 24 July, 2003, at <http://www.msnbc.com/news/943532.asp>.

¹³ *Supra* note 10.

Tyco and others, resulted by September 2002 in a loss to U.S. stock markets of half of their capitalizations, and a loss in investors' net worth of \$8.5 trillion¹⁴.

Enron initially rocked stock market observers worldwide, when in filing its third quarter reports in 2001, it issued financial restatements for the first two quarters and for the preceding four years. The corporate giant in 2000 had been listed 7th on the Fortune 500 list with revenues exceeding \$100.8 billion. Following its financial restatements, however, Enron showed:

- decreases in profits of \$99 million for 2000, \$248 million for 1999, \$33 million for 1998, and \$28 million for 1997;
- increases in debts of \$711 million for 2000, \$561 million for 1999, \$685 million for 1998, and \$628 million for 1997;
- shareholder equity reduced by \$754 million for 2000, \$710 million for 1999, \$391 million for 1998, and \$258 million for 1997;¹⁵ and
- bankruptcy which included the loss of all Enron employee stock option values and significantly, all pension investments in the company's 401K plans.

Following Congressional hearings into the collapse of Enron, the Powers report¹⁶ cited the following factors as responsible:

- complete failures of external and internal accounting systems and auditors;
- improper use of generally accepted accounting principles ("GAAP") including the use of inadequately disclosed special purpose enterprises and off-balance sheet transactions to disguise debts and falsely inflate profits;
- CEO/CFO corporate governance and management failure in overseeing internal controls and disclosures, and failure to conform to existing codes of conduct (*i.e.* ethical codes);
- failures of the Board of Directors in oversight duties;
- corruption by senior officers in receiving tens of millions of dollars in fraudulently conferred bonuses¹⁷;

¹⁴ Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, (2002) 8 Stan. J. L. Bus. & Fin. 127 at 12), [hereinafter Aronson]. For a general overview of the events which resulted in the collapse of each of these corporations, see the Interactive Timeline at the WashingtonPost.com website.

¹⁵ Enron's failure at the time was considered the largest corporate bankruptcy in U.S. history. These staggering figures were surpassed later that year when WorldCom announced its bankruptcy with worse debts.

¹⁶ *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* 1 February 2002. William C. Powers, Jr., Chair. Available at <http://news.findlaw.com/hdocs/docs/enron/sicreport/>, [hereinafter Powers Report]. Powers' testimony before the Senate Committee on Commerce, Science, and Transportation (February 12, 2003) is available at; <http://commerce.senate.gov/hearings/021202powers.pdf>.

- failure by external legal counsel to properly investigate in light of allegations of improper accounting practices; and
- failure of external attorneys and auditors to recognize inherent conflicts of interest in reviewing their own work.

The Congressional Committee also recognized the failures of the oversight of the accounting profession, the susceptibility of the Financial Accounting Standards Board to corporate lobbying, the corporate lure which pressured accountants into permitting incomplete or misleading financial statements, and the lack of arms length valuations.¹⁸ Addressing the issues raised by the Powers Report, Congress enacted SOX, described in the next part.

B. Key Provisions of the SOX

Upon signing SOX into law on 30 July 2002, President Bush remarked that the Act provided for “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt”. SOX’s purpose is stated as being “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”¹⁹

Briefly, SOX imposes new responsibilities and obligations upon CEOs and CFOs, audit committees and auditors, Boards of Directors, and attorneys with respect to their reporting requirements, via internal and external controls. *Internal controls* provided in SOX include new disclosure and certification requirements for CEOs and CFOs with attached civil and criminal liability; restrictions on officer and director transactions and disgorgement of bonuses and profits where financial restatements are issued; whistle-blower protections; black-out periods on insider trading intended to protect employees stock option values and pensions invested in 401Ks; and rules applicable to in-house attorneys. *External controls* provided in SOX include the establishment of a new regulatory body, the Public Company Accounting Oversight Board (PCAOB) to oversee accounting firms; auditor and audit committee reporting requirements to PCAOB; and rules for external attorneys providing legal advice.

Many of the provisions in SOX are applicable to foreign issuers, which is described in more detail below.

¹⁷ For example, the Powers Report found that Fastow had received \$30 million, Kopper had received \$10 million, and many other received hundred of thousands.

¹⁸ The various limitations of the FASB were noted by no less than five former Chairmen of the Securities and Exchange Commission during the Congressional Oversight Hearing on Accounting and Investor Protection Issues Raised by Enron and other Public Companies (12 February 2002), available at http://banking.senate.gov/02_02hrg/021202/index.htm

¹⁹ SOX preamble. In fact this phrase was initially considered for inclusion in the title of SOX.

C. Extraterritorial Provisions of SOX Affecting Canadian/Foreign Issuers Listed in the U.S.

The provisions of SOX do not distinguish between American and foreign issuers; rather SOX applies to every issuer with registered securities under section 12. SOX also applies to those required to file periodic reports to the SEC under section 15 of the Securities Exchange Act, 1934.²⁰

Accordingly, any Canadian private company listed on NYNEX, AMEX, NASDAQ or the OTC Bulletin Board will be subject to the provisions of SOX. The U.S. position, impliedly, seems to be that if a foreign private company chooses to publicly trade in the U.S., then that private company must comply with U.S. securities legislation.²¹ While SOX does provide the SEC discretion to exempt foreign private issuers from its provisions, it seems unlikely that the SEC will make any such exemptions in the near future for two reasons: (i) to do so might be perceived as relaxing corporate standards which is precisely the opposite of the intent of SOX, and (ii) to do so might encourage companies to incorporate themselves or their subsidiaries in foreign jurisdictions. Whether SOX will extend to foreign government issuers remains uncertain pending judicial interpretation; but in the meantime, SOX does apply in the following ways to foreign private issuers, including Canadian companies, listed on U.S. exchanges.

1. CEO and CFO Accountability

CEO and CFO Certifications

Under SOX, CEOs and CFOs are required to make certifications, subject to civil and criminal liability, attesting to the accuracy of periodic and annual reports filed to the SEC pursuant to the Securities Exchange Act, 1934.

²⁰ Securities Exchange Act 1934 § 1, 48 Stat. 881 (1934), available at <http://www.law.uc.edu/CCL/34Act/> (hereinafter SEA). Note: Under SOX, the traditional exemptions available under the Securities Exchange Act to foreign issuers do not exist. "Foreign private issuer" is defined in SEC R. 3b-4, and generally includes any corporation or other organization incorporated or organized under the laws of any foreign country unless it meets the following two conditions: (1) More than 50% of its voting securities are directly or indirectly held of record by residents of the U.S.; and (2) Any one of the following applies: (i) The majority of the executive officers or directors are U.S. citizens or residents, (ii) More than 50% of the assets of the issuer are located in the U.S., or (iii) The business of the issuer is administered principally in the U.S. For an expanded discussion, see Wayne Kirk, *Sarbanes-Oxley Issues for Foreign Private Issuers Considering Listing in or Accessing Public Capital Markets in the United States*, at http://thelenreid.com/articles/article/art_183.htm#ff.

²¹ For insight on the extraterritorial provisions of the SOX, the legality of which is beyond the scope of this paper, see Detlev Vagts, *Extraterritoriality and the Corporate Governance Law*, (2003) 97 Am. J. Int'l. L. 289.

(i) *Section 302 Certifications and Civil Liability*

Pursuant to section 302, civil liability is attached to the certification requirements which require each CEO and CFO to affirm that he or she has:

reviewed the report;

based on the officer's knowledge it does not contain any misleading statements, whether by affirmative statement or omission;

and it does not contain any untrue or misleading statements, and to the officer's knowledge all financial information does "fairly present" the financial condition of the company.²²

CEOs and CFOs must also certify that they are responsible for the creation, maintenance and design of "disclosure controls and procedures"²³ to ensure that material information is made known to them; that they have tested these control procedures within 90 days prior to the report; and they must present their conclusions about the effectiveness of the report.²⁴

CEOs and CFOs must also attest to disclosures made to auditors and the audit committee relating to the design and operation of internal controls which could adversely affect reports, and to fraud.

(ii) *Section 906 Certifications and Criminal Liability*

Criminal liability with potential of fines up to U.S. \$5 000 000 and imprisonment of 20 years attach to the s. 906 certification requirements. Pursuant to s. 906, CEOs and CFOs are required to certify by written statement the periodic reports²⁵ containing financial statements are compliant with the respective requirements under the Securities Exchange Act, 1934, and that information therein "fairly presents, in all material respects, the financial condition and results of the operations of the issuer."²⁶ A CEO or CFO who signs a certification "knowing" it to be false will be subject to potential imprisonment up to ten years, and a maximum fine of U.S. \$1 000 000. Further, a "wilful" certification incurs potential imprisonment up to twenty years, and a maximum fine of U.S. \$5 000 000. Knowing requires only proof of knowledge that the statement was

²² SOX § 302 amends the SEA §§ 78m, 78(o)(d), and in subsection 302(b) provides that foreign corporations or transfers of domicile outside the U.S. do not affect the certification requirements. § 302 also amends the Federal securities laws and requires SEC implementation and/or rules.

²³ As directed by SOX § 302(a), this SEC rule became effective 29 August 2002. A summary of this rule is available at <http://www.sec.gov/rules/final/33-8124.htm>.

²⁴ SOX § 302(4).

²⁵ Filed pursuant to SEA §§ 13(a) or 15(d).

²⁶ SOX § 906.

false, while “wilful” generally means proof that the individual was intending to break the law.²⁷

2. Prohibitions on Personal Loans to Directors and Executive Officers

Pursuant to SOX, issuers are prohibited from extending, or arranging through a subsidiary or third party, for any credit in the form of a loan to any director or executive officer.²⁸ The provision does not affect loans existing at the time SOX was enacted, except to prohibit material modification or alteration, or renewal of such loans. Companies also are prohibited from procuring loans from third parties for directors or officers.²⁹ Note that this provision conflicts with traditional Canadian corporate practice wherein companies regularly issue personal loans to executives and officers.

(i) Forfeiture of CEO and CFO Bonuses and Profits for Material Non-Compliance Resulting in Financial Restatement

CEOs and CFOs are required to return bonuses and other performance-based compensations wherever a company is required to issue a financial restatement because of material non-compliance with U.S. securities laws³⁰.

3. Insider Trading Restrictions During Pension Blackout Periods

Directors and executive officers including CEOs and CFOs are prohibited from trading company equity securities conferred on them in their position as officers, during a pension blackout period.³¹

4. Code of Ethics for Senior Financial Officers

SOX requires each company to set out in its annual report whether it has adopted a code of ethics for senior financial officers, including the CFO, controller, and principal accounting officer.³² If not, then reasons why not must be included in the annual report. Pursuant to SEC Rule 406/407 section (B), these rules include a definition of the term “code of ethics” as a written standard reasonably designed to deter wrongdoing and promote:

²⁷ For more information, see Bruce C. Bennett and Graham Robinson, *Executive Certifications*, (10 October 2002), at <http://www.cov.com/publications/311.PDF>.

²⁸ SOX § 402.

²⁹ SOX

³⁰ SOX §§ 304 and 1103.

³¹ See SOX § 306 generally, and the definition of “blackout period” in subsection 306(a)(4).

³² SOX 406 and 407 contemplate SEC rules.

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- Full, fair, accurate, timely and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
- Compliance with applicable governmental laws, rules and regulations;
- The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
- Accountability for adherence to the code.

The new rules also provide for three options by which a company is to make its code of ethics publicly available: through its annual report, its website, or free of charge to anyone who asks for it.³³

D. Enhanced Financial Disclosures

SOX introduces new financial disclosure requirements for issuers, to be regulated by rules issued by the SEC.³⁴ The rules must prescribe disclosure requirements regarding (a) off-balance sheet transactions; (b) presentation of “pro forma” figures; (c) and call for SEC studies on special purpose entities and whether the financial statements are harmonious with GAAP. SOX also institutes real time disclosures on material changes in the financial condition of an issuer by issuers on a “rapid and current basis”.³⁴

Section 404 provides that every annual report filed by an issuer with the SEC must now contain a report from managers, an ‘internal control report’, setting out (a) management’s responsibility for establishing and maintaining adequate internal control structure and procedures for financial reporting; and (b) an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. These rules came into force on the 6 June 2003.

³³ For a complete review of SEC Rules pertaining to SOX §§ 406 and 407 *Code of Ethics* requirements, see http://www.sarbanes-oxley.com/displaypcaob.php?level=2&pub_id=SEC-Rules&chap_id=SEC5&message_id=133

³⁴ See e.g. SOX §§ 401 and 409.

³⁴ *Ibid.*

E. New Regulatory Board and Obligations of Auditors and Audit Committees

1. Establishes Public Company Accounting Oversight Board

SOX creates the Public Company Accounting Oversight Board [PCOAB] to oversee accounting procedures and auditors of issuers.³⁵ Public accounting firms conducting audits of issuers must now register³⁶ with the PCAOB,³⁷ and thereafter file reports on the internal control assessment of management.³⁸ Foreign public accounting firms are specifically subject to oversight by the PCAOB if they provide reports on U.S.-listed issuers.³⁹ The PCAOB has broad powers to promulgate rules and standards binding upon auditors,⁴⁰ and also has enforcement powers including the ability to set up investigations and disciplinary proceedings.⁴¹ Notably, the SEC has oversight of the PCAOB.⁴²

2. Independence of Auditors and Duties of the Audit Committee

SOX includes provisions that seek to ensure the independent, arms-length relationship between auditors and corporations, and prohibit any auditors engaged by an issuer from performing non-audit services for the issuer.⁴³ Furthermore, if a company's CEO, CFO or other senior financial officer was employed within the past year with an auditing firm, the firm cannot perform audit services for the company. Auditors must file timely reports to an issuer's Audit Committee of any auditing services provided highlighting critical accounting policies employed, all alternate treatments from GAAP, and other material written communications between the auditors and management.⁴⁴

³⁵ SOX § 101.

³⁶ SOX § 102.

³⁷ Within 180 days of the PCAOB coming into existence. The PCAOB submitted its By-laws to the SEC for approval 9 January 2003. Filing requirements are to be submitted by 15 July 2003.

³⁸ SEC R. 404. For a discussion of this requirement, see http://www.sarbanes-oxley.com/displaypcaob.php?level=2&pub_id=SEC-Rules&chap_id=SEC14&message_id=268

³⁹ SOX § 106.

⁴⁰ See generally SOX § 103.

⁴¹ SOX § 105.

⁴² SOX § 107.

⁴³ See SOX § 201.

⁴⁴ SOX § 204.

Pursuant to SOX, the Audit Committee must pre-approve all audit services conducted by an audit firm for the company, including even the issuing of comfort letters by an auditor.⁴⁵

(i) *Corporate Responsibility and Audit Committee*

SOX structures audit committee obligations and CEO and CFO obligations together under the heading "Corporate Responsibility", implying the role Congress envisions for Audit Committees to assume in the future of U.S. corporate governance.

There are strict requirements on the membership and composition of Audit Committees. Members must be "independent" which means they cannot accept any consulting, advisory or other compensatory fee from the issuer, apart from any salary for membership on the Audit Committee or Board of Directors; and members cannot be a person otherwise "affiliated" with the issuer or a subsidiary.⁴⁶

Every Audit Committee must have a "financial expert" sitting,⁴⁷ or provide reasons why not in their annual reports. "Financial expert" is defined in the SEC rules as a person who through education or relevant auditing experience including positions as a public accountant, auditor, principal financial officer, comptroller or principal accounting officer of an issuer, or similar work experience has acquired: (i) general knowledge of the GAAP and financial statements, and experience applying GAAP to financial statements, (ii) experience preparing or auditing financial statements, (iii) experience with internal accounting controls, and (iv) understanding of the functions of an audit committee.⁴⁸

Audit Committees have the power to retain independent counsel,⁴⁹ another statutorily imposed characteristic meant to cement their independence. However, the Audit Committee does maintain a relationship of communication and reporting with management. SEC Rules provide that Audit Committees shall be:

- directly responsible to management for the appointment, compensation and oversight of the work of external auditors;

⁴⁵ SOX § 202, but see *de minimus* requirement in § 202.

⁴⁶ SOX § 301. The SEC may provide exemptions as specified in subsection 301(3)(c).

⁴⁷ These requirements came into force 25 January 2003, with reporting required by 15 July 2003. A list of important SOX compliance dates in 2003 is at http://www.whitecase.com/memo_sarbanes_oxley_act_important_dates_in_2003_02_12_2003.pdf.

⁴⁸ SEC R. 406 / 407-2, at http://www.sarbanesoxley.com/displaycaob.php?level=2&pub_id=SECRules&chap_id=SEC5&message_id=129.

⁴⁹ *Ibid.*

- responsible for resolving any disputes between auditors and management;
- responsible for establishing procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal controls and auditing matters; and
- responsible for “whistle-blower protections” in that the Audit Committee must maintain the anonymity of any employee complaints tendered regarding questionable accounting or auditing practices.⁵⁰

F. Professional Responsibility of Attorneys

SOX also provides for the SEC to create minimum standards relating to the professional responsibility of attorneys who “appear and practice” before the SEC.⁵¹ These attorneys must report material violations of securities laws or fiduciary duties by an issuer they represent “up the ladder”; that is, to the chief legal counsel or CEO or another equivalent officer; or to make a “noisy withdrawal”.⁵² If the officer does not take ‘appropriate’ action, the attorney is required to report his or her concerns to the Audit Committee or to another committee of the Board of Directors. Lawyers in the U.S. and internationally have objected to these requirements on the grounds that they may constitute a conflict of interest or breach of the attorney-client privilege.⁵³

The extent to which these provisions will apply to foreign lawyers, however, appears limited. A foreign attorney is apparently not subject to these provisions of SOX if he/she is “non-appearing” before the SEC; “non-appearing” is defined as (1) admitted to practise law outside the U.S., (2) does not hold himself out as practising U.S. federal or state securities laws, and (3) conducts activities that would constitute appearing and practicing before the SEC only incidentally to,

⁵⁰ SEC R. 301, *Standards Relating to Listed Company Audit Committees*, an overview of which is available at <http://www.sec.gov/rules/final/33-8220.htm#back>. These rules came into on 25 April 2003.

⁵¹ SOX § 307.

⁵² A summary of these provisions is found in *SEC Implements Standards of Professional Conduct for Attorneys and Solicits Further Comment on the Noisy Withdrawal Proposal*, (February 2003), at <http://www.chapman.com/lawpractice/publications/CC-SU-2003-02-attystds.pdf>.

⁵³ See e.g. the Letter from Fernando Peláez-Pier, Chair of the International Bar Association Section on Business Law, to Giovanni Prezios, General Counsel U.S. Securities and Exchange Commission, *Re: Proposed Rulemaking under Section 307 of the Sarbanes-Oxley Act of 2002: Rules of Professional Responsibility for Lawyers* (5 November 2002), at http://www.ibanet.org/pdf/SBL_letter_FPP.pdf. Subsequent comments by lawyers responding to the SEC rules have been rebutted, an account of which is at <http://www.sec.gov/rules/proposed/33-8150.htm#v>. For a contrast, see the discussion *infra* regarding Canadian lawyers and rules of professional conduct.

and in the ordinary course of foreign law practice or only in consultation with a U.S. attorney,

G. Criminal Liability for White Collar Crimes, Corporate Fraud and Accountability

SOX enhances criminal penalties for white collar crimes including attempts and conspiracies to commit criminal fraud, for mail and wire fraud, for retaliation against whistle-blowers, and empowers the SEC to prohibit persons from acting as officers or directors.⁵⁴

III. CANADA'S RESPONSE TO SOX

A. One Size Doesn't Easily Fit All

While SOX clearly addresses many of the issues leading to the corporate scandals in the aftermath of Enron, it is not so clear that SOX can be appropriately applied to foreign issuers.⁵⁵ This is particularly true of Canadian issuers who have evolved in a corporate culture with significant differences from their counterparts in the United States. Unlike the U.S., Canada has no federal securities regulator. Because of constitutional division of powers, Canada's provinces regulate securities and there are 13 securities regulators throughout the country.⁵⁶ Canada has two national stock exchanges, the Toronto Stock Exchange ("TSE") and the Toronto Stock Venture Exchange ("TSX Venture Exchange"), both jointly referred to as "TSX".

Unlike the predominantly widely-held corporations in the U.S., in Canada companies list earlier meaning that they generally have fewer and more controlling shareholders and have been characterized thus:

⁵⁴ See SOX § 901-906, and 1101-1107.

⁵⁵ See *e.g.* the speech of Lawrence Cunningham, *supra* note 2.

⁵⁶ These are the Alberta Securities Commission (<http://www.albertasecurities.com/>); the British Columbia Securities Commission (<http://www.bcsc.bc.ca/>); the Commission des valeurs mobilières du Québec (http://www.cvmq.com/index_en.asp); the Manitoba Securities Commission (<http://msc.gov.mb.ca/>); the Newfoundland and Labrador, Securities Division, Department of Government Services and Lands (<http://www.gov.nf.ca/gsl/>); the Nova Scotia Securities Commission (<http://www.gov.ns.ca/nssc/>); the Prince Edward Island Security Office (<http://www.gov.pe.ca/securities/>); the Securities Division of the Saskatchewan Financial Services Commission (<http://www.sfsc.gov.sk.ca/>); and the New Brunswick Securities Commission (<http://www.investor-info.ca/>).

"a small number of large inter-listed companies: Of Canada's roughly 4 000 public companies, 177 of the largest have securities trading in the U.S. markets...";⁵⁷

"a large number of small public companies";⁵⁸

"a higher proportion of companies with controlling shareholders".⁵⁹

This has caused critics to complain that SOX is a "one size fits all" response to the U.S. scandals which "does not fit" in Canada. Furthermore, Canadian issuers listed in the U.S., prior to Enron and SOX, were considered to have comparable, satisfactory regulatory compliance under Canadian laws, under the multi-jurisdictional disclosure project of the SEC.⁶⁰ As one vocal proponent of existing Canadian corporate governance laws, Barbara Stymiest, President and CEO of the TSX Group has stated, Canada has been ranked by McKinsey as having the lowest governance risk premiums at 11%, and was described in 2000 by the International Monetary Fund as having a "well-developed general legal and securities regulatory framework which is consistent with IOSC."⁶¹

But what was true pre-Enron *et al.*, is not necessarily true post-SOX, as will be discussed below.

⁵⁷ Nicholls, *supra* note 11.

⁵⁸ *Ibid.* Nicholls explains this as "A large number of small public companies—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 fear that the economic interests of small companies are at risk of being sacrificed on the altar of regulatory harmonization."

⁵⁹ *Ibid.* Nicholls explains this as "A higher proportion of companies with controlling shareholders—a much higher proportion of public companies with significant or controlling shareholders distinguishes Canadian capital markets from those in the US." Professor John Coffee has suggested that in markets like Canada's, which are characterized by such large share block holdings, the risk of governance scandals at least of the Enron/WorldCom scale is lower than in the U.S., where corporate share ownership is typically widely dispersed. Yet lower is probably not zero probability, as evidenced by well-known Canadian scandals associated with such firms as Bre-X, Livent, Y.B.M. Magnex, and stretching further back, Windfall Oil. However, TSX Group president and CEO Barbara Stymiest has recently dismissed these as being different in kind from the notorious U.S. debacles since the Canadian fiascos did not involve, as she put it, a "complex web of various financial and legal experts." Note that Stymiest has also commented that these scandals, apart from Bre-X, were primarily due to fraud by the respective corporations, and not as in the cases of Enron *et al.*, to a prescriptive regulatory environment conducive to CEO, CFO, legal and accounting practices which were technically legal but flawed and fraudulent.

⁶⁰ See: <http://www.sec.gov> for more details.

⁶¹ International Monetary Fund Report on the Observance of Standards and Codes in Canada (June 2002), at <http://www.imf.org/external/np/ros/can/index.htm>.

B. Facing Realities and Forcing Issues

It seems that the 177 Canadian companies listed on the U.S. stock exchanges currently have no choice but to adapt their corporate governance procedures to comply with the extraterritorial provisions of SOX, if they wish to continue their listing in the U.S.

Second, the *perception*—even if only among U.S. investors—that SOX creates a tough, robust prescription for best corporate governance practices can lead to another perception that a non-prescriptive or principles-based approach is soft on governance issues. Given that the dynamics of securities markets rise and fall on the whims of perception and opinion, any resulting perceptions of the Canadian marketplace must be taken seriously. Commentators such as David Brown of the Ontario Securities Commission have stated that Canada needs to be seen as tough on corporate governance in order to remain competitive in attracting capital in an era of globalized capital marketplaces where investors have many choices.

Conversely, Barbara Stymiest, and Doug Hyndman of the British Columbia Securities Commission contend that Canada's principles-based approach would provide a contrast to the U.S. corporate governance regime providing a competitive advantage over the U.S. in the globalized marketplace. Both Stymiest and Hyndman underscore the importance of the competitive advantage in the pre-SOX Canadian regulatory system that enabled access to capital at a lower costs. The Canadian Securities Administrators, an umbrella organization representing securities regulators, has expressed its concerns that investors should be protected without unduly compromising the efficiency of Canadian capital markets, and that any new legislation should reflect Canada's distinct market structure, regulatory approach and legal systems.⁶²

In other words, each side of the debate about the merits of Canada harmonizing its legislation with SOX turns on the issue of 'remaining competitive' in a globalized marketplace. And each side has the opposite of view of what will permit Canada to remain competitive.

The reality is that the U.S. currently controls 50% of the world's non real-estate assets. Given the interdependence of markets due to globalization, and the influence of the U.S. upon those markets, it is not surprising that SOX would have caused self-reflection by other domestic securities regulators, perhaps even without the extraterritorial provisions. And yet the extraterritorial provisions force domestic regulators to deal with the messy results of having dually (*i.e.* in the U.S.) listed domestic issuers conforming to one regime of

⁶² Roma Luciw, *Made in Canada Securities Rules called Robust*, GLOBE AND MAIL, 27 June 2003, available at <http://ctv2.theglobeandmail.com/servlet/story/RTGAM.20030627.wbsecurities0627/business/Business/businessBN/ctv-business>.

governance standards, and non-U.S. listed domestic issuers conforming to another regime.

This prickly possibility has also forced the issue in Canada, not only of whether to harmonize Canadian legislation with SOX, but whether to harmonize domestic securities legislation that is currently generated by Canada's 13 securities regulators⁶³ and instead create a uniform securities regime devoid of domestic barriers and more accessible to foreign investors.⁶⁴

C. Canadian Corporate Governance Initiatives Before and After SOX

Even prior to enactment of SOX, Canada had undertaken reform measures based on the findings of Canadian studies on corporate governance reform.⁶⁵ Chief among these was the establishment of a Canadian Public Accountability Board ("CPAB") created to review auditing practices. The CPAB was created by the accounting profession, and provincial and federal regulators. The Dey Report and the Saucier Reports⁶⁶ both resulted in corporate governance measures which were considered robust prior to SOX. The TSX also issued "Proposed Corporate Governance Guidelines"⁶⁷ in April 2002, and "Revised Requirements, Guidelines and Practice Notes" in November 2002, both of which were pending subject to OSC approval.⁶⁸

⁶³ That is, constating provincial legislation enables provincial securities regulators to enact rules or subordinate legislation.

⁶⁴ See e.g. recommendations issued by Wise Persons Committee *Five Year Review Committee Final Report - Reviewing the Securities Act (Ontario)*, 21 March 2003, at <http://www.gov.on.ca/FIN/english/publications/2003/5yrsecuritiesreview1.htm>

⁶⁵ Chief among these studies is the 'Dey Report': Dey, Peter. *Where Were The Directors?, Guidelines for Improved Corporate Governance in Canada*, The Toronto Stock Exchange Committee on Corporate Governance in Canada (December 1994), at http://www.ecgi.org/codes/country_documents/canada/dey.pdf. Similar initiatives are reflected in the 'Saucier Report': Saucier, Guylaine. *Beyond Compliance: Building a Governance Culture*, Joint Committee on Corporate Governance (November 2001), at http://www.ecgi.org/codes/country_documents/canada/beyond_compliance.pdf.

⁶⁶ The 'Saucier Report' made wide-ranging recommendations on strengthening corporate governance in Canada and included recommendations on the need for audit committee members to have "financial literacy", which are similar to SOX audit committee member requirements.

⁶⁷ TSX Group *Proposed New Disclosure Requirement and Amended Guidelines*, 26 April 2002, at http://142.201.0.1/en/tradingServices/docs/2450Apr26-02_Request_for_Comments.pdf.

⁶⁸ TSX Group *Revised Requirements, Guidelines and Practice Notes*, 20 November 2002, at <http://142.201.0.1/en/pdf/notices/April26-2002-RequestforComments-AppendixA-113.pdf>.

Following enactment of SOX, David Brown of the OSC on 15 August 2002, wrote an open letter to Barbara Stymiest of the TSX, seeking TSX's views on whether it would be (i) appropriate to adopt measures in Canada mirroring SOX, (ii) whether it would be appropriate to implement SOX measures as mandatory in Canada, and (iii) whether it would be appropriate to reformulate the TSX proposed guidelines and Saucier Committee Guidelines.⁶⁹ David Brown also asked for TSX comments on specific aspects of SOX relating to corporate governance, and noted that:

As you have mentioned many times, the reforms in the U.S. have wide-sweeping implications globally and especially on Canadian markets. As you have further noted, the seamless integration of North American markets is essential to the efficient functioning of Canada's capital markets. As a result, it is essential that we undertake in Canada second phase of corporate focusing primarily, but not exclusively, on reforms that have been proposed and/or implemented in the U.S. and elsewhere.⁷⁰

The Canadian Council of Chief Executives in September 2002 issued a report entitled *Governance, Values, and Competitiveness—A Commitment to Leadership*,⁷¹ which favoured Canada's adopting a SOX-like approach to corporate governance with respect to certification, legal penalties, sanctions, and ethical codes.⁷²

⁶⁹ Letter from David A. Brown Q.C., Chair of the Ontario Securities Commission, to Barbara Stymiest, President and C.E.O. of the Toronto Stock Exchange Group (15 August 2002), at: http://www.osc.gov.on.ca/en/HotTopics/currentinfo/prom_inv_conf/pic_20020815_tsx_letter.pdf. See also the entire exchange of correspondence between OSC and TSX stemming from SOX at this same website, and exchange of correspondence between the OSC and other market participants and stakeholders commenting on the effects of SOX in Canada.

⁷⁰ *Ibid.*

⁷¹ Canadian Council of Chief Executives, *Governance, Values and Competitiveness: A Commitment to Leadership*. A statement of the Canadian Council of Chief Executives, September 2002, at <http://www.ceocouncil.ca/English/Publications/reports/sep26-02.pdf> [hereinafter CCCE]. Commenting on the access to capital markets, they wrote: "To enable Canadian companies to compete effectively for capital within a highly-integrated global market, we support discussions among stock exchanges, regulators, institutional shareholders and other parties about whether to make detailed certification by chief executives, comparable to [those] required in the United States by *Sarbanes-Oxley*, a mandatory requirement for listing on Canadian stock exchanges." The comment implies that the enactment of SOX in an integrated market requires consideration by other States over whether to enact similar legislation, which in turn seems based on an assumption that the rules-based approach of SOX will be more effective at strengthening corporate governance and will require other States to demonstrate that their corporate governance practices are at least as strong as those of SOX.

⁷² *Ibid.*

The Canadian Institute of Chartered Accountants in September 2002 issued for comment new requirements in the form of their *Independence Standards* regarding auditor independence inspired by the SEC and initiatives of the International Federation of Accountants.⁷³

In December 2002, the Ontario Government passed the 2002 amendments in the form of Bill 198,⁷⁴ discussed below, that spearheaded a shift to the prescriptive approach in SOX.

In March 2003, the Five Year Review Committee, commenced its study of the Securities Act (Ontario) in 1998, released its final report,⁷⁵ which seems to be influenced by the SOX. In their Final Report, the Committee made the following recommendations that I believe will be influential in shaping the future of corporate governance reform in Canada:

- Uniform Securities Legislation throughout Canada: “It is our very strong view that a nation that commands only two percent of the global economy suffers daily from a regulatory regime which comprises 13 separate regulators”;⁷⁶
- Support for strengthening enforcement powers of the Ontario Securities Commissions to include greater civil and criminal penalties, and the introduction of anti-fraud and anti-market manipulation rules;⁷⁷
- Enhancement of corporate governance and accountability of public companies;⁷⁸
- Accountability and governance of the OSC;⁷⁹

⁷³ The Canadian Institute of Chartered Accountants, *Independence Standards*, September 2002, at http://www.cica.ca/index.cfm/ci_id/8422/la_id/1.htm [hereinafter CICA]. The CICA guidelines were drafted prior to the creation of SOX, the result of a Committee forum held in June 2001. The recommendations, in brief, included a principle- versus rule-based approach, ongoing harmonization efforts with SEC initiatives, enforceability under CPAB, and strict independence. Such independence is facilitated by recognizing sources of influence, enumerating “threats and safeguards”, contextualizing “objectivity” in principles rather than rules, and explicating conditions under which an audit should (and should not) be performed.

⁷⁴ Bill 198, *supra* note 8.

⁷⁵ *Supra* note 61.

⁷⁶ *Ibid.* at 29–41. Note, the need for Canada to have uniform securities legislation is agreed to in principles, but how this will be achieved—whether through a single piece of legislation adopted by all 13 regulatory markets, or by a passport system—is still uncertain.

⁷⁷ *Ibid.* at 205–254.

⁷⁸ *Ibid.* at 168–174.

⁷⁹ *Ibid.* at 61–65.

- Civil liability for secondary market disclosure by issuers, and support for such reforms in Bill 198,⁸⁰
- Introduction of a system of governance for mutual funds;⁸¹ and
- Responding to issues regarding regulation in an Internet-wired world where regulators are challenged to determine what public policy considerations are raised by increasingly 'sophisticated technologies, and the appropriate regulatory response.'

As such, the emphasis in Canada includes and goes beyond SOX in terms of addressing corporate governance reform. The difference with SOX is that it has shifted focus in Canada to a rules-based approach. Critics believe this will increase the costs of doing business in Canada, unduly burden small companies with regulatory compliance requirements, and as stated earlier, result in Canada losing any competitive edge as a capital market following a principles-based approach.⁸²

In July 2003, responding to a discussion paper, the CCCE stated:

Given the impact of increasing economic integration in North America and globally, meaningful reform of securities regulation is no longer merely desirable. It is necessary for the survival of meaningful capital markets in Canada and for the entrepreneurial activity that flows from existence of such markets.⁸³

Finally, the federal government has also commissioned a Wise Persons Committee to study the Uniform Securities Regulation project, an effort to harmonize securities regulation across Canada⁸⁴. On this issue, the Canadian

⁸⁰ *Ibid.* at 129–133.

⁸¹ *Ibid.* at 189–203.

⁸² See e.g. Barbara Stymiest, T.S.X. C.E.O., Remarks to the Canadian Club of Ottawa (15 April 2003) at <http://www.tsx.com/en/mediaCentre/events/speeches/index.html#11>, where she says: "The challenge is this: By its unilateralism, *Sarbanes-Oxley* implies, a future in which the only way to access U.S. markets is to enmesh a company or institution in American law. *Sarbanes-Oxley* would embed in the largest foreign companies an American approach which virtually every country except the U.S. views as fundamentally flawed in its reliance on highly prescriptive rules. The consequence of this system was captured nicely by *The Economist* last week in noting that while there have been criminal charges against individuals at Enron, the U.S. government has yet to demonstrate convincingly that Enron broke the law. "If only life were simpler", *The Economist* lamented, "if only American law were simpler is probably more to the point—like Canada's, Britain's, Australia's and frankly, the rules of most other markets in the world. It is their very simplicity that makes them stronger. It is the loopholes so endemic to intricately prescribed rules that make the U.S. approach weaker in my view."

⁸³ CCCE *Competing for Growth: Doing what is Right for Canada in the Reform of Securities Regulation*, July 2003, at <http://www.bcni.com/English/Publications/reports/july-03.htm>.

⁸⁴ For a review of submissions to the Wise Persons Committee by scholars, corporations, and securities regulators, see their website at http://www.wise-averties.ca/submissions_en.html.

Securities Administrators have not been silent. Indeed, they have swiftly and ardently advanced the idea.⁸⁵

D. Fingerprints of SOX: New Ontario Legislation—Bill 198

In Canada, the Ontario legislative terrain is particularly important in any discussion of corporate governance and SOX on two counts. First, “Ontario is the lead regulator of the TSX, and therefore regulates the largest proportion of the country’s market capitalization”.⁸⁶ Second, the head of the OSC, David Brown has taken the lead through his open letter of August 2002, *supra*, of soliciting responses from Canadian regulators on the best way to respond to SOX. David Brown has also been very vocal about enacting Canadian legislation that would be “second to none”, as robust as SOX in protecting investors, but also capable of recognizing the particular needs of Canadian public companies and therefore would distinctly be “made in Canada”.⁸⁷ Mr. Brown engaged with a significant representation of stakeholders in Canadian capital markets including stock exchanges, SROs, industry associations, public interest groups, and groups of market participants, and fed the results into Bill 198.⁸⁸

Bill 198 was passed into law in Ontario on 9 December 2002, and has been agreed to by a total of 12 of the 13 securities regulators in Canada.⁸⁹ In other words, except for the province of British Columbia, Ontario and the other provinces will implement the provisions of Bill 198 in their respective securities markets. Bill 198 responds to SOX and also incorporates many of the suggestions made by previous corporate governance reform committees, discussed *supra*.

Bill 198 affects securities legislation by amending the Ontario Securities Act. to:

- Create new civil remedies for investors trading in secondary markets;
- Create new criminal offences and raises penalties for violations of securities legislation;
- Expand enforcement powers of the Ontario Securities Commission; and

⁸⁵ On 30 January 2003, the CSA released their *Blueprint for Uniform Securities Laws for Canada*, at http://www.bcsc.bc.ca/Publications/Concept_Proposal.pdf.

⁸⁶ *Supra* note 61.

⁸⁷ See however the comments of Nicholls, *supra* note 11, that the “made in Canada” approach should perhaps be replaced with a “made for Canada” approach.

⁸⁸ See David Brown, Chair of the O.S.C., *Finding Common Ground: A Robust Canadian Response to the Financial Reporting Scandals*, remarks delivered at the FEI Canada Peak Performance Conference, Banff, Alberta (13 June 2003).

⁸⁹ Except for British Columbia.

- Expand rule-making powers of Ontario Securities Commission with respect to composition and conduct of audit committees, internal controls systems of issuers, disclosure controls and procedures, and CEO and CFO certifications.

On 27 June 2003, the OSC released rules relating to CEO/CFO certifications, audit committees, and disclosure principles.⁹⁰ The rules are not yet binding, and comments are invited for submission to the OSC by 25 September 2003.

1. CEO and CFO Certifications—MI 52-109

Effective January 1, 2004, MI 52-109⁹¹ requires CEOs and CFOs of all issuers to file quarterly and annual certificates, personally certifying to their knowledge that the issuers' corresponding filings do not contain any misrepresentations and are "fairly presented". The term "fair presentation" does not include a reference to generally accepted accounting principles, unlike the external auditor's report and financial statements. David Brown of the OSC has stated this omission was intentional "to prevent management from relying entirely upon compliance with GAAP procedures in this representation, particularly where the results of a GAAP audit may not fairly reflect the overall financial condition of a company."⁹²

CEOs and CFOs must also certify that they are (i) responsible for designing or supervising the design and implementation of internal controls, disclosure controls and procedures, and (ii) disclosed to the issuer's auditors and audit committee, or persons performing the function of an audit committee all significant weaknesses in the design or operation of the internal controls that could contribute to fraud or adversely affect timely disclosures, and (iii) disclose in the MD&A any significant changes in the issuer's internal controls or other factors that could affect those controls, as well as any actions taken to correct same.

Unlike the SOX/SEC rules, the CEO and CFO under the OSC rules do not need to certify on an annual and quarterly basis that they have evaluated and

⁹⁰ Full text of the proposed *Promoting Investor Confidence* rules is available on the OSC website at: http://www.osc.gov.on.ca/en/HotTopics/prom_inv_conf.html#expanded.

⁹¹ OSC Multilateral Instrument 52-109 *Certification of Disclosure in Companies' Annual and Interim Filings*, 27 June 2003, at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_52109_20030627_multilateral-instrument.htm [hereafter MI 52-109].

⁹² OSC *Companion Policy 52-109CP* to MI 52-109, at <http://www.spsc.gov.sk.ca/ssc/files/publish/52-109cp.pdf>. MI 52-109, *supra* note 93 at Part 4, notes that "fair presentation" includes the selection and proper application of appropriate accounting policies; disclosure of financial information that is informative and reasonably reflects the underlying transaction; and inclusion of additional disclosure necessary to provide investors with a materially accurate and complete picture of the financial condition, results of operations and cash flows.

disclosed their conclusions. Also unlike SOX, an external auditor is not required to verify management certifications.

However, the 'disclosure controls and procedures' do mirror the SOX provisions relating to CEO and CFO certifications of financial and non-financial information. This rule will be phased in after a one-year period, and in the meantime issuers are permitted to file a "bare" version of their annual and interim CEO/CFO certifications which does not include the Disclosure and Internal Controls representations.

(i) Liabilities

Maximum penalties for Securities Act offences have been increased from \$1 million fines and 2 years imprisonment, to a maximum of \$5 million fines and imprisonment for 5 years less a day.

2. Continuous Disclosure—CSA National Instrument 51-02

The new OSC proposed rules work with CSA proposal to include requirements for continuous disclosure and corporate reporting relating to annual and quarterly filings of MD&As, and CEO and CFO certification thereof.

3. Audit Committees—MI 52-110

Modelled on SOX and other U.S. counterparts, proposed Multilateral Instrument 52-110 *Audit Committees*⁹³ has been issued to "establish and maintain strong, effective and independent audit committees"⁹⁴ for reporting issuers. MI 52-110 specifies membership requirements and increases the responsibilities of audit committees. Each audit committee must have a charter setting out its specific mandate, which is to be included in the Annual Information Form ("AIF").

(i) Membership

Perhaps the most significant provisions of MI 52-110 are that it requires that an audit committee be "independent" and "financially literate". "Independence" of an audit committee member is defined to mean the member has no material connection to the issuer which could affect the member's judgment in reporting to the issuer's Board of Directors. The AIF must disclose the names of all members, and state reasons for retaining a member who is not independ-

⁹³ OSC Multilateral Instrument 52-110 *Audit Committees*, 27 June 2003, at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_52110_20030627_multilateral-instrument.htm [hereafter MI 52-110], will come into force on the earlier of (i) the first annual meeting after 1 January 2004, or (ii) 30 June 2004.

⁹⁴ An overview of MI 52-110 is at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_52-110_20030627_rocpromi.htm.

ent.⁹⁵ Every member of the audit committee is required to be “financially literate”, which is described in the rules as having “the ability to read financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer’s financial statements.”⁹⁶

Notably however, MI 52-110 does not require that every audit committee have a “financial expert” as does SOX, although the Companion Principles to the rules recommends that a financial expert sit on the audit committee to assist in overseeing audits. “Financial expert” is described as a person who has:

- An understanding of financial statements and the accounting principles used by the issuer to prepare its financial statements;
- The ability to assess the general application of such accounting principles in connection with the accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of issues that can reasonably be expected to be used in preparing the issuer’s financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal audit controls and procedures for financial reporting; and
- An understanding of audit committee functions.

The rules require issuers to disclose in their AIF the identity of any financial expert, and otherwise, to explain why the audit committee does not have a financial expert.⁹⁷ The only exception to this rule are small cap companies, which are exempt from requiring an independent or financially literate audit committee. Similarly in the U.S., small business issuers have been granted limited extensions regarding the constitution of audit committees but are expected to comply eventually with the same standards as other public companies.

In Ontario, apart from the independent and financially literate requirement, small cap companies like all other public companies will be required to comply with the following responsibilities of audit committees.

(i) *Responsibilities of the Audit Committee*

MI 52-110 applies to all reporting issuers, except under section 1.2 to investment funds, issuers of asset-backed securities, designated foreign issuers and certain subsidiary entities of reporting issuers.

⁹⁵ In MI 52-110, s. 1.4, “material relationship” is defined as one which could “in the view of the issuer’s board of directors, reasonably interfere with the exercise of a member’s independent judgment.”

⁹⁶ M 52-110, s. 1.1.

⁹⁷ *Supra* note 88, s. 3.

Pursuant to MI 52-110, the Audit Committee will be responsible for recommending external auditors to the Board of Directors, overseeing the work of these external auditors, and recommending their compensation. The Audit Committee will also be responsible for dispute resolution between the external auditors and management regarding financial reporting, and for pre-approving any non-audit services provided by the external auditors (subject to a *de minimus* provision at s. 2.4). The Audit Committee is also required to review and approve the issuer's hiring policies regarding employees who were formerly employed with past or present external auditors of the issuer.

The Audit Committee will also have responsibilities of:

- Reviewing the issuer's financial statements, Management Discussion and Analysis (MD&A) and earnings press releases prior to filing and any public disclosure by the issuer; and
- Ensuring adequate procedures exist for review of the issuer's disclosure of financial information originating in or from the issuer's financial statement. The Audit Committee must also periodically assess these procedures.
- Establishing procedures for protecting "whistle-blowers". These procedures must include confidential, anonymous submission to the issuer of employee concerns regarding any questionable accounting/auditing procedures.

E. The British Columbia Response

BC is the only securities regulator which has not officially adopted the Ontario model set out in Bill 198 and the subsequent rules of the OSC issued thereto. Rather, BC has issued its own draft legislation requesting comments to be returned by the end of 2003. Essentially, Doug Hyndman speaking on behalf of the BC Securities Commission has taken the view that a 'principles-based' approach will benefit Canada long-term, while a rules-based approach as prescriptive as SOX or Bill 198 will only serve to provide some short-term satisfaction: "Investor confidence cannot be bolstered simply by adding rules that make regulation more complex and burdensome, without actually improving investor protection. Investors would soon realize that the new rules had not delivered what was promised. In the meantime, many would have been tempted to relax their vigilance, assuming that the new rules had taken care of the problem. This would serve only to aggravate their ultimate disillusionment."⁹⁸

⁹⁸ David Hyndman, Chair of B.C. Securities Commission, *What Kind of Securities Regulation for Canada?*, remarks to the CCCA National Spring Conference, Calgary Alberta (28 April 2003), at http://www.bsc.bc.ca/Publications/Hyndman_CCCA.pdf. "In light of recent corporate scandals in the United States and the U.S. legislative response, some people have suggested that our promotion of streamlining and simplification is out of step with the times. They say we need to add more rules in Canada, like those recently adopted in the

The B.C. perspective shuns burdensome regulation, and finds that it only creates an illusion of investor confidence without any substantive investor protection. BC also takes the position voiced by Hyndman that a rules-based approach with “excessively detailed and prescriptive requirements can confuse market participants, causing them to lose sight of the underlying principles”. B.C. further cites examples of “detailed disclosures” that “add little useful information and obscures the disclosure that really matters to investors.”⁹⁹

Highlights of the B.C. Model of corporate governance reform are:

- Replacement of “bulky” prospectuses, with “continuous market access system” achieved by asking public companies to disclose all material information all the time. The rationale is that continuous disclosure will assist issuers more than providing a “snapshot-in-time document”, and by having their information readily available in the marketplace would enable issuers to be nimble in going to the market using a mere press release. Documents provided by issuers to investors would also become part of the public record.
- A “firm only” registration: this holds employers responsible for the conduct of their representatives, and dispenses with the registration of individuals in the securities business, furthers cuts down on costs.
- Replacing a detailed rules approach with a principles-based code of conduct for the securities industry.
- Provides investors a general right to sue when they suffer damages as a result of someone violating securities legislation.¹⁰⁰
- Increased enforcement powers and penalties of the B.C. Securities Commission to provide stronger deterrence against misconduct.

While a resolution of the debate over rules-based versus principles-based system as providing best practices for corporate governance is beyond the scope of this paper, the fact that Canada is embroiled in a debate between major securities legislators is part of its response to SOX.

U.S., to give investors confidence that we have ‘robust’ regulation to protect against failures in corporate governance and disclosure that might lead to serious investor losses. We disagree... The BC model is a better answer for the times... For too long, regulators have thought more rules are the answer to every problem in the market. The goal of the BC model is to make regulation more effective and to improve the efficiency and competitiveness of our markets. That is the way to give investors confidence. We want to clear away the clutter from decades of legislating and rule making, and develop a system that is clear, simple, and focused on the goals of investor protection and market integrity.”

⁹⁹ *Ibid.*

¹⁰⁰ *Ibid.* Note that “the right is balanced by protections for defendants against abusive litigation.”

F. Response of the Law Society of Upper Canada to the Attorney Requirements in SOX

The Law Society of Upper Canada ("LSUC") is the provincial law society responsible for regulating lawyers in Ontario. Mr. Vern Krishna, then Treasurer of LSUC, responded to David Brown's enquiry as to whether SOX should apply to lawyers. Mr. Krishna clarified that unlike the regulation of lawyers in the U.S., in Canada lawyers are regulated by their provincial law societies created by statute. These law societies decide who may be admitted to the bar, and set stringent standards on codes of conduct and professional responsibility of lawyers. These rules impose far greater responsibilities upon lawyers than the attorney obligations imposed by SOX. Mr. Krishna wrote:

The relatively small number of lawyers who appear before your Commission [OSC] and the great number of lawyers who do not are already required to meet the standards set by the Rules. These Rules, including those in respect of "whistle blowing", either meet or exceed the existing standards of professional conduct for American lawyers appearing before the S.E.C.¹⁰¹

Mr. Krishna also specifically referred to Rule 2 of the LSUC's Rules of Professional Conduct and the commentary which specifically deals with "whistle blowing", and reaffirmed that the LSUC regulations "are more comprehensive and will be more stringent than the American rules or any parallel regulation that the Ontario Securities Commission might consider...While adequate regulation of those involved in the capital markets is necessary to maintain the public's confidence in the markets, the public must also be assured that lawyers are

¹⁰¹ Letter from Vern Krishna, Treasurer of the Law Society of Upper Canada, to David Brown, Chair of the O.S.C., (31 October 2002) available at www.osc. -- Treasurer Krishna quoted from the Commentary to Rule 2: "A lawyer employed or retained to act for an organization, including a corporation, confronts a difficult problem about confidentiality when he or she becomes aware that the organization may commit a dishonest, fraudulent, criminal, or illegal act. This problem is sometimes described as the problem of whether the lawyer should "blow the whistle" on his or her employer or client. Although the *Rules of Professional Conduct* make it clear that the lawyer shall not knowingly assist or encourage any dishonesty, fraud, crime, or illegal conduct (rule 2.02(5)), it does not follow that the lawyer should disclose to the appropriate authorities an employer's or client's proposed misconduct. Rather, the general rule, as set out above, is that the lawyer shall hold the client's information in strict confidence, and this general rule is subject to only a few exceptions. Assuming the exceptions do not apply, there are, however, several steps that a lawyer should take when confronted with the difficult problem of proposed misconduct by an organization. The lawyer should recognize that his or her duties are owed to the organization and not the officers, employees, or agents of the organization. The lawyer should therefore ask that the matter be reconsidered, and the lawyer should, if necessary, bring the proposed misconduct to the attention of a higher (and ultimately the highest) authority in the organization despite any directions from anyone in the organization to the contrary. If these measures fail, it may be appropriate for the lawyer to resign in accordance with the rules for withdrawal from representation (rule 2.09)."

regulated in a way that protects the fundamental values of the legal profession for the sake of the public interest. Our *Rules of Professional Conduct* are informed by this principle. Our intent is that there be clear Rules for all lawyers practicing in Ontario, or Ontario lawyers practising elsewhere, on conduct involving corporate misfeasance. If there is a need to further address this subject in the Rules, the law Society will undertake that initiative."¹⁰²

IV. CONCLUDING OBSERVATIONS

SOX has had far-reaching effects upon Canadian corporate governance reform. With the exception of the province of British Columbia, Canada has largely raced to follow the U.S. in adopting measures that will be seen to be as "tough" as SOX, (i) without waiting long enough to scrutinize the long-term success or failure of SOX in restoring investor confidence;¹⁰³ (ii) without clearly distinguishing between the purpose of corporate governance being to regulate efficient marketplaces or to restore investor confidence;¹⁰⁴ and (iii) operating under an untested—but possibly prescient—assumption that the stringent rules-based approach of SOX is indeed the benchmark for corporate governance.¹⁰⁵ Although SOX may have been tailor-made to address uniquely American market concerns, its perceived effectiveness has forced Canada to largely abandon existing corporate governance frameworks in favor of adopting SOX-like rules of corporate governance, in order to remain competitive in the global marketplace.

Twelve out of thirteen securities regulatory jurisdictions (*i.e.* all provinces except British Columbia) in Canada have adopted the provisions of Bill 198 and the OSC Rules which effectively mirror the changes introduced in the U.S. by SOX, as *generally summarized* in the chart below:

¹⁰² *Ibid.* See also Anisman, *supra* note 6, for a view agreeing with that of Professor Krishna.

¹⁰³ For example, apart from the philosophical merits of a rules-based or principles-based approach to securities regulation, the costs associated with SOX could be excessively burdensome for many issuers, and could have a negative impact upon the desirability of foreign investors participating in U.S. markets if they believe they will be affected by these increased costs in order to access capital in U.S. markets. See *e.g.* Consuelo Mack and Wally Griffith, *The Downside of Sarbanes-Oxley: Law to Curb Corporate Fraud has Unintended Consequences*, MSNBC, at <http://www.msnbc.com/news/943532.asp?0bl=-0&cp1=1>. See also the comments of David Brown regarding cost-benefit studies undertaken to determine the costs of implementing SOX-like rules in Canada, available at OSC website: http://www.osc.gov.on.ca/en/About/News/Speeches/spch_20021205_critical-asset.htm.

¹⁰⁴ Anisman, *supra* note 6.

¹⁰⁵ However, see note 1 *supra*.

U.S. SOX	CANADA Bill 198 and OSC Rules
Regulation of Audit Committees and requirements regarding composition	√
Creation of Regulatory Body with oversight of accounting profession	√ ¹⁰⁶
CEO and CFO certifications with exposure to civil and criminal liability	√
Continuous Disclosures and Internal Control Requirements	√
Increased civil and criminal liabilities	√
Prohibition on corporate loans to Directors and officers/ disgorgement of bonuses if profits restated	No
Attorney "up the ladder" reporting requirements	Already in place in Canada pre-Sox ¹⁰⁷

SOX, through its extraterritorial provisions forced foreign companies listed in the U.S. to comply with its provisions. As such, U.S. Congress (perhaps unintentionally) has enacted legislation which interferes with the sovereignty of other countries *vis-à-vis* domestic regulation of corporate governance. A company incorporated and headquartered in Alberta for example, must comply with SOX's rules of corporate governance if it wishes to list in the U.S.; compliance with Alberta's corporate governance rules were no longer sufficient post-SOX, if the company wished to continue its listing in U.S. markets.

Another corollary effect of SOX is that it smacks of legislative hegemony. SOX has essentially forced other countries to debate harmonization with SOX or risk remaining competitive for foreign capital investment; countries like Canada have determined that they cannot afford to continue with principles-based or other corporate governance legislation that will not protect investors as vigorously as SOX, and therefore may deter foreign investors. Thus, in order to remain competitive, countries are rushing to enact SOX-inspired rules-based legislation.¹⁰⁸ The potential problem of course is that SOX has yet to prove that it is effective.

On the other hand, SOX has had some arguably positive effects in Canada. Despite the corporate governance reform activity over the past fifty years in Canada, SOX has forced Canada to resolve the outstanding issue of its domestic

¹⁰⁶ However, a public regulatory body to oversee the accounting profession was already contemplated in Canada prior to SOX.

¹⁰⁷ See Vern Krishna letter, *supra* note 101.

¹⁰⁸ See *e.g.* International Bar News, *supra* note 7.

markets. Canada is being forced to reconcile the paradox of having 13 securities regulators when it wants to represent its markets to the world in an accessible, comprehensive manner, and also achieve domestic harmonization to create a more efficient national market. SOX has been the catalyst which has witnessed a solidarity among 12 of the 13 Canadian regulators to respond cohesively to address new legislative issues raised by SOX. SOX may yet be the catalyst that will enable Canada to advance uniform corporate governance and securities reforms.

In an era of globalized, interdependent markets, it is perhaps not surprising that the actions of the U.S. Congress in enacting SOX would reverberate throughout the world, even without the extraterritorial provisions. Because of the globalization of capital markets and the premium, influential position of the U.S. in those markets, it seems that U.S. legislative hegemony may prevail in corporate governance issues. SOX may unleash a new era of U.S. hegemony in setting global market place standards.

From the Canadian perspective, by throwing its hat in the U.S.-led legislative ring and enacting Bill 198, Canada demonstrates its faith in the continued viability of the U.S. marketplace; once a safe bet, but in today's world of strife and risks affecting domestic economies, and considering the exorbitant costs which will be associated with the implementation of SOX in the U.S., it is a somewhat risky bet.