Playing BY THE RULES

Comparing principles-based and rules-based corporate governance in Canada and the U.S.

BY ERINN B. BROSHKO AND KAI LI

Following the collapse of Enron and other accounting fraud and corporate scandals involving firms such as Global Crossing, Adelphia, Tyco and WorldCom, and in light of the demise of Arthur Andersen, one of the Big Five accounting firms, the Sarbanes-Oxley Act of 2002 (SOX) was signed into law in the United States by President Bush on July 30, 2002. SOX was enacted in an attempt to eliminate accounting fraud and management wrongdoings and to restore confidence in the U.S. financial markets. Arguably, SOX is the most sweeping package of corporate governance legislation since federal securities laws were enacted in the 1930s. Both the New York Stock Exchange (NYSE) and the Nasdaq National Market (Nasdaq) also promptly revised their respective corporate governance rules. All firms listed on these two exchanges must comply with the corporate governance requirements provided under SOX and the revised stock exchange rules.

As a participant in the North American financial community, Canada followed the U.S. trend for more strict corporate governance requirements with the implementation in 2004 of National Instrument 58-101—Disclosure of Corporate Governance Practices (NI 58-101), National Policy 58-201—Corporate Governance Guidelines (NP 58-201) and Multilateral Instrument 52-110—Audit Committees (MI 52-110). All firms listed on the Toronto Stock Exchange (TSX) are subject to these new corporate governance requirements.

The corporate governance regimes in Canada and the U.S., while similar in certain respects, are fundamentally different in their respective approaches to corporate governance regulation. Under the Canadian principles-based approach, with the exception of mandatory rules relating to audit committees, companies are required to publicly disclose the extent of their compliance with the suggested best practices and, where a firm's practices depart from such guidelines, to describe the procedures implemented to meet the same corporate governance objective. Hence, the Canadian approach is in the form of comply or disclose. A similar principles-based approach is also adopted in the United Kingdom, European and Australian markets. In contrast, the U.S. rules-based approach is oriented toward mandatory compliance with legislation and stock exchange requirements, with a much greater emphasis on regulatory enforcement rather than voluntary compliance.

The objective of this paper is twofold. First, we present a comparison of the different corporate governance regimes in Canada and the United States from a theoretical and legal perspective. Second, we provide new empirical evidence regarding the corporate governance practices of Canadian and U.S. firms within their respective principles-based and rules-based regulatory environments. Our discussion in the paper offers general guidelines to help readers discern and better understand the different governance regimes in Canada and the U.S. This comparison is of value to both firms considering a listing in Canada and/or the U.S. and institutional investors who hold equity stakes in either of these two countries.

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Principles- versus rules-based

The corporate governance regimes in Canada and the U.S. are fundamentally different. Canada employs a principles-based approach to corporate governance through the implementation in NI 58-101 and NP 58-201 of best practices guidelines in combination with mandatory disclosure as to the extent of compliance with such guidelines and, where a firm's practices depart from that approach, to describe the procedures implemented to meet the same governance objective. The emphasis on disclosure is intended to give the firm the flexibility to tailor its corporate governance practices to its specific circumstances while providing investors with information relevant to evaluating such practices. Such a principles-based approach is, in fact, a quasi principles-based approach given that compliance with certain rules is mandatory, such as rules relating to audit committees under MI 52-110.

The U.S., on the other hand, has employed a rules-based corporate governance approach that requires mandatory compliance with legislation, including SOX, and the rules of the NYSE and Nasdaq. That being said, such a system is more accurately labelled a quasi rules-based system because, in a few instances, rules require only disclosure of the extent of compliance with a suggested best practice, such as the requirement for firms to disclose under SOX whether or not the firm's audit committee has a member who is an audit committee financial expert.

While a principles-based approach has been characterized by some as being too weak to seriously address the corporate governance failures seen over the last few years, others have argued that the differences between the Canadian and U.S. capital markets justifies such an approach. Such differences include the fact that a greater proportion of Canadian publicly-traded firms, including many large-cap firms on the S&P/TSX Composite Index, are closely held or managed by the firm's founders and the fact that Canada's capital markets are comprised of a greater number of small-cap firms that lack the financial resources to comply with the stringent requirements enunciated in the U.S. Moreover, it is argued that Canada on a whole lacks the depth of candidates needed for Canadian firms to comply with the more strict U.S. independence rules relating to board and committee composition.

One further argument in favour of the principles-based approach is that the requirement for a firm to simply disclose whether or not it has complied with the enunciated best practices allows the capital markets, and hence ultimately the investing shareholders, to be the judge of the effectiveness of a firm's corporate governance policies. However, allowing the market to be the judge also places the onus on the investors who are often uninformed and have small investment positions to decide whether or not a firm's corporate governance policies are sufficient. Douglas Hyndman, the chairman of the British Columbia Securities Commission, noted in 2002: "We should let the market work, as only it can, rather than stepping in to say that government has all the answers and investors can go back to sleep." While this is, in theory, a compelling argument, many investors, notwithstanding sophisticated/institutional investors, may not have the expertise, time or resources to undertake a thorough evaluation of a firm's corporate governance practices. Also, given that one of the main reasons for implementing corporate governance requirements in the first place is to enhance investor confidence in the capital markets, a principles-based approach that allows firms to implement ineffective corporate governance practices may, more than a rules-based approach, not meet this objective.

The rules-based approach, however, has the benefit of providing for precise application but it can only address circumstances known or anticipated by the legislators at the time of implementation. By their very nature, rules become outdated as circumstances change and, thus, results in firms complying with the letter of the law, rather than the spirit, or underlying principles, of the law. On the other hand, without investors effectively monitoring firms' corporate governance policies, the principles-based system could result in firms complying with those best practices that suit the narrow purposes of management, and not shareholders. In the opinion of the Canadian Council of Chief Executives, "… standards based on principles leave more room to exercise judgment, but are both more effective in guiding behaviour as circumstances change and are much harder to evade than specific rules."

While there are persuasive arguments for and against both the principles- and rules-based approaches to corporate governance, Canada has embraced the former, thus placing the onus on the market to ultimately judge the adequacy of a firm's governance regime, while the U.S. has embraced the latter, thus placing the onus on legislators and regulators to draft effective laws to regulate and enforce corporate governance. For Canadian provincial securities regulators, it remains to be seen—likely in the

next economic downturn—whether the made-in-Canada solution is effective or whether Canada will move more towards the U.S. style of rules-based corporate governance.

Canada versus the U.S.

Broshko and Li (2006, Table A) provide a succinct summary of the corporate governance requirements in Canada and the U.S. Along most dimensions, the requirements reflect the fundamental differences in these two countries' approaches to corporate governance. For example, the Canadian rules recommend that the board of directors be comprised of a majority of independent directors and that the firm disclose, in its management information circular or in its annual information form, the extent of its compliance with that and the other guidelines, including the identity of such independent directors and the basis for the board's determination of their independence and, where their practices depart from that approach, the procedures implemented to meet the same governance objective.

In the U.S., board independence requirements for firms listed on the NYSE are outlined in the NYSE's Listed Company Manual (the NYSE Rules), and for firms listed on the Nasdaq are set out in the Nasdaq's Marketplace Rules (the Nasdaq Rules). The NYSE and Nasdaq Rules both require firms to have a board comprised of a majority of independent directors and to disclose the names of the independent directors and the board's basis for such a determination in the listed firm's annual proxy statement or its annual report.

With respect to nominating and compensation committees, the Canadian rules recommend that each firm establish such committees and that they be comprised entirely of independent directors. In the United States, the NYSE Rules, unlike the Nasdaq Rules, require each firm to have a compensation committee and a nominating and corporate governance committee comprised entirely of independent directors. The Nasdaq Rules, however, do not require the establishment of formal compensation and nominating committees; instead, the compensation of the CEO and other executive officers must be determined, or recommended to the board for determination, by either a compensation committee comprised solely of independent directors or a majority of independent directors on the board, and director nominees must be selected, or recommended for the board's selection, by either a nominating committee comprised solely of independent directors or a majority of the independent directors.

Regarding the composition of the audit committee, however, the Canadian approach is converging towards the U.S. rules-based approach. Specifically, in Canada and the U.S., the audit committee must be comprised of at least three members, each of whom must be independent (under the more strict independence definition than that applied for board and nominating and compensation committee composition purposes, see Broshko and Li (2006, Table A)). This audit committee composition requirement in Canada is an example of a limited divergence away from the principles-based approach (i.e., comply or disclose) and underscores the regulators' belief in the importance of publicly traded firms having audit committees comprised of entirely independent directors who perform, and are responsible for, the valuable gate-keeper role for the review of the firms' financial statements.

With respect to the financial literacy of audit committee members, under the Canadian, NYSE and Nasdaq Rules, each member of the audit committee must be financially literate or become financially literate within a reasonable period of time after his or her appointment to the audit committee.

Under Item 401(h) of Regulation S-K in the U.S., each firm is required to disclose in its annual report the name of an audit committee member who is an audit committee financial expert, or to explain why the membership of the audit committee does not include such an expert. This requirement is one example where the U.S. regime has taken a principles-based approach, rather than the strict compliance rules-based approach.

Last, in an effort to improve disclosure controls and procedures and internal control over financial reporting, the U.S. under Section 404 of SOX requires publicly traded firms to publish information in their annual reports concerning the scope and adequacy of their internal control structure and procedures for financial reporting, and also requires them to include in their annual reports an assessment of the effectiveness of such internal controls and procedures. Furthermore, the auditors for each firm must, in the same report, attest to and report on the assessment of the effectiveness of the internal control structure and procedures for financial reporting. The CEO and CFO for these companies are also required to certify on a quarterly basis, among other things, as to certain matters involving disclosure controls and procedures and internal control over financial reporting.

Canadian provincial securities regulators had proposed

similar rules that would apply to certain Canadian publicly traded firms, and have implemented similar CEO and CFO certification requirements. However, in March 2006, the Canadian provincial securities regulators announced that after careful consideration of the feedback they received and recent developments internationally, particularly in the U.S., they will not require auditors to attest to and report on the assessment of the effectiveness of the internal control structure and procedures for financial reporting. This significant departure from the U.S. rules is premised on the Canadian provincial securities regulators' belief that quality, reliability and transparency of financial reporting can be improved on a cost-effective basis by strengthening the CEO and CFO certification requirements.

Implementation: North and South

We will now provide evidence of how these different corporate governance requirements are implemented in practice by firms in Canada and the U.S. Our data comes from the Investor Responsibility Research Center (IRRC). Of the 283 Canadian firms covered by IRRC, 176 are exclusively listed on the TSX. Of the 1,477 U.S. firms covered by IRRC, 985 are listed on the NYSE

Table 1

A Summary of Corporate Governance Practices in Canada and the United States in 2004

	Principles-based Approach		Rules-based Approach			
	TSX		Nasdaq		NYSE	
	Mean	Median	Mean	Median	Mean	Median
Board of Directors						
Board size	8.5	8	8.3	8	9.8	10
Fraction of board independent	.61	.62	.68	.70	.72	.73
Board with separate CEO/board chairman	.81	1	.45	0	.31	0
Committees of the Board of Directors						
Board having audit committee	.98	1.0	1.0	1.0	1.0	1.0
Audit committee size	3.5	3	3.4	3	3.9	4
Audit committee independent	.85	1.0	.94	1.0	.95	1.0
Board having compensation committee	.85	1.0	1.0	1.0	1.0	1.0
Compensation committee size	2.8	3	3.2	3	3.7	4
Compensation committee independent	.84	1.0	.93	1.0	.94	1.0
Board having nominating committee	.57	1.0	.94	1.0	.98	1.0
Nominating committee size	2.0	3	3.2	3	3.8	4
Nominating committee independent	.83	1.0	.91	1.0	.92	1.0
Board having corporate governance committee	.65	1.0	.82	1.0	.96	1.0
Corporate governance committee size	2.3	3	2.8	3	3.8	4
Corporate governance committee independent	.82	1.0	.91	1.0	.92	1.0
Sample size	176		451		985	

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and 451 are listed on the Nasdaq. Due to data limitations, our comparisons are limited to board composition and board committees and the results are presented in Table 1.

If we use the Canadian firms exclusively listed on the TSX as the baseline, it is clear that U.S. firms, especially the NYSE firms, are quite different from the Canadian firms in terms of corporate governance practices along almost every dimension we examine. In comparison to Canadian firms, U.S. firms tend to have bigger boards and, in response to the requirement that the board be comprised of a majority of independent directors, boards of U.S. firms consist of a higher fraction of independent directors. On the other hand, U.S. firms are much less likely to separate the CEO role with the chairman of the board, with only 31 (45) percent of the NYSE (Nasdaq) firms having the chairman of the board not being the CEO of the firm. In contrast, 81 percent of Canadian firms have separate CEOs and board chairs. Interestingly, while only 26% of Canadian firms have independent chairmen of the board, the corresponding numbers for the NYSE and Nasdaq firms are even lower at 10% and 13%, respectively.

In response to the implementation of rules requiring firms to establish independent audit committees, we find that almost all Canadian and U.S. firms have established audit committees. The fraction of independent directors on the audit committee is 85% for Canadian firms, 95% for the NYSE-listed firms, and 94% for the Nasdaq-listed firms. Canadian firms are less likely to have compensation, nominating and corporate governance committees. Only 85% of Canadian firms have compensation committees, and less than 70% of Canadian firms have corporate governance committees. Canadian firms are least likely to establish nominating committees. In contrast, all U.S. firms have compensation committees, and a much higher fraction, between 94 (82) to 98 (96)% of U.S. firms have established nominating (corporate governance) committees. For Canadian firms with those committees, the number of members sitting on the compensation, nominating and corporate governance committees is fewer than their U.S. counterparts. Moreover, the fraction of independent directors sitting on these committees is significantly lower in Canadian firms than in the U.S. firms. Just over 80% of the committee members are independent in Canada, while more than 90% of the committee members are independent in the U.S.

Overall, the evidence in Table 1 suggests that the corporate governance practices in Canada are quite different than those in the U.S., despite the suggestions by the popular press and legal scholars that the corporate governance practices of Canadian and U.S. firms are converging. We note two caveats to our findings: first, the conclusions provided are intended to show general trends in Canada and the U.S. and, as expected, there are exceptions to such trends; second, the changes in governance rules both in Canada and in the U.S. are fairly recent and the Canadian culture of compliance expected by many will take time to materialize. We plan to conduct a study in the future to consider the evolution and extent of this culture of compliance and at that time will be in a better position to pass judgment on the Canadian principles-based regime in light of the U.S. rules-based system.

Conclusion

This paper explains from both a theoretical and legal perspective the U.S. rules-based approach and Canadian principles-based approach in terms of the regulation and

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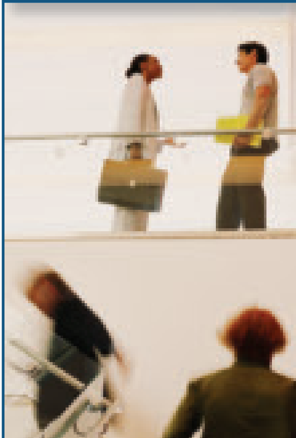

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enforcement of corporate governance. We identify the following factors that attribute to the Canadian preference towards a principles-based system. First, the Canadian capital markets are comprised of a far greater proportion of companies that are closely held or managed by the firm's founders, coupled with a greater number of smaller firms that lack the financial resources to comply with the stringent U.S. rules. Furthermore, it is argued that Canada on a whole lacks the depth of candidates needed for firms to comply with the more strict U.S. rules relating to board and committee composition. Second, the debate in the legal literature seems to suggest that the principles-based approach is more effective in establishing a culture of compliance with corporate governance principles rather than simply compliance with bright-line tests found in a rules-based system. Finally, the principles-based approach imposes the onus of implementing governance standards on the capital markets and its participants, rather than on the legislators and regulators as under the rules-based approach. The general sentiment in Canada with respect to corporate governance is best captured by the comments made by the former Bank of Canada governor, Gordon Thiessen: "I don't know that you'll ever have a system where regulators can see and do everything. What you need is a strong sense of commitment and concern on the part of boards of directors."

Our empirical evidence illustrates that the different regulatory regimes in Canada and the U.S. have, to a certain extent, resulted in considerably different corporate governance practices. Our research shows that Canadian firms, in comparison to U.S. firms: have smaller boards with fewer independent directors; are less likely to have CEOs also serving as the chairman of the board; and are less likely to have compensation, nominating and corporate governance committees, and the fraction of independent directors sitting on these committees is significantly lower. We hesitate to draw any conclusions at this point of time regarding the merits of the Canadian principles-based system in comparison to the U.S. rules-based system in light of the implementation of corporate governance structures by Canadian and U.S. firms, respectively, due to the evolutionary and dynamic nature of the Canadian system. The extent to which Canada maintains its principles-based system, or moves more towards a rules-based system, likely depends upon whether Canada experiences its own series of Enron-like failures during the next downturn of the economy. ∎

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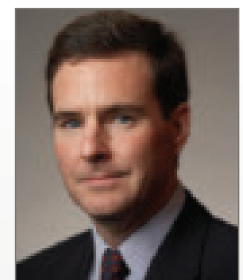

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