



***GOVERNANCE, VALUES
AND COMPETITIVENESS
A COMMITMENT TO LEADERSHIP***

***A STATEMENT OF THE
CANADIAN COUNCIL OF
CHIEF EXECUTIVES***

SEPTEMBER 2002



“We face an uncertain economy, falling stock values and now a spate of high profile corporate scandals primarily centred in the economy of our most important economic partner, the United States. As a result, public confidence in enterprise and in corporate leadership has fallen dramatically. In Canada, our record of corporate governance has been second to none worldwide. However, we cannot be complacent. We can do better and we will.”

These words, emerging from the April 2002 general meeting of the *Canadian Council of Chief Executives* in Montreal, set the stage for the Council's *Corporate Governance Initiative*. Formally launched on July 8, 2002 and co-chaired by Council Chairman, Charles Baillie and Council President and Chief Executive, Thomas d'Aquino, the undertaking has involved the Council's membership in an intensive round of consultations and research on best practices.

The result of our work is this statement entitled ***Governance, Values and Competitiveness: A Commitment to Leadership***. It acknowledges that Canada on the whole maintains a high standard of corporate governance but indicates that we as chief executives should constantly aspire to do better. We also challenge all of the partners in the enterprise system to join us in our efforts to ensure that Canadian business is conducted in the most transparent, accountable and ethical manner.

This statement represents the Council's best efforts to reflect a strong consensus among members. Collectively, we stand solidly behind the principles underlying the statement. It is up to individual boards of directors and each of the partners in the enterprise system, however, to determine how adherence to principles will be translated into action.

A debate on the future of corporate governance in Canada and throughout the world is well underway. In this debate, Canada and Canadian business leaders can continue to take the lead. It is our hope that this statement will be seen as a constructive contribution both to public confidence in Canada's financial markets and to our country's competitiveness and influence within the global economy.



GOVERNANCE, VALUES AND COMPETITIVENESS

On behalf of the Board of Directors
and of the members of the
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RATIONALE AND SUMMARY

Canada has a high standard of corporate governance, and international research has shown consistently that Canadian business leaders are considered to be among the most credible, most ethical, least corrupt and most value-driven managers in the world. But even in Canada, there have been prominent incidents of both illegal and unethical behaviour, and the sheer scale of the most recent examples in the United States has lessened public confidence in enterprise worldwide. Trust is the indispensable foundation of free enterprise, and the extent of the current market turmoil demands an effective response from business leaders.

As chief executive officers, each of us has a responsibility to our own shareholders to uphold the good name of our respective enterprises. Furthermore, it is in our interest, and in the interest of our shareholders, to ensure that capital markets work efficiently. As members of the *Canadian Council of Chief Executives*, we are determined to serve our country as well.

Let us be very clear about our goal. The value of markets to society flows from the interplay of conflicting ideas, and free enterprise can only flourish with the support of numerous individuals willing to invest their time and money in ventures that by their very nature involve risk. Markets that succeed in fostering a high degree of innovation inevitably will generate significant numbers of business failures as well. The rule of law is vital to the efficient functioning of free markets, and violations of rules designed to protect the integrity of markets should be punished severely. The rules governing markets also have to evolve as circumstances change, but simply adding rules does not necessarily make markets work better. Indeed, an excess of rules and regulations can easily suffocate the very spirit of innovation and risk-taking that makes markets so successful in driving human progress.

In the United States, the response to recent corporate scandals has been a raft of new legislative and regulatory restrictions. We believe that by building on Canada's traditional strengths and values, our country can craft a more effective strategy. By offering in this document our thoughts on *governance, values and competitiveness*, our goal is to move public discussion in Canada beyond wholesale adoption of the American model. We suggest an alternative approach, one that relies more on collaboration than on confrontation, but one that we believe would be more effective in bolstering confidence in Canadian markets and Canadian companies, in reinforcing Canada's reputation as a home to ethical and well-run businesses, and in building on this strength as a means of increasing Canada's competitiveness and global influence.

To this end, we lay out in considerable detail our consensus view on principles of corporate governance. In discussing detailed practices, we recognize that one size does not fit all, that factors such as a company's size, sector, geographic location, ownership structure and growth rate may affect its priorities at any given time. Some recommendations also reflect distinguishing characteristics of the Canadian market, notably the relatively large proportion of publicly traded companies with controlling shareholders.

Many of our recommendations represent established practice among major publicly traded companies in Canada, but bear repeating as part of a comprehensive framework. In addition, we suggest reforms that would build on Canada's strong foundation and, by raising the bar for both boards and chief executive officers, contribute to a collaborative, made-in-Canada approach to the challenge of ensuring public confidence in capital markets.



Corporate governance is in the end an expression of values rather than a set of rules. We therefore commit ourselves to living these values, both by supporting appropriate action by our respective boards of directors and shareholders and through our corporate and personal networks in the private, public and non-profit sectors.

In discussing the roles and responsibilities of chief executive officers, we focus on the need for trust and accountability and put forward several recommendations, including:

- **Compensation.** We understand the frustration felt by investors when senior executives are rewarded handsomely for past performance that proves to be short-lived. We continue to believe that executive compensation should be tied significantly to both short and longer-term performance, but suggest that boards could consider a heavier emphasis on compensation tied to sustained appreciation in shareholder value.
- **Insider trading.** Shareholders and other investors have a right to know the extent to which our confidence in the future of our enterprises is reflected in the allocation of our personal investments. We are prepared to assist in the more rapid dissemination of insider trading information by filing reports on all of our transactions involving company stock, related derivatives and the exercise of options within two business days.
- **Certification.** Even though the United States *Sarbanes-Oxley Act* may not apply to all Canadian companies, we believe that as Canadian chief executives, we should be prepared to offer a comparable certification of our annual and quarterly reports.
- **Legal penalties.** A material misrepresentation in such a certification would expose chief executives to significant consequences through the courts and regulatory bodies as well as in the marketplace. We encourage governments and regulators to enforce existing rules more vigorously and ensure that penalties for violations better reflect the gravity of the offence.
- **Sanctions within compensation.** Just as boards decide how best to align the interests of chief executive officers with those of shareholders through the provision of bonuses and other incentives for meeting designated performance targets, compensation agreements also could provide for sanctions that would reinforce legal and regulatory penalties.
- **Access to capital markets.** 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 that required in the United States by *Sarbanes-Oxley*, a mandatory requirement for listing on Canadian stock exchanges.
- **Ethics and corporate citizenship.** Putting words on paper is not enough. Our companies must live up to the principles we espouse. Our codes of business conduct and ethics must have teeth, including a means for employees to alert management and the board to potential misconduct without fear of retribution. More broadly, our companies must practice a standard of good corporate citizenship at home and abroad that will reinforce the reputations of our individual companies and will improve public perceptions of free enterprise worldwide.



While chief executive officers can and should make an important contribution to improving corporate governance, the central role in making decisions about governance practices belongs to the board of directors. The independence, leadership, composition and development of the board is critical, and we therefore make additional recommendations with respect to:

- **Board independence.** The issue of independence is critical and we endorse the definition of independence in the *TSX Corporate Governance Guidelines*. We agree that a substantial majority of the board of directors should be composed of independent directors. We suggest a similar standard of independence for the audit, governance and compensation committees of the board, but note that most of Canada's largest widely held companies in fact exceed this standard and have no related directors on these key committees.
- **Board leadership.** We recognize that the trend in most jurisdictions is toward the separation of the positions of chief executive officer and chairman of the board. Where these positions are now joined, the board must decide whether and when to separate them. Whenever these positions are not separated, independent directors should elect and disclose the name of a lead director who will be responsible for ensuring that the board is in a position to act independently of management when necessary.
- **Audit committee.** The audit committee requires both independence and a high degree of financial expertise. It should have direct authority over the work of the company's external auditors. The audit committee should adopt whatever policies it considers necessary to ensure the auditor's independence in fact and in appearance, and should approve and disclose any non-audit services provided to the company by its audit firm.
- **Equity compensation.** The compensation of both directors and senior managers should provide incentives to focus on the sustainable growth of shareholder value and should avoid unintended incentives such as an undue emphasis on short-term changes in the stock price. All compensation plans involving stock options or the issuance of shares should be subject to shareholder approval.
- **Stock option costs.** Companies should calculate and disclose in their financial statements a fair evaluation of the costs of stock options and other forms of equity compensation. To ensure that this practice in fact helps investors to make choices between companies, it is urgent for the accounting profession to develop a consistent reporting framework for such costs and we support the recent decision of the Accounting Standards Oversight Council to address this issue.
- **Transparency and disclosure.** Companies should adopt and disclose both their corporate governance guidelines and a comprehensive code of business conduct and ethics. They should disclose all fees paid to external auditors and related firms, as well as all forms and sources of compensation for senior executives. All insider trades and exercises of stock options should be reported to regulators within two days.

While most of what needs to be done to enhance public confidence can and should be carried out within the private sector, chief executive officers and boards of directors cannot meet the challenge on their own. Everybody who influences the process of corporate decision-making -- shareholders, directors, executives, employees, accountants, financial analysts, journalists and educators as well as government officials and regulators -- must be part of Canada's strategy. We therefore offer reflections on how others could reinforce the impact of measures being taken



within individual corporations. In addition to brief comments about the roles of financial analysts, investment dealers, educational institutions and the media, we discuss the roles of:

- **Auditors and the accounting profession.** In addition to the recently announced changes in the structure and process of regulatory oversight, there is a need for the accounting profession to expand the scope and substance of audit services to directors to enable them to meet today's demands for greater accountability. There is an urgent need to develop a consistent approach to the reporting of the costs associated with stock options that will enable investors to make fair comparisons between companies. More broadly, work on globally accepted accounting principles must be accelerated.
- **Institutional shareholders.** Because of the sheer size of their holdings, institutional shareholders such as pension funds and mutual funds are exerting growing influence over corporate decisions. We support the public disclosure by all institutions of their proxy voting guidelines and record. To complete the circle of accountability, we suggest that institutions consider disclosing additional information such as their compensation policies.
- **Governments and regulators.** Ensuring good corporate governance is part of the responsibility of governments to foster a competitive business environment. Canada has no shortage of laws, but existing rules have not always been consistently or vigorously enforced. Regulators need the resources to do their jobs effectively. At the same time, it is vital to ensure that the cumulative impact of legal and regulatory requirements does not undermine either the competitiveness of Canadian firms or the goal of effective governance.

We suggest measures to enhance public disclosure such as expediting release of insider trading reports. We call on provincial governments to reconsider their long-standing opposition to a national securities regulator. And we highlight the need for governments, their agencies and Crown corporations to practice the same degree of transparency and accountability and to adopt codes of conduct and ethics comparable to those being demanded of the private sector.

At its core, free enterprise is about hope, about providing avenues for people to pursue their dreams of better lives for themselves and their children. Recent events have undermined public confidence in markets and dashed the hopes of many investors in the short term. But the current turmoil reinforces the need for Canadians to stay true to their values, to learn from the mistakes that have been made and to build on Canada's many strengths as we look to the future. Three years ago, in our Council's *Canada Global Leadership Initiative*, we suggested that Canada should aim for nothing less than to become "*the best place in the world in which to live, to work, to invest and to grow.*" We promise to do our part in helping Canadians to achieve this goal together.



INTRODUCTION

Canadian corporate governance standards are among the highest internationally, and Canada's enterprises and business leaders have a very strong record of integrity, which should serve as a competitive advantage for our country. But even in Canada, there have been prominent examples of both illegal and unethical behaviour, and the sheer scale of some of the most recent scandals in the United States has lessened public confidence in enterprise throughout the world. This damage to public trust, both in the integrity of the business community and in the value of efficient markets, could be more enduring and in the long run have even more serious consequences than the significant financial losses that many investors have suffered in the short term.

Free markets work well in fuelling human progress, but trust is their indispensable foundation. As the chief executive officers of leading Canadian enterprises, we therefore are deeply disturbed by the irresponsibility of some of our peers. Even one breach of trust of the magnitude of those at Enron or WorldCom is too many. We encourage governments to prosecute violations of the law with full vigour, including confiscation of ill-gotten gains and penalties that include jail time where justified. Justice must be done and seen to be done.

"No matter how bold or how brilliant, our plans will come to nothing unless the new economy remains anchored firmly on a very old idea, an idea that is never out of fashion: the idea of integrity."

Prime Minister Jean Chrétien

The extent of today's turmoil demands action by more than governments, regulators and the courts. Each of us has a responsibility to uphold the good name and build the value of our respective enterprises, and in doing so, we have a direct interest in ensuring that capital markets work efficiently. As members of the *Canadian Council of Chief Executives*, we are determined to serve our country as well.

Canada's publicly traded companies, in collaboration with stock exchanges and regulators, have introduced significant improvements in corporate governance over the past decade, but improvement is a continuing process. By offering in this document some detailed thoughts on *governance, values and competitiveness*, our goal is to build on this progress and to suggest enhancements that could bolster confidence in Canadian markets and Canadian companies, reinforce Canada's reputation as a home to ethical and well-run businesses, and in doing so, contribute to Canada's competitiveness and global influence.

Most of our recommendations address issues of corporate governance and reflect what we consider to be leading-edge practices that have been proposed or adopted by legislators, regulators, stock exchanges, professional bodies and business associations worldwide. Members of the Canadian Council of Chief Executives head companies with a variety of corporate structures, including both widely held and majority controlled publicly traded corporations as well as privately held Canadian companies and wholly owned subsidiaries. Most of our recommendations are primarily relevant to publicly traded companies, but while good governance practices may take different forms in privately held companies, the underlying principles and values are important to the success of all of our enterprises and of our economy as a whole.



THE VALUE OF VALUES: THE CHALLENGE AND OPPORTUNITY FOR CANADA

A decade ago, Canada faced its own crisis of confidence. Spiraling government deficits, stubborn inflation and abrupt exposure to greater competition had our economy reeling. As governments raised taxes and slashed spending, family incomes stagnated and many feared that Canada's culture and values were doomed to be overrun by the harsh dictates of a global market.

But Canadians refused to give up. We admitted our weaknesses, took steps to address them, and steadily built on our strengths. Today, the benefits of our old-fashioned focus on fundamentals have become clear. Incomes are now rising more rapidly than in the United States. Our rate of job creation is the fastest in the G-7. So is the country's overall pace of economic growth. Ours is the only G-7 economy with a surplus in both the current account and total government budgets. In short, Canadians have shown that we can successfully pursue our own distinctive path within a highly integrated continental and global economy.

Today, Canada is strong, but global financial markets are facing a test of confidence. With a handful of exceptions over the years, Canada has by and large avoided fraudulent practices of the kind now making headlines. But the world's capital markets are highly integrated, and Canadians too are being affected by global events. Successful and enduring enterprises can only be built on a foundation of public trust, and investors today are feeling betrayed. Combined with the unraveling of the dot-com bubble, recent breaches of trust by a few major corporations have undermined the credibility of all businesses. The resulting fall in stock prices in turn has wiped out a huge portion of the value of public and private pension plans and threatened the dreams of millions of individual investors, their plans to fund university educations for sons and daughters and their hopes of future security.

“Strengthening confidence requires action from a wide range of capital market participants, including the accounting profession, corporate leaders, stock exchanges, regulators and governments. While private sector solutions are preferred in many areas, if they do not occur governments and regulators should be prepared to step in to ensure that public confidence is maintained in Canada's capital market system.”

Deputy Prime Minister and Finance Minister John Manley

We are confident in the underlying strength of Canadian enterprise and of the Canadian economy. But if the conditions that have so grievously wounded public trust are not addressed promptly and convincingly, we will put at risk the very market-based policy framework that has been so successful in building prosperity within Canada and globally and that remains the key to future growth.

Whenever any form of wrongdoing seems rampant, a call for more rules and tougher enforcement is understandable. While we recognize that governments may at times feel compelled to act, we would suggest that their goal must always be to preserve the strengths of a competitive market, not to suppress the initiative and risk-taking that is essential to human progress.



No law can prevent bad judgment or stop all criminal acts. *In the public and private sectors alike, the ability to earn trust depends utterly on the moral compass of those at the helm. Good governance, in the end, is not a set of rules, but rather an expression of values.*

“If countries are to reap the full benefits of the global capital market, and if they are to attract long-term ‘patient’ capital, corporate governance arrangements must be credible and well understood across borders.... To remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices so that they can meet new demands and grasp new opportunities.”

Organisation for Economic Co-operation and Development

Market forces have made commitment to values such as fairness, honesty and integrity into an important source of competitive advantage for companies and countries alike. Improving confidence in the integrity of Canadian markets helps Canadian companies to be more competitive by cutting their cost of capital, a key factor in enabling them to increase their pace of investment, create more jobs and generate higher returns. In other words, Canadian workers and investors both win when our country’s capital markets are strong.

The private sector took the lead in introducing improvements in governance in Canada in the early 1990s. *We believe that most of the actions needed in Canada to address issues of public confidence again can and must be taken within the private sector.*

Research by McKinsey & Company, for instance, has shown that governance has moved to the heart of investment decisions. More than 60 percent of the institutional investors it surveyed worldwide said corporate governance issues might lead them to avoid individual companies. An overwhelming majority also said that good governance effectively lowers a company’s cost of capital when they indicated that they would pay a premium for the shares of companies with high governance standards. In McKinsey’s 2001 survey, this premium ranged from a low of 11 percent in Canada to an average of 22 percent in Latin America and Asia and 30 percent or more in Eastern Europe and Africa.

Canada’s standing in this survey is clear evidence of high regard for the integrity of our country’s business environment and reporting standards. Research by other global organizations including the World Economic Forum, IMD and Transparency International confirms that *Canadian business leaders are considered to be among the most credible, most ethical, least corrupt and most value-driven managers in the world.*

“In an increasingly globalized world economy, competition is intense and good corporate governance can make a difference to how Canadian companies are viewed. There are benefits to being recognized as a country where excellence in corporate governance receives a high priority; these benefits accrue to individual Canadian companies when operating abroad, as well as to the entire Canadian capital market as viewed by international investors.”

Joint Committee on Corporate Governance



In terms of corporate governance, Canadian enterprises that do business or raise capital in equity markets in the United States clearly must be prepared to comply with whatever new rules are imposed there. But this necessary degree of integration need not prevent Canada from pursuing its own distinct strategy.

In a world rife with scandal, suspicion and finger-pointing, Canada continues to bring unique strengths to the table. Our labour market offers a talented, well-educated and multicultural workforce. Our business environment features increasingly competitive levels of corporate taxation. Our communities are renowned for offering a high quality of life. Our public service, police and judiciary are recognized worldwide for their honesty and integrity. Our multicultural society is a beacon of tolerance and diversity.

The very turmoil that has created so much market uncertainty therefore creates an opportunity for Canada to establish another important advantage in the global competition for people and investment. Establishing Canada's reputation as the location of choice for well-run and responsible enterprises would represent a powerful contribution to our broader goal of making this country *the best place in the world for people to live and to work and for enterprises to invest and to grow.*



WHO DOES WHAT: A FRAMEWORK FOR GOOD GOVERNANCE

Canada already is recognized as a country with high standards of ethics and corporate governance. Consider for example the findings of the 2001 Canadian Spencer Stuart Board Index, prepared in collaboration with the Clarkson Centre for Business Ethics and Board Effectiveness. It noted that among the top 100 widely held public companies in Canada, 70 percent now split the roles of chief executive officer and chair, compared with just 25 percent in the United States. Another 20 percent of Canadian boards have independent lead directors. Canadian boards are far more likely than their American counterparts to formally evaluate the performance of the board as a whole and more than twice as likely to evaluate individual directors. Canadian boards have a smaller percentage of related directors than American companies of comparable size, and Canadian chief executives sit on slightly fewer outside boards.

Looking at other key indicators of good governance within Canada's largest publicly traded companies, Spencer Stuart noted that 75 percent of audit committees and close to two thirds of human resource, compensation, nomination and governance committees are composed entirely of directors unrelated to management. Fully 80 percent of boards held meetings during 2001 without management present, up from 50 percent just three years earlier. On nine out of ten boards, directors are able to engage outside advisors to support their work, and Spencer Stuart says this practice "is well on its way to becoming universal in Canada". All of the companies in the index publish a statement of corporate governance in either their proxy circulars or annual reports.

Canadian standards not only compare favourably with those in the United States and the United Kingdom, but are considerably higher than those in most other industrialized nations in Europe and Asia. That said, there remains room for improvement.

"Free markets are not a jungle in which only the unscrupulous survive, or a financial free-for-all guided only by greed. The fundamentals of a free market -- buying and selling, saving and investing -- require clear rules and confidence in basic fairness."

United States President George W. Bush

Even before Enron, the United States had begun to make changes in response to recommendations such as those made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees that reported in 1999. More recently, the *Sarbanes-Oxley Act* adopted by the United States Congress has accelerated the pace of reforms being carried out by the Securities and Exchange Commission and major American stock exchanges. And in the United Kingdom, significant new work is being done both to address auditing and accounting issues and to enhance the effectiveness of non-executive directors.

In the face of these changes, Canada has not been standing still. For example, the response of the Toronto Stock Exchange to the November 2001 recommendations of the Joint Committee on Corporate Governance has been coupled with swift collaborative action by regulators and accountants to create a new oversight body for the accounting profession. More recently, the Canadian Institute of Chartered Accountants has published a draft set of new independence



standards for auditors, while the Accounting Standards Oversight Council has initiated discussion of whether Canada should change its accounting rules with respect to the expensing of stock options. More generally, the Ontario Securities Commission has launched a comprehensive review of the province's regulatory framework as it affects stock exchanges, accountants, lawyers, analysts and investment dealers.

In making our assessment of the best path forward for Canada, we recognize the reality of increasingly integrated continental and global financial markets. Many Canadian companies, because of the international scope of their activities, will be directly affected by new rules in other countries, especially the United States. Even within Canada, our enterprises and stock markets must compete for capital and therefore must win the continuing confidence of Canadian and foreign investors alike. This does not mean, however, that Canada should automatically follow the lead of the United States in every respect.

Canada starts in some respects from a stronger base. Our market has unique characteristics. And while our goal must be to achieve similar or better outcomes, there are more ways than one to improve corporate governance and to build investor confidence.

For example, there are two broad approaches to issues of both corporate governance and accounting practices: principles-based and rules-based. Rules-based standards can be very precise, but can only address specific known circumstances. Rules tend to lag as circumstances change, and this approach tends to encourage compliance with the letter of the law rather than its underlying principles. 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. The United States has traditionally favoured a rules-based approach; Canada, like most of Europe, has preferred standards based on principles.

"We believe that Canadian market issues demand made-in-Canada solutions."

David Brown, Chair, Ontario Securities Commission

This bias is reflected in the Canadian approach to improving corporate governance. Rather than requiring Canadian publicly traded companies to adopt specific governance practices, the Canadian approach has been to establish comprehensive guidelines and then to require disclosure of the extent to which companies comply and a public explanation of any discrepancies. Investors then reward or penalize individual companies accordingly. Recent reforms in the United States, by contrast, have been heavily oriented toward mandatory compliance with new legislation, regulation and stock exchange listing requirements.

As Canada continues to review the subject of corporate governance and the workings of its capital markets, we would suggest that a three-tiered approach is most likely to be effective. Initially, we believe that Canada's traditional emphasis on disclosure remains the most effective tool for enhancing the efficiency of markets. In an era of heightened investor skepticism and scrutiny, the quality of corporate governance is becoming a significant factor in the ability of enterprises to compete for capital.



Next, Canada's stock exchanges and self-regulating professions must monitor the resulting pattern of behaviour and decide whether and when it may be beneficial to make certain provisions mandatory within their areas of competence. Legislation and regulation by governments should be the last resort, and the onus should be on governments to prove prior to acting both that a legislative or regulatory response is necessary and that the specific measure proposed is the best way to solve the problem. In this respect, it is vital to ensure that the cumulative impact of legal and regulatory measures does not undermine the competitiveness of Canadian firms, the efficiency of our capital markets or the goal of effective governance.

“The Securities and Exchange Commission has a year to bring in regulations putting the Sarbanes-Oxley legislation into effect. The SEC estimates that it will take some 24 complex packages of new regulations to do the job.... It is inevitable, in something so sweeping and so new, that mistakes will be made and will have to be corrected. Corporate America faces, in consequence, the prospect of being whipsawed between mistakes, interpretations and corrections until their system of securities regulation settles again into relative stability.”

Barbara Stymiest, Chief Executive Officer, Toronto Stock Exchange

As Toronto Stock Exchange Chief Executive Officer Barbara Stymiest said in a letter to Ontario Securities Commission Chair David Brown on September 17, 2002, the OSC's recent review of 517 listed Canadian companies found no serious evidence of wrongdoing. If Canada's system of governance is working so well, she asked, what justification can there be for copying the “draconian and potentially costly measures” being taken in the United States? “It is not obvious to either of us,” she added, “that the best way to restore confidence in Canadian capital markets that are working is by making them more like American markets that are not.”

In considering how best to improve corporate governance in Canada, we should not start by assuming that the United States has all the answers. In governance as in other spheres, there may be instances in which regulatory harmonization becomes necessary, but we believe that there remains considerable scope to shape a made-in-Canada approach to today's challenges. What matters in the end is not what rules Canada puts in place, but whether Canada in fact achieves the desired outcomes in terms of corporate behaviour, public confidence, international reputation, market efficiency and competitiveness.

Transparency, accountability and integrity are the key elements of good governance, in the public and private sectors alike. The focus of this statement is on recommendations that we are making as chief executive officers for consideration by shareholders and their representatives on boards of directors. Many of these recommendations represent established practice among publicly traded companies in Canada, but bear repeating as part of a comprehensive framework. In addition, we suggest reforms that would build on this strong foundation and raise the bar for both boards and chief executive officers.

After laying out what can and should be done within the corporation, we reflect on the roles of auditors and the accounting profession, institutional shareholders, analysts and investment dealers, educational institutions, the mass media and other distributors of financial information, regulators and governments, and discuss how they might play more effective roles within a collaborative Canadian effort to ensure public confidence in the workings of the marketplace.



WITHIN THE CORPORATION: PRIORITIES FOR CHIEF EXECUTIVE OFFICERS AND BOARDS OF DIRECTORS

“The only fair risks are based on honest information. Tricking an investor into taking a risk is theft by another name. Corporate executives must set an ethical tone for their companies. They must understand the skepticism Americans feel and take action to set clear standards of right and wrong. Those who break the rules tarnish a great economic system that provides opportunities for all.”

United States President George W. Bush

CHIEF EXECUTIVE OFFICERS

Serving as the chief executive officer of a corporation is a privilege that comes with substantial responsibilities -- to our shareholders, to our employees, to our customers and suppliers and to the public. Our primary responsibility is to run the company well, in a manner that builds value for the shareholders who have entrusted us with their investments. Specific operational responsibilities include:

- Running the corporation’s day-to-day business operations;
- Leading the strategic planning process by developing plans, presenting them to the board, implementing them with board approval and suggesting changes as necessary;
- Developing annual operating plans and budgets for review by the board, and implementing them once approved;
- Recruiting, developing and retaining talented and motivated employees;
- Identifying and managing the risks that the corporation takes in the course of its business; and
- Putting in place and supervising a reporting system capable of producing financial statements that fairly present the corporation’s financial condition and enable investors to understand the business and to make investment decisions accordingly.

There is no one formula for sustained corporate growth. We would argue, however, that all successful strategies require the chief executive officer to earn trust on behalf of the corporation. The chief executive officer must earn the trust of managers and employees in order to recruit and retain the human resources needed for effective management of physical, intellectual and financial capital. He or she plays the lead role in persuading investors, both directly and indirectly through intermediaries such as financial analysts and the media, to trust the enterprise with their capital. And the reputation of the chief executive officer is critical to earning the trust of customers, suppliers and other stakeholders, building relationships that are essential to sustained growth in shareholder value.

To earn this trust, it is not enough for the chief executive officer to be highly skilled and competent. We also must personify the values of our enterprises, “walk the talk” of our ethical principles both within our enterprises and in the broader community. And while it is the right and responsibility of the board of directors, on behalf of shareholders, to determine corporate governance practices for the enterprise, we as chief executive officers can and should be a significant force for improvement by working with our boards to achieve the highest standards of governance.



To be effective in meeting these responsibilities, we must demonstrate leadership on three fronts. First, we must show that we are willing to be held accountable for our own performance. Second, we must champion a high standard of ethical conduct by all of our employees. Third, we must ensure that our values are reflected in the way our enterprises interact with the broader community, whether at home or abroad.

RECOMMENDATION 1

Trust and accountability. In addition to managing the corporation and delivering results for shareholders, we must report clearly and accurately on the results of our decisions and be accountable for our actions. To this end, we offer the following suggestions:

- a) **Compensation.** While the level and form of compensation is a matter to be decided by the boards of individual companies, we understand the frustration felt by investors when senior executives are rewarded handsomely for past performance that proves to be short-lived. We continue to believe that executive compensation should be tied significantly to both short and longer-term performance, but suggest that boards could consider a heavier emphasis on compensation tied to sustained appreciation in shareholder value.

This goal could be served through a variety of means. To take just two possible examples, boards could consider the payment of some or all of performance-based pay in the form of stock that must be held until retirement or departure, or a requirement that a significant portion of after-tax proceeds from the exercise of stock options remain invested in company shares for a minimum period.

- b) **Insider trading.** Shareholders and other investors have a right to know the extent to which our confidence in the future of our enterprises is reflected in the allocation of our personal investments. We are prepared to assist in the more rapid dissemination of insider trading information by filing reports on all of our transactions involving company stock, related derivatives and the exercise of options within two business days.
- c) **Certification.** In the past, we always have signed off on the accuracy of our companies' financial statements. We acknowledge, however, that the United States *Sarbanes-Oxley Act* has raised the bar in this respect. Even though this legislation may not apply to all Canadian companies, we believe that as Canadian chief executives, we should be prepared to offer a comparable certification of our annual and quarterly reports. In particular, in line with the new requirements in the United States, we are prepared to give our word and certify:
- That we have reviewed each annual and quarterly report;
 - Based on our knowledge, that the financial statements and information in the report fairly present in all material respects the financial condition and results of operations of the company and that the report neither contains any untrue material statement nor omits to state a material fact necessary to prevent the statements that are made from being misleading; and
 - That we have designed and put in place internal controls to make sure that material information is made known to us, and reported to the auditors and the audit committee on any significant deficiencies.



- d) **Legal penalties.** While such a certification by a Canadian chief executive officer would not necessarily be subject to the specific penalties prescribed for violations of the *Sarbanes-Oxley Act*, Canada's existing rules and regulations ensure that a material misrepresentation would expose chief executives to significant consequences through the courts and regulatory bodies as well as in the marketplace.

We would, however, encourage governments and regulators to enforce these rules more vigorously and ensure that penalties for violations better reflect the gravity of the offence. We also are prepared to support discussions among Canadian issuers, stock exchanges, regulators, institutional shareholders and others about whether additional measures might enhance the efficiency and reputation of Canadian equity markets.

- e) **Sanctions within compensation.** Just as boards decide how best to align the interests of chief executive officers with those of shareholders through the provision of bonuses and other incentives for meeting designated performance targets, compensation agreements also could provide for sanctions that would complement and reinforce legal and regulatory penalties. Boards could, for instance, consider a provision within employment agreements that would reduce, or require repayment of, relevant performance-based pay in the event of a material restatement of the company's financial results.

RECOMMENDATION 2

Code of ethics. In order to serve the interests of our shareholders, it is not enough to make business decisions guided only by what is permitted by the letter of the law. Sustainable growth in shareholder value requires that we set high ethical standards for operating our businesses and champion a corporate culture based on doing what is right. We recognize that it is the actions rather than just the words of the chief executive that sets the tone for the behaviour of employees within our companies and that determines the company's reputation with customers, suppliers and other stakeholders.

As a starting point for a corporate culture based on the idea that doing the right thing is essential for the sustainable growth of shareholder value, companies should have a written code of ethics or conduct. Whether a company chooses to adopt a code that is simple or elaborate, all employees should understand and agree to its terms as conditions of employment. Furthermore, it must have an effective reporting and enforcement mechanism, including a means for employees to alert management and the board to potential misconduct without fear of retribution. Violations of the code should be addressed promptly and effectively. The code should deal with:

- a) the purpose and values of the business;
- b) relationships with stakeholders including customers and suppliers, and with the media;
- c) compliance with the spirit and letter of the law at home and abroad;
- d) environmental protection;
- e) product quality and safety;
- f) workplace health and safety;
- g) employment practices, human rights and non-discrimination;



- h) employee and customer privacy;
- i) confidentiality and the use of the company's physical and intellectual property;
- j) conflicts of interest and insider trading;
- k) political contributions; and
- l) corporate and employee involvement in the community.

RECOMMENDATION 3

Corporate citizenship. The real value of a code of ethics lies in its application to the daily conduct of our businesses. Our businesses must live up to, and be seen living up to, the principles we espouse. Furthermore, we believe that the extent to which our companies demonstrate strong moral values and good corporate citizenship in the conduct of our business affects not only our own reputation and shareholder value, but also public perceptions of the free-enterprise system.

“Business behaviour can affect relationships among nations and the prosperity and well-being of us all. Business is often the first contact between nations and, by the way in which it causes social and economic changes, has a significant impact on the level of fear or confidence felt by people worldwide.”

Principles for Business, Caux Round Table

The recognition that companies must take into account the interests of a wide variety of stakeholders in order to serve the interests of their shareholders is expressed in a variety of ways. Some of the terms used are corporate social responsibility, corporate citizenship, the “triple bottom line” and sustainable development.

Each company must decide for itself how best to express and integrate its values with its business strategy. Many companies already subscribe to leading-edge principles and practices related to their particular industries and circumstances. In the chemical industry, for instance, the *Responsible Care* program initiated by Canadian companies is now a model that has been adopted across the industrialized world and increasingly in developing economies as well.

We would note, however, that there is strength in numbers, and suggest that participation in broader collective initiatives may serve both to build an individual company's reputation and to enhance public trust in the free enterprise system as a whole. Leading-edge initiatives that could be considered by those enterprises not already committed to them include:

- a) **Corporate citizenship globally.** The World Economic Forum in partnership with the Prince of Wales International Business Leaders Forum established a *Framework for Action* for global chief executives through the task force report *Global Corporate Citizenship: The Leadership Challenge for CEOs and Boards* published in January 2002. More broadly, the *Global Compact* launched by United Nations Secretary General Kofi Annan in 1999 has won the support of the International Chamber of Commerce.



- b) **Corporate citizenship in Canada.** The *Imagine* program of the Canadian Centre for Philanthropy is one of the world's first and most successful "percent clubs", through which companies commit a minimum share of profits to philanthropic purposes. It has had a meaningful impact in boosting corporate donations to charity in Canada and its list of Caring Companies includes about half of the members of the *Canadian Council of Chief Executives*. It is now being relaunched with an expanded mandate that measures and recognizes a broader range of corporate involvement in the community, emphasizes the leadership of the chief executive officer in fostering innovative partnerships and encourages greater public reporting of a company's actions in the community.

"Stockholders and other constituencies can reasonably expect that directors will exercise vigorous and diligent oversight over a corporation's affairs. However, they should not expect the board to micromanage the corporation's business."

The Business Roundtable (United States)

BOARDS OF DIRECTORS

The chief executive officer reports to shareholders through the board of directors, and the members of the board therefore are the central decision-makers in the practice of good corporate governance. To these men and women is entrusted the responsibility for ensuring that the decisions and actions of management do in fact serve the interests of shareholders, and in carrying out this responsibility, no set of rules will be sufficient without a high degree of commitment by strong, principled and competent directors. The board's core functions are well understood. They include:

- Choosing the chief executive officer, approving other key executive appointments and ensuring a succession plan;
- Ensuring that processes are in place for the recruitment, training and development of executives who exhibit the highest standards of integrity as well as competence;
- Overseeing management in the competent and ethical operation of the corporation;
- Monitoring and assessing the performance of the chief executive officer and setting compensation accordingly, and ensuring that an appropriate portion of compensation is tied to both the short and longer-term performance of the corporation;
- Advising management on significant issues;
- Overseeing the strategic planning process;
- Reviewing and approving significant corporate actions;
- Ensuring that systems and processes are in place to monitor the principal risks of the business;
- Ensuring a formal process for selecting and reviewing the performance of directors;
- Managing potential conflicts of interest;
- Selecting independent auditors and ensuring integrity and clarity of financial reporting;
- Monitoring the effectiveness of governance practices; and
- Overseeing the process of disclosure to shareholders and to the public.



Most recommendations worldwide for improving corporate governance centre on the structure and practices of the board of directors. In discussing detailed practices, we must recognize that one size does not fit all, that the size, sector, geographic locations, ownership structure and growth rates of different companies lead to different priorities at different times. In general, however, we recommend that to the extent corporations do not already follow these practices, boards, on behalf of shareholders, consider how best to achieve the underlying objectives of our recommendations.

One particular feature of the Canadian equity market is the relatively large proportion of publicly traded companies with controlling shareholders. For such companies, the recommendations in this statement will have to be interpreted and applied in a manner that reconciles the responsibilities and requirements of the controlling shareholder with the rights and expectations of other shareholders. We believe, for instance, that controlling shareholders are strongly motivated to monitor and assess objectively the performance of management and therefore should have the right to participate in all key committees of the board.

“Having independent directors, whose votes are not controlled by the CEO, is essential, of course, for any effective board of directors. However, we need to be careful that in the process, we do not create a competing set of directors and conflicting sources of power that are likely to impair a corporation’s effectiveness.”

United States Federal Reserve Board Chairman Alan Greenspan

RECOMMENDATION 4

Board independence. The relationship between the board and management is critical to building value for shareholders. On the one hand, a relationship that is adversarial or confrontational will be destructive; board and management must be able to work together effectively as a team. On the other hand, in order to protect the interests of shareholders, the board must be in a position to evaluate objectively the performance of the chief executive officer and take action accordingly. In order to achieve a degree of independence from management sufficient to perform its core oversight functions, we agree that:

- a) A substantial majority of the members of the board of directors should be independent of management;
- b) The audit, compensation, nominations and governance committees should be composed of a substantial majority of independent directors;
- c) Each committee of the board should have a written charter that addresses its purpose and responsibilities and requires it to report to the full board on a regular basis;
- d) The issue of independence is of critical importance and in this regard we endorse the *TSX Corporate Governance Guidelines* that stipulate that a director is independent of management if he or she is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director’s ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding;
- e) While management has an obligation to provide the board with appropriate and timely information, directors have an obligation to make further enquiries where necessary and therefore should have access to outside advisors;



- f) The board of directors should decide whether or not the chief executive officer should also serve as board chair, while recognizing that the trend in Canada and in several other jurisdictions is towards separation of the two functions; and
- g) If the positions of chair and chief executive officer are not separated, independent directors should elect and publicly disclose the name of a lead director who will preside at all meetings where management is not present and be responsible for ensuring that the board is in a position to act independently of management when necessary.

“We believe that it is important to emphasize the significance of, and our support for, continuing education for directors.”

Joint Committee on Corporate Governance

RECOMMENDATION 5

Board recruitment and development. In determining the optimal number and mix of board members, we agree that each board should:

- a) Ensure that there is a formal and transparent procedure for the nomination of directors for election and re-election to the board, usually through a nominations committee. In doing so, it should ensure that the number of directors and their mix of skills and competencies is aligned with the corporation’s strategy;
- b) Ensure that while necessary competencies remain the pre-requisite for election to the board, it takes into account other factors including candidates’ employment obligations and other board commitments, character and other personal qualities, and the benefits of diversity;
- c) Ensure that prospective directors understand the demands and expectations of the company; that they have informed the chairs of any other boards on which they already sit; that they are willing to offer their resignations in the event of any significant change in their primary occupation; and that their other corporate interests be formally recorded so that management and the board can manage potential conflicts of interest effectively;
- d) Provide an orientation program for new directors to familiarize them with the company’s strategic plan, significant financial, accounting and risk issues, compliance programs, conflict policies, principal officers and internal and external auditors;
- e) Provide ongoing educational opportunities to directors to prepare them for emerging issues and to take steps to remedy any performance deficiencies identified; and
- f) Plan for the departure of directors and designation of new members through procedures that may include regular peer review, a mandatory retirement age or term limits.



RECOMMENDATION 6

Audit committee. The audit committee plays a critical role in ensuring that the corporation's financial performance is reported fully, fairly and accurately to regulators and to investors on a timely basis. This requires members who are prepared to spend the time necessary to address effectively the complex issues involved and to challenge management where necessary. In addition to being composed of a substantial majority of independent directors, the audit committee therefore should:

- a) Ensure that each member is financially literate and that at least one member has accounting or related financial management expertise;
- b) Have the ability to oversee all internal audit functions and have full access to company books and records and to outside resources and advice as well as whatever funding is required to carry out its duties;
- c) Subject to the direction of the shareholders with respect to the appointment and remuneration of the company's independent auditors, be directly responsible for the oversight of their work. The letter of engagement to the auditor should bear the signature of the committee's chair, supported by those of any other officers or directors needed to bind the corporation;
- d) Adopt whatever policies it considers necessary to ensure the external auditor's independence in fact and in appearance, including the identification and disclosure of the types of non-audit services it considers incompatible with the principles underlying independence and the approval and disclosure of any non-audit services provided to the company by its audit firm;
- e) Ensure an effective separation of the internal and external audit functions through policies that could include a prohibition on the provision of internal and external audit services by the same or affiliated firms or a cooling-off period before an audit partner or member of the auditing team can be hired as the company's chief executive officer, chief financial officer or controller;
- f) Ensure that all "pro forma" earnings releases are reconciled to generally accepted accounting principles, and where more than one treatment or interpretation of an item is acceptable under generally accepted accounting principles, discuss fully with the auditors which treatment should be considered preferable under the circumstances;
- g) Hold sessions with both internal and external auditors without management attendance on a regular basis;
- h) Ensure that effective procedures are put in place for the receipt, retention and treatment of complaints regarding matters of accounting, financial reporting and related internal controls; and
- i) Periodically discuss other financial issues including: proposed changes to accounting policies or the method of application of new accounting standards; the financial information provided in public communications such as news releases; risk assessment and risk management; accounting judgments and quality control; and internal controls and audits.



RECOMMENDATION 7

Assessment and compensation practices. Monitoring and assessing the ongoing performance of the business, the executive team, the chief executive officer, and the effectiveness of the board itself, is another critical function of the board, and one that is usually assigned to the Human Resource and Compensation Committee or the Governance Committee. Like the audit committee, these committees need to demonstrate independence and to act independently to be effective, and should be composed of a substantial majority of independent directors. Either directly or through such committees, the board should:

- a) Ensure a regular assessment of the effectiveness of the board as a whole, of its committees and of the contributions of individual members;
- b) Ensure that the compensation of directors, especially of those acting as lead directors or committee chairs, reflects the responsibilities they are assuming;
- c) Review annually the performance of the chief executive officer and review with the chief executive officer the evaluation of senior management;
- d) Review and approve the compensation package for the chief executive officer and senior executives;
- e) Prohibit loans of a personal nature to directors and executive officers except for those made by financial institutions in the ordinary course of business and those made for specific corporate purposes such as relocation or the purchase of a minimum shareholding required as a condition of employment;
- f) Ensure that directors have sufficient time to consider large or particularly complex compensation or human resource proposals, including the opportunity to request additional information and access to external advisors;
- g) Ensure that the agenda for each meeting of a committee dealing with human resource or compensation issues includes as a matter of course a session without management attendance; and
- h) Have a continuing process for succession planning that includes an updated profile of the qualities needed in the chief executive officer; the recruitment, training and development of executives who exhibit the highest standards of integrity as well as competence; and contingency plans for the departure, death or disability of top executives.



“In the last decade, management has faced increased market pressures for short-term stock price performance and corresponding pressures to satisfy market expectations on a quarterly basis. This, coupled with increased reliance on forms of compensation that focus on short-term stock appreciation, may have created incentives that tipped the balance toward the promotion of self-interest rather than the protection and promotion of long-term shareholder value.”

*Ira M. Millstein, Co-Chairman, Blue Ribbon Committee on
Improving the Effectiveness of Corporate Audit Committees*

RECOMMENDATION 8

Equity compensation. Investors are demanding a clearer picture of the impact of different forms of compensation on current and future earnings, a trend recognized in Canada by the recent decision of the Accounting Standards Oversight Council to consider whether Canadian companies should be required to expense the cost of stock options even before the United States takes such a step. To ensure that the efforts of individual companies to disclose such costs in fact improve transparency in the market, we support the rapid development of a consistent reporting framework that will enable investors to make fair comparisons between companies.

Whether through stock options or other means, a corporation’s compensation practices should give management and employees a significant incentive to focus on sustainable growth in shareholder value. The interests of directors also should be aligned with this goal. To this end, the board should:

- a) Provide a meaningful portion of the compensation of directors in the form of long-term equity or require directors to buy and hold a meaningful amount of stock as long as they remain on the board;
- b) Ensure that the design of compensation to management and employees reflects an appropriate balance between the short and longer-term performance of the company. It is especially important to avoid unintended incentives such as an undue emphasis on short-term changes in the stock price;
- c) Calculate and disclose in the financial statements a fair evaluation of the cost of stock options and other forms of equity compensation;
- d) Prohibit directors and senior officers from trading the company’s shares or other securities during any pension fund or employee retirement plan blackout period; and
- e) Enable shareholders to vote on all compensation plans involving the granting of stock options or the issuance of shares.



“I challenge business leaders to take strong action to ensure that corporate governance in Canada passes the test of transparency and contributes to confidence in our institutions, confidence that is the pillar of the entire economy.”

Prime Minister Jean Chrétien

RECOMMENDATION 9

Transparency and disclosure. Major corporate investments inherently involve risk, and often ask shareholders to forego immediate returns in order to create greater wealth over time. Given the nature of financial markets today, this requires boards and management to manage the expectations of shareholders and to encourage intermediaries such as analysts and journalists to understand the trade-offs being considered as companies develop and act on their strategic plans.

To be credible in explaining their strategies, however, it is essential for companies to communicate in plain language wherever possible, and to be as open as they can within the constraints of legal and regulatory requirements and of a competitive marketplace. In particular, companies must not only practice good governance, but be seen to be doing so. To this end, each board should:

- a) Adopt and disclose its corporate governance guidelines in its annual report, management information circular or through other publicly accessible means such as its corporate website. Each board must decide what level of detail would best support investor confidence in the company, but disclosure of governance guidelines and practices could extend to board roles and responsibilities, board composition and size, board independence, director qualifications, mandate and membership of committees, director access to management and to outside advisors, director compensation, director orientation and continuing education, board and management succession planning, board and management performance evaluation, extent of directors' shareholdings, and the number of board and committee meetings and attendance rates;
- b) Adopt and disclose publicly a code of business conduct and ethics for directors, officers and employees and encourage the reporting of illegal or unethical behaviour;
- c) Ensure the visible independence of auditors by disclosing all fees paid to the audit firm and to any affiliated firms or organizations;
- d) Disclose all sources and forms of compensation of executive compensation as well as the company's underlying executive compensation policies;
- e) Contribute to market transparency by requiring disclosure of all exercises of stock options and all trades in the company's stock and related derivatives by corporate insiders within two business days, and encourage regulators to ensure prompt public distribution of this information; and
- f) Reconsider current communications policies such as the provision of quarterly earnings guidance that may be having the unintended effect of encouraging investors to focus excessively on short-term results rather than the progress of the company's longer-term strategy.



BEYOND THE CORPORATION: TOWARD A COLLABORATIVE STRATEGY FOR IMPROVING GOVERNANCE

Chief executive officers and boards of directors alone cannot resolve all of the public's current concerns. Our ability to use high standards of corporate governance to improve the competitive performance of our enterprises relies to a considerable extent on the influence of many other people and organizations, and restoring public confidence will require actions that extend well beyond boardrooms and executive suites.

We would suggest that the best path forward for our country lies in continuing the high level of collaboration between the public and private sectors that has worked so well in the past. More broadly, though, we suggest that *everybody who participates in or influences the process of corporate decision-making -- shareholders, directors, executives, employees, accountants, financial analysts, journalists and educators as well as government officials and regulators -- can and must be part of Canada's strategy.* To this end, we offer some reflections on actions that are being taken and could be taken by some of these other key actors.

AUDITORS AND ACCOUNTING FIRMS

Companies and their shareholders rely heavily on the honesty and competence of their independent auditors. While it is the responsibility of the board and its audit committee to recommend the appointment of the auditor and to supervise its work, it also is the responsibility of the auditing firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with generally accepted auditing standards. Also, the auditor has a responsibility to inform the board of any concerns it may have about matters such as the appropriateness or quality of accounting treatments and weaknesses in internal controls. In particular, where more than one treatment is acceptable under generally accepted accounting principles, the auditor has a responsibility to discuss the ramifications of these alternatives with the audit committee and be prepared to indicate which treatment in its view is preferable under the circumstances.

“Information is the lifeblood of the capital markets. Investors risk their hard-earned capital in the markets in great measure based on information they receive from their target companies. They need reliable information on a timely basis. They want it in language they can understand, and they should receive it in formats they can easily use for analysis.”

*Samuel A DiPiazza Jr. and Robert G. Eccles
Building Public Trust: The Future of Corporate Reporting*

The accounting scandals in the United States have already led to a legislative response there. The *Sarbanes-Oxley Act* among other measures established a Public Company Accounting Oversight Board to set auditing, quality control and independence standards for all auditors of public companies. In Canada, a similar result has been achieved collaboratively by federal and provincial regulators and the Canadian Institute of Chartered Accountants.



They have worked together to create a new Canadian Public Accountability Board made up of eleven individuals, seven from outside the accounting profession. This new oversight board will in turn require firms auditing public companies in Canada to: undergo more frequent and rigorous inspections; accelerate the adoption of tougher standards on auditor independence, including limits on the types of non-audit services that can be provided to audit clients; rotate the lead partner on an audit on a regular basis; have a second partner review each audit; and ensure that consultation takes place on difficult, sensitive or contentious issues.

“It takes a long time for rules to catch up to what’s going on out there, and rules also encourage loophole hunting and finding ways to get around them. With the principles, you know where you have to get with regard to independence in any situation you’re in.”

*Donald Wray, Chair, Public Interest and Integrity Committee,
Canadian Institute of Chartered Accountants*

In early September 2002, the Canadian Institute of Chartered Accountants released new draft independence standards to apply to Canadian auditors. The proposed package includes a few measures intended to harmonize with recent legislative and regulatory changes in the United States, notably the requirement to rotate the lead partner on an audit at least once every five years and to establish a specific list of services that auditors would be prohibited from supplying to audit clients. At the same time, however, it proposes a uniquely Canadian approach by combining some of the new hard-and-fast rules of the United States Securities and Exchange Commission with a more fundamental shift from a rules-based to a more rigorous principles-based independence code.

This principles-based approach, consistent with that of the International Federation of Accountants, requires auditors to be proactive in ensuring that their independence is not threatened. The proposed CICA principles recognize that a wide range of activities, interests and relationships may threaten auditor independence. These include:

- Self-review threats which occur when practitioners find themselves reviewing their own work;
- Self-interest threats which occur when an auditor could benefit from a financial interest in a client;
- Advocacy threats which occur when an auditor acts on a client’s behalf in situations such as a legal dispute or stock promotion;
- Familiarity threats which can occur through long involvement with a particular company or more specifically as a result of having a relative in a client company’s management or accepting significant hospitality from a client; and
- Intimidation threats which can occur when a client puts pressure on an auditor in a disagreement either over accounting treatment or over fees.

In addition to changes in the structure and process of regulatory oversight, recent events have other implications for major audit firms. There will be substantial change in the nature of the services provided by outside auditors and the manner in which they relate to the companies they audit. Even as the scope for provision of non-audit services by auditing firms is reduced, they are likely to experience increased demand for audit-related services flowing from broader



and more substantive certifications being required of senior executives. This could require enhancing the scope and substance of audit reports to shareholders and the services provided by auditors to audit committees as well as expansion of the audit opinion to address such issues as management estimates, the possibility of fraud, risks, liquidity and future scenarios.

At the same time, we would encourage standard setters both at home and abroad to address the specific issues that have come to the fore in recent months. In particular, it is urgent to develop a consistent framework for corporate reporting of the costs associated with stock options and we would support the recent initiative of the Accounting Standards Oversight Council toward this end. We would hope that corporate directors and senior managers will be engaged actively in the development of such standards.

Both on the issue of stock options and more broadly, it is important to recognize that global financial markets are highly integrated. We therefore consider it important for Canadians to play an active role in improving transparency across national borders and helping to accelerate the development of a globally accepted standard for accounting principles.

INSTITUTIONAL SHAREHOLDERS

Whether in a small start-up venture or a multinational enterprise, shareholders take the risk of investing their money in the expectation of earning a suitable return. Decisions by individual investors in a public company to buy or sell shares reflect their degree of confidence in the abilities of management and in the company's strategy for delivering competitive returns. But companies tend to work best when they are able to attract shareholders willing to commit their capital for the long term and therefore to engage in the governance process. Shareholder participation in governance is as important to companies as citizen engagement is to the functioning of democracies, and company management and regulators therefore share a corresponding responsibility to enable active participation by shareholders.

“Shareholders, through the boards of directors, and working within government regulations are responsible for setting acceptable standards of corporate governance. Management is responsible for setting ethical standards for its behaviour and is accountable for its actions. It is neither the responsibility nor the prerogative of management to set the standards for corporate governance.”

Ontario Teachers' Pension Plan Board

Most individual investors hold shares indirectly through pension funds and mutual funds. These institutional investors therefore control a large portion of the equity of publicly-traded Canadian companies and account for the vast majority of the trades made on Canadian stock exchanges every day. Some institutions have used their clout to become powerful agents of reform in corporate governance. Others, however, have been equally influential in pushing for quick returns and reacting instantaneously to quarterly earnings reports. This latter trend may be driven in part by the compensation of institutional managers themselves to the extent that this is related to the short-term performance of assets under management. The resulting decisions of such managers can be inconsistent with the recommendations of many institutional investors for better governance and a stronger focus on long-term strategy.



Because of the sheer size of their holdings, institutional shareholders are exerting a growing influence on a wide range of corporate decisions. As early as 1996, our survey of members of what was then the Business Council on National Issues revealed a significant degree of influence over corporate strategy, executive compensation and the choice of directors together with moderate interest in operational decisions including investments in new plant and equipment and moves to add or cut jobs. In addition, 43 percent of the responding chief executive officers said short-term stock price performance rather than long-term growth had become the dominant concern of institutions as a group, with two-thirds identifying mutual fund managers as those most likely to want shareholder value maximized now rather than over the long haul.

As chief executives, it is our responsibility to earn the confidence of current and potential shareholders. We cannot dictate their goals or require them to commit to the long-term growth of our enterprises. But we agree that to the extent better governance practices will contribute to maximizing the sustainable growth of shareholder value, transparency and accountability must start here.

Institutional investors are a major force for improving corporate governance. We recognize the valuable work that is being done by organizations such as the Ontario Teachers' Pension Plan Board in publishing both their detailed proxy voting record and the broad principles that guide their decisions as shareholders committed to good governance. We would encourage all institutional investors to follow suit by adopting and publishing proxy voting guidelines that indicate general preferences on governance issues but leave room for judgment to be exercised on a case by case basis, as well as disclosing proxy voting records of decisions that are fully within the discretion of the institutional manager.

More generally, we would encourage institutional investors to practice the same degree of transparency and disclosure as they favour in the corporations in which they invest. This could involve disclosure of additional information such as the compensation of top institutional managers as well as the institution's underlying executive compensation policies, especially those linked to the short and long-term performance of assets under management.

ANALYSTS AND INVESTMENT DEALERS

“ When the day is done, the most effective way to develop the independence and professionalism of analysts employed by dealer firms is for the dealers' boards of directors and chief executive officers to “walk the talk” of good governance and strong ethics.”

Securities Industry Committee on Analyst Standards

Investment dealers play two key roles in capital markets: helping enterprises to attract investors and helping investors find appropriate vehicles for their investments. These dual roles impose a heavy responsibility that goes well beyond the strict legal requirements of a prospectus. As the current situation demonstrates clearly, however, the goal of encouraging greater public participation in equity markets can only be achieved if analysts give unbiased and competent advice that avoids or at least discloses any actual or potential conflicts. The particularly wide gap between certain analyst recommendations and subsequent stock performance in parts of



the high technology sector in recent years suggests the need for substantial action by third-party analysts and their employers.

The key issues in this sector, including potential conflicts of interest, internal reporting relationships and disclosure requirements, have been extensively reviewed by the Securities Industry Committee on Analyst Standards and addressed in its final report in October 2001. We endorse the report's recommendations and support the subsequent efforts of the Investment Dealers Association, the Toronto Stock Exchange, securities regulators and others to take action based on these recommendations.

EDUCATIONAL INSTITUTIONS

While academia may seem far removed from boardrooms and trading floors, we cannot expect tomorrow's employees, managers and directors to be champions of a high standard of ethical behaviour in the workplace unless these principles are integrated into the educational system.

Within our elementary and secondary schools, it is important for all children to be exposed as early as possible to the consequences of ethical breaches such as cheating and to acquire the basic economic and financial literacy required to participate effectively in the democratic process and to manage personal and family decisions about savings and investment.

At a more advanced level, we would suggest that Canada's business schools should consider how more effectively to integrate ethical principles and their application to the workplace into all of their undergraduate and graduate courses. In addition, we would encourage efforts to expand research into the links between the practice of good corporate citizenship and high ethical standards and superior corporate performance in a competitive global market.

MEDIA AND INFORMATION DISTRIBUTORS

Most individual investors rely not on the detailed documents disclosed by companies, but on the summaries and interpretations of corporate information provided through the mass media. Furthermore, while companies are not the sole source of information available to investors, only the information provided directly is subject to extensive regulation.

The transparency so essential to efficient markets therefore depends heavily on the competence and honesty of all individuals and companies involved in the distribution of corporate information and analysis. Effective management of potential conflicts of interest is as important here as within publicly traded corporations, investment dealers, accounting firms and regulatory bodies.

Reporters and editors bear a heavy responsibility both to report facts accurately and to exercise judgment in asking questions of companies and other sources, in assessing the interests and potential biases of those providing information and in helping their audiences to understand the meaning of the information that is available. A greater emphasis on helping investors to understand and evaluate the longer-term strategies being pursued by public companies also would contribute to unwinding the current focus on quarter-by-quarter results.



GOVERNMENTS AND REGULATORS

“I think in Canada we have an excellent system of corporate governance. I think Canadians should have every confidence in our regulators.”

Industry Minister Allan Rock

The value of markets to society flows from the interplay of conflicting ideas, and free enterprise can only flourish with the support of numerous individuals willing to invest their time and money in ventures that by their very nature involve risk. Markets that succeed in fostering a high degree of innovation inevitably will generate significant numbers of business failures as well. The rule of law is vital to the efficient functioning of free markets, and violations of rules designed to protect the integrity of markets should be punished severely. The rules governing markets have to evolve as circumstances change, but simply adding rules does not necessarily make markets work better. Indeed, an excess of rules and regulations can easily suffocate the very spirit of innovation and risk-taking that makes markets so successful in driving human progress.

On the whole, Canada’s legal framework has worked well to protect investors and to provide a solid foundation for business growth, and we believe that most of the actions needed in Canada to restore confidence in equity markets and the integrity of business leadership can and should be achieved within the private sector. But governments too play important roles and Canadians will be served best when businesses and governments work as a team. Business depends on government to foster the right environment; our responsibility in turn is to make the most of that environment as we build competitive enterprises that create jobs and increase prosperity.

“Our view is that disclosure is a much better approach than attempting to regulate behaviour, if one is seeking to build a healthy governance culture. Indeed, we believe that regulation aimed at changing board behaviour may turn out to be counterproductive.”

Joint Committee on Corporate Governance

We agree with the belief expressed by Ontario Securities Commission Chair David Brown that Canadian market issues demand made-in-Canada solutions. As he pointed out in a letter to all capital market participants in early September, 2002, some Canadian rules such as our requirement for immediate disclosure of material changes are already even more robust than the most recent measures taken by American legislators and regulators. In other cases, he noted that differences in market structure make American measures inappropriate here or demand different tools or unique responses in order to preserve the competitiveness of all traded companies including smaller issuers. Our only point of departure is with respect to the Commission’s decision to base its current wide-ranging review “on the assumption that it makes regulatory sense to harmonize the U.S. initiatives unless there are cogent reasons for not doing so.” We look forward to participating in a constructive dialogue in the months ahead on the issue of what path forward will best serve the interests of Canadian markets, Canadian shareholders and Canadian enterprises.

In our view, Canada’s approach to improving corporate governance should continue to emphasize consultation and collaboration rather than coercive legislation as in the United States. In taking this position, we are not suggesting that the expected standard of practice in



Canada should be anything less than the best. Rather, we believe that Canada can achieve similar or better results in terms of maintaining and building confidence in our markets through a combination of means that are less likely to damage the competitiveness of Canadian enterprises.

“In the midst of the mounting number of corporate failures, we've also witnessed unprecedented efforts by the private sector to acknowledge problems in the system and try to solve them.”

United States Securities and Exchange Commission Chairman Harvey Pitt

To protect Canadian investors and to support the competitiveness of Canadian financial markets and Canadian-based enterprises, we would suggest that governments and regulators focus in particular on action in the following areas:

Enforcement. Canada has no shortage of laws, but the existing rules and regulations have not always been consistently or vigorously enforced. Governments and regulatory agencies should act swiftly to prosecute violations of the law by companies, executives, directors and auditors for violations of public trust, and penalties should include confiscation of illegally obtained gains and significant jail terms where justified by the degree of the offence. To this end, governments should ensure that regulators are able to recruit, retain and develop high quality employees and have sufficient funding to do their jobs effectively.

Disclosure. Regulators should continue to rely primarily on requirements for transparency and public disclosure as the most flexible and effective lever for enabling markets to reward good governance. However, it is essential for regulatory agencies to do their part in ensuring that corporate disclosures such as insider trading transactions flow through to the public much faster than they do presently.

New regulation. While we believe that most of the actions necessary to improve corporate governance practices can and should be carried out within the private sector, we agree that governments should monitor progress and act accordingly. But regulation should be a last resort, and the onus should be on governments to prove prior to acting both that a legislative or regulatory response is necessary and that the specific measure proposed is the best way to solve the problem. It also is vital for governments and regulators to ensure that the cumulative impact of legal and regulatory measures does not so burden executives or affect the recruitment of directors that the competitiveness of Canadian firms is undermined or that the goal of effective governance is impaired.

Collaboration across jurisdictions. Governments and regulators must work effectively across jurisdictional boundaries to ensure that Canadian markets work as seamlessly and efficiently as possible. In particular, we urge provincial governments to reconsider their long-standing opposition to a national securities regulator. Consolidating the regulatory process would both improve efficiency and ensure a high and consistent standard for corporate governance from coast to coast.

Governance in the public sector. Free markets rely on good government. It therefore is vital for political leaders and senior government officials to demonstrate their commitment to a degree of transparency and accountability comparable to that which they expect and require in the private sector, and for departments, agencies and Crown corporations to maintain similarly high standards of governance and in particular to adopt and disclose comparable codes of conduct and ethics.



A COMMITMENT TO LEADERSHIP

Individually, as chief executive officers, directors and often significant shareholders, we have a responsibility to guide our companies through the current market turmoil. Collectively, we share other responsibilities as well.

Canadians should be able to count on business leaders to instill confidence in the integrity of our financial markets; to add to Canada's reputation as a country that is well-governed and home to well-run enterprises; and to help Canada in its continuing quest to spread the benefits of democracy and free markets to the less fortunate around the world.

We are determined to live up to these expectations. To this end, we make a commitment to all Canadians, a commitment to leadership on three fronts:

In the economy. Canada's largest enterprises already account for a disproportionate share of private-sector research and investment in training. We are leaders in improving productivity, in the adoption of new technologies, in the development of products for export and in wage rates.

As the chief executive officers of large enterprises, we commit ourselves to a leadership role in driving Canada's economy forward through innovation, both within our own enterprises and by encouraging action by smaller and medium-sized enterprises, working through our customer and supply chains, through industry associations and with colleges, universities and other educational institutions.

Furthermore, we commit to acting as ambassadors for Canada abroad, enhancing our country's reputation as a desirable place to work and to invest and helping to forge new bilateral and multilateral agreements that will add to the prosperity of Canadians and to others around the world.

In corporate governance. As chief executives, we rededicate ourselves to upholding the highest standards of ethical behaviour in carrying out our responsibilities to our shareholders and other stakeholders. Within our individual enterprises, we will support our boards of directors in implementing the highest standards of corporate governance. And collectively, we commit ourselves to encouraging the identification and adoption of improved governance practices within all organizations with which we deal, in the private, public and non-profit sectors. In particular, as the chief executive officers of major Canadian enterprises, we will support the efforts of smaller and newer publicly traded companies to move quickly toward global best practices in governance.

In corporate citizenship. We recognize that to be effective in sustaining and building shareholder value, managers and employees must practice what they preach. Good corporate citizenship at home and abroad, including respect for human rights, environmental stewardship and community investment, plays an essential role in enhancing public trust, attracting and retaining talented people and reducing investor perceptions of risk. We therefore commit ourselves to continuing to review our strategies and practices with respect to corporate citizenship and considering on an ongoing basis innovative approaches that are consistent with our duty to shareholders.



As the headlines of the past two years attest, the irresponsible exploitation of capitalism can lead to excess. But the free market system is also remarkably resilient and continues to do a better job than any of the alternatives of identifying and calling to account those who fail in their responsibilities. The fact remains that free enterprise has contributed immensely to human progress by providing ways for innovative and talented people to work together.

As the scale and complexity of the challenges facing the world have increased, financial markets have taken on a crucial role in enabling good ideas to get the backing they need. Business investment bears intrinsic and unavoidable risks, and the failure of companies is a necessary part of the process of finding the best paths forward. But there can be no tolerance in this process for deliberate deceit, and we encourage governments and regulators in the United States, in Canada and elsewhere to prosecute and punish violations of the law. At the same time, we urge governments not to undermine the very strengths of the system they are trying to protect by going too far in restricting business judgment and initiative.

At its core, free enterprise is about hope, about providing avenues for people to pursue their dreams of better lives for themselves and their children. The recent rash of corporate scandals has compounded the impact of a cyclical downturn in the markets and dashed the hopes of many investors in the short term. But the current turmoil reinforces the need for Canadians to stay true to their values, to learn from the mistakes that have been made and to build on Canada's many strengths as we look to the future.

Canada has made huge progress during its 135-year history and in particular during the past decade. We believe that this country has even greater potential waiting to be unleashed. Three years ago, in our Council's *Canada Global Leadership Initiative*, we suggested that Canada should aim for nothing less than to become "*the best place in the world in which to live, to work, to invest and to grow.*" We promise to do our part in helping Canadians to achieve this goal together.



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CANADIAN COUNCIL OF CHIEF EXECUTIVES

The Canadian Council of Chief Executives is Canada's premier business organization. Composed of the chief executives of 150 of the country's leading enterprises, it engages in research, consultation and advocacy on a wide variety of public policy issues including fiscal and monetary policy, international trade and investment, education, health and the environment, foreign policy and security, and corporate governance.

A non-profit, non-partisan organization, member companies administer in excess of C\$2.1 trillion in assets, have a yearly turnover of over C\$500 billion and are responsible for the vast majority of Canadian investment, exports and research and development.

The Council's mission is to be the world leader among CEO-based business associations in advancing sound public policy ideas and solutions. In 2001, the Council celebrated its 25th anniversary and through its *Canada Global Leadership Initiative* committed itself to help make Canada "*the best place in the world in which to live, to work, to invest and to grow.*"