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BACKGROUND PAPER ON "CONFIDENCE CONTROL AND COMPENSATION IN THE MODERN CORPORATION" LA SAPINIÈRE, SEPTEMBER 5 TO 7, 2003

Introduction[*]

Corporate Governance is being challenged as never before. Public confidence in the corporate governance regime is critical to the success of the capital markets and, indeed, to the success of the free market system. That confidence has been hugely eroded during the past few years. Instances of specific corporate débacles spring quickly to mind: Enron, WorldCom, etc. The spree taken by the markets during the dot com boom, followed by a major wealth-destroying decline embittered investors, and carried even more of the responsibility for the erosion of public confidence.

Challenges beget opportunities. The post-Enron focus of legislative, regulatory and community attention on corporate governance has created an extraordinary opportunity to identify, and to apply, the teachings from these market experiences. The quick passage of the *Sarbanes-Oxley Act* through the United States Congress well illustrates the scope of the opportunity.

[*] We have not provided an Executive Summary. But the reader in a hurry might wish to read the last two sections only, starting at page ■. The opening portion of the discussion provides background for the views expressed in those two sections.

Conferences such as this one have been held in their hundreds. The atmosphere is electric with change.

Pre-Enron, there were a few key elements of corporate governance for public corporations.* The affairs of a public corporation were primarily in the hands of executive management. It was supervised by a board of directors, some of whose members were required to be independent. Many commentators favoured separation of the positions of Chair and CEO, but this was not the norm. The board was required to establish an audit committee, composed primarily of independent directors. The audit committee reviewed management's financial statements, which were reported on by external auditors. The external auditors were required to satisfy professional standards dictated by regulators and by their professional bodies. Among the topics addressed by the board of directors was the compensation of executive management. Equity compensation, including stock options, was a major topic of discussion, focussing primarily on whether stock options should be expensed.

How have the post-Enron changes affected matters?

Executive management continues to be supervised by a board of directors, but with significantly toughened independence requirements either implemented or under development in most jurisdictions. The emphasis on separation of the functions of Chair and CEO is steadily increasing. Rules surrounding audit committees, as to their independence and as to the extent of responsibilities they must perform, are becoming significantly more onerous. New governmental

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* Here, as throughout the paper, we deal primarily with the model in Canada, the United Kingdom and the United States; we are well aware that different regimes exist on the Continent of Europe and hope there will be some discussion of them during the Ditchley conference.

or quasi-governmental agencies have been established to supervise external auditors, and the rules surrounding their relationships with the public corporations they audit have become stricter. It now seems clear that the expensing of stock options will be generally required. All of these changes represent extension and toughening of the key elements of corporate governance previously in force.

Granted, Sarbanes-Oxley did bring some significant innovations. The most important of these, in our view, are the requirement for CEO/CFO certification of financial statements and the section 404 requirements concerning internal controls. We recognize that the certification requirement puts CEOs and CFOs under great pressure, but that is exactly what was intended. We believe the requirement is beneficial, particularly since most corporations are responding to it by developing an internal arrangement for confirmatory reports by division heads and other members of management, upon which the CEO and the CFO can rely in their provision of the required certification.

We are more sceptical about the internal controls requirement. It seems to us a gift to the audit profession, involving substantial cost that might well prove disproportionate to ultimate benefit. It is focused more on a series of inputs -- i.e. a set of steps required by the auditors -- than on outputs -- i.e. satisfactory controls. The CEO/CFO certification focuses much more on outputs. Essentially it says to the CEO/CFO: “We don’t care how you prepare the basis for certification. Just do it and if you don’t do it well, you will go to jail.” That leaves the specifics up to the people who should know best -- the CEO and CFO -- rather than auditors, who earn more fees with a more onerous section 404 process. Analytically, this would lead us to expect the internal arrangements for confirmatory reports developed to support CEO/CFO certification would be more beneficial than the innovations that are already beginning to be wrought in response to section 404, although it has not yet become effective. Anecdotally, based on the brief experience to date with the new regime, that is the result which we see emerging.

But what is important for present purposes is that the CEO/CFO certification and internal controls regime, while innovative, are peripheral to the mainstream of corporate governance. They do not detract from the general comment that the key elements of the regime are unchanged, except by being made more rigorous.

When an important tool breaks, a knee-jerk reaction is to replicate it in tougher material -- steel instead of iron. But the careful engineer will consider whether the design of the tool itself requires reconsideration. In corporate governance terms, the process of replicating the existing elements of the structure in a more rigorous way seems to us to have overlooked the need for this type of reconsideration. The huge amount of post-Enron corporate governance literature contains little that goes back to first principles.

The objective of this brief paper is to canvass some questions that we think should be addressed in the course of a more fundamental review. Further, we raise for discussion some possible approaches to issues that trouble us and which we feel are not being addressed, or are not being adequately addressed. Nothing in what follows is intended to be definitive. We hope the points we raise will serve their purpose as a basis for discussion at an important Ditchley conference, bringing together commentators from several countries to discuss these issues, which fundamentally affect our free market system.

The Existing Tools - Are They Adequate?

Almost any good idea can have adverse consequences if pressed to a logical extreme. This is as true of the key elements of corporate governance discussed above as it is of other good ideas. Experience will be required before we can determine whether Sarbanes-Oxley and other regulatory initiatives have pressed things to the point of adverse consequences. It has been truly said that one is often not certain of having gone far enough until it becomes apparent one has gone too far. We believe the potential exists that the Sarbanes-Oxley changes have gone too far in some areas and not far enough in others.

First, as to **independent directors**. Sarbanes-Oxley pushes further the trend towards an environment in which supervision of executive management is through a board dominated by independent directors. This is reinforced by the requirement for an entirely independent audit committee with decision-making authority on some important issues. Toughened liability rules may be expected to make the independent directors zealous in their performance of the supervisory responsibility, and the lead director or non-executive board chair would be alert to verify a continuing high standard of commitment by the independent directors. In this environment, independent directors may be expected to "flex their muscles" more than has previously been the case. Indeed, that outcome is the principal objective of the new requirements.

But in keeping with our concern that it is possible to have too much of a good thing, some consideration should be given to whether the responsibilities being imposed on independent directors go beyond what is desirable. We stress that we do not question the use of independent directors in the corporate governance regime. The comparison should not be with perfection, but with whatever alternative might be available. We are aware of no broadly superior alternative. But this does not mean there is no appropriate limit on the responsibilities that should be given to independent directors. Logically, as their role and responsibility increase, the roles and responsibilities of other participants such as executive management and major shareholders and investors must decrease. Each aspect of this -- the increase in the responsibilities of independent directors and the decrease in responsibilities of others -- seems to us to merit scrutiny.

By definition, an independent director has another "day job" -- the commitment to the public corporation must be part-time, for otherwise the individual would be part of the executive team and disqualified from treatment as independent. To carry out adequately his or her responsibilities as an independent director, the individual must be prepared to devote substantial working time, think issues through carefully and take strong positions. In the event of crisis, the commitment involved to carry out the responsibility as a surrogate for the various stakeholders in the corporation can become extraordinary.

Agency theory suggests that the quality of performance by independent directors as surrogates will be significantly affected by whether their economic objectives are congruent with those of their stakeholders, and whether they are adequately motivated to provide the requisite degree of commitment. As to the congruity of motivations, the "independence" definition typically operates in a negative way: it denies independent status to a person with interests that directly conflict with those of the corporation or of a significant stakeholder class. But this does not mean the motivations of the independent director are necessarily congruent with the stakeholder class. For example, many independent directors hold only a very minor -- or even zero -- equity investment in the public corporation where they are carrying out the surrogate role.

In the hope this will contribute to further analysis of the complex policy issues surrounding responsibilities of independent directors, we summarize the considerations we have identified that motivate individuals to accept this responsibility:[*]

1. Compensation

The problem here is circularity. If the director is inadequately compensated (i.e., compensated at a level less than foregone opportunity cost), then the motivation provided is inadequate. If the director is adequately compensated -- at levels equal to or above his or her foregone opportunity cost -- then there is economic motivation not to "buck the traces" since this might prejudice a well-remunerated position. The latter issue becomes, in our view, particularly troubling if significant equity-based compensation is provided;

2. Personal or Corporate Favours

All of us can reach back to the "bad old days" when it was apparent that nominally independent directors were beneficiaries of benefits going beyond remuneration and potentially tainting their independence. Experience of the last few years indicates that such practices continue in some public corporations. It seems clear that these practices detract from independence;

3. Personal Prestige

Board membership, particularly of a major public corporation, can enhance the director's prestige in the community. But this type of motivation, again, might detract from willingness to buck the traces. Furthermore, it can deteriorate in force when the public corporation encounters significant financial difficulty -- which might well be the time when it most needs independent directors;

4. Personal Growth

Some directors join a corporate board to learn more about the particular industry or about governance in general. In terms of independence, this seems to us a benign motivation, although a director so motivated (i.e., one who feels that he or she requires this learning experience) is unlikely to be the best qualified person for the job. Also, questions arise as to whether this type of motivation will provide sufficient incentive when problems arise that require a high degree of commitment;

5. *Board Community*

The annual agenda for a public corporation board typically involves a mixture of business meetings, seminars on strategy or developing issues, and social functions such as board dinners. An individual approached to join a board of directors that is comprised of people who are talented or prominent (or both) might well be

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[*] This list was originally developed by Roger Martin. Jim Baillie has tried, without success, to think of additional considerations that should be added.

attracted by the opportunity to spend time with such a group. This is another benign motivation for board membership, and consistent with independence, but it cannot be assumed to result in the degree of commitment to the surrogate role that corporate governance rules require;

6. *Public Service*

Some independent directors simply wish to provide a public service --"to give something back". This, again, seems to us a benign motivation. Indeed, if we were confident that all independent directors were so motivated, then our concerns about increasing reliance on this governance tool would be significantly diminished. But we think many are more motivated by one or more of the factors above. Perhaps more importantly, we think this is the perception of the community, which means that there is cynicism about whether it is really public service that motivates an independent director.

This analysis does not lead to the conclusion that there are no independent directors who carry out their responsibilities well. Each of us has served on boards with co-directors who perform superbly. But we are worried about whether there is an adequate supply of such persons -- or, more precisely, assuming there is now an adequate supply, we worry whether the pool will decrease in consequence of current trends. In the past, neither of us has been sympathetic with the oft-heard complaints from CEOs about the lack of availability of qualified directors. We think their focus has been on other CEOs as directors and we believe a widening of the horizon in the selection process can vastly increase the pool of qualified candidates.

That being said, the prospect of a decrease in the available pool seems to us inherent in a number of current developments. Liability concerns (based not only on Sarbanes-Oxley but also on other regulatory initiatives) are increasingly serious. D & O insurance is becoming hugely more expensive. In Canada, fears are augmented by the increasingly extraterritorial reach of legislators and courts in the United States and by concerns with statutory liability of directors. This distinctively Canadian phenomenon creates for directors of Canadian public corporations the nightmare of substantial personal liability if an insolvency occurs, motivating directors to consider resigning just when they are most needed. The prospect of personal liability becomes more serious as the level of independent director responsibilities increase.

The significance of the decrease in the role and responsibilities of other participants, (including executive management, major shareholders and investors) that must logically accompany an increase in the responsibilities of independent directors also requires analysis in determining whether the changes have gone too far.

In any public corporation that operates within even the most basic principles of corporate governance, executive management is far better qualified than the independent directors to identify issues and formulate strategy. Its members, including the CEO, have the time; they have the knowledge; they have the motivation.* In a well-run board, the independent directors recognize this and take seriously the distinction between "supervising" and "managing" the affairs of the corporation. But as the screw is tightened on their fiduciary responsibilities and their legal liability for failure to perform to a high standard, it seems to us there is a real danger

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* Warren Buffet, as usual, is on point: "Any change we make in the composition of our board will not alter the way Charlie and I run Berkshire." (Berkshire Hathaway, 2002 Annual Report, page 19.)

that the motivation to cross the line between supervision and management will correspondingly increase. Anecdotally, in some boards with which we are involved, we have already seen an increasing amount of time allocated to board meetings and an increasing degree of involvement by the independent directors in board affairs. Within reasonable limits, this is very desirable. Going beyond those limits, it can detract from the ability of executive management to make the basic decisions about the corporation's affairs. There has been much talk by institutional investors and others about having independent directors flex their muscles, but we believe none of these commentators would wish the involvement of independent directors in corporate affairs to trespass from supervision into management.

Our second concern with the possible consequences of the rule-toughening currently underway relates to the **audit committee**. Here, again, we think the fundamental concept is meritorious. An audit committee comprising independent and unconflicted directors can bring significant value through a review of the corporation's financial statements in consultation with external and internal auditors and executive management. But (also here again), it seems to us possible to go too far: we do not accept the proposition that increases in the responsibilities of the audit committee and the legal liabilities to which it is subject will necessarily result in corresponding benefits. To entrust (as Sarbanes-Oxley does) the audit committee with independent responsibility for dealings with the external auditor, for decisions as to contested matters of accounting disclosure and for supervision of internal controls -- in an environment where inadequate performance can lead to legal liability -- has the potential to result in a diversion of resources and an emphasis on conservatism as a matter of self-protection. It can also result in very substantial expense, of which the concerns mentioned above as to cost of compliance with the internal controls regime of section 404 are a good example.

Here, as with the notion of reliance on independent directors, our concern is that analysis of these issues does not seem to have preceded the various regulatory initiatives. We are confident that such an analysis would have concluded in a favour of continued reliance both on independent directors and on audit committees. The question is the degree of reliance that is appropriate. Also, there should in our view be some canvassing of the possibility that there might be other tools available to respond concerns with the quality of corporate governance.

One more comment on independent directors and executive management. It seems to us a teaching to be derived from corporate events of the past few years is that detailed rules and liability provisions, no matter how far-reaching, are inadequate to control an environment in which executive management is heedless of fiduciary obligations and motivated by self-enrichment. In the last resort, only a corporate culture in which such conduct is simply unacceptable can prevent its occurrence. In well-run corporations, this is taken for granted. But compliance with the various regulatory initiatives does not ensure this outcome. How to encourage development of the appropriate corporate culture is another topic as to which we think further analysis is merited.

Our third area of concern relates to **equity compensation**, including stock and stock options. Here, we think further analysis might well conclude that regulatory change has not gone far enough. The debate about expensing of stock options, while important, does not seem to us to address the main issues. Attached is a summary of a Harvard Business Review paper by Roger Martin on this topic. It takes issue with the view that equity compensation (particularly stock options with a short term) helps match motivation of executives with those of shareholders at large. Indeed, because of the differences described in Roger's paper between the expectations market and the real market, such compensation can create direct conflicts of interest between the two groups. The conclusion the paper reaches is that stock-based incentives should be eliminated.

Whether or not one accepts this far-reaching conclusion, it must be recognized that experiences in the late 1990s demonstrate there are some fundamental problems with stock-based incentive compensation. We think a full analysis would likely conclude that stock options, in particular, motivated executive management in many public corporations to take actions that were ultimately injurious to shareholders as a group, although often vastly beneficial to the members of executive management.[*]

A number of public corporations in the recent past have recognized (implicitly or explicitly) the perverse nature of the incentives often provided through stock options by making significant changes in their granting practices. For example, the use of restricted stock is becoming more common. But we find it disappointing that, at the official level, there seems to be no movement by way of response to what we consider to have been a disastrous practical experience, other than a trend towards the expensing of stock options as a matter of accounting practice.

Some policy papers have addressed the issue. For example, in the United States the Conference Board's Blue Ribbon Commission on Public Trust and Private Enterprise put forward Four Guiding Compensation Principles, intended as guidelines rather than as legal requirements.

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[*] One official report that has explored the topic is the November 2002 report of the High Level Group of Company Law Experts (the "Winter Report") to the European Commission. "To the extent these forms of remuneration [equity] allow realization of profits as a result of short term share price increases, they increase the pressures for executive directors to produce short term positive results according to the time contingency in their remuneration term". (p. 64)

They included linkage of compensation with performance, reliance on an independent compensation committee of the board, neutrality of accounting rules and full disclosure. The recommendations of the Winter Report are to similar effect, adding a proposal for shareholder approval of equity-linked compensation. We think all of these recommendations are commendable, but we question whether they deal adequately with an issue that seems to us to be at the heart of the erosion in public confidence in corporate governance. We understand more aggressive initiatives to address this issue are unfolding in the United Kingdom: we look forward to a discussion during the Ditchley conference of those initiatives and the teachings they might provide for Canada and the United States.

Some Possible Modifications to Corporate Governance Trends

Suggestions for Consideration -- (1) Objectives

So far in this paper, our theme has been that there are important aspects of corporate governance which require deeper analysis before important regulatory innovations are made. The reader might find helpful some preliminary and tentative suggestions as to regulatory innovations that we think would merit consideration in the course of such an analysis.

Before turning to these suggestions, an overview of the objectives emerging from preceding sections is appropriate. A preliminary point should be made. To the extent feasible the corporate governance regime should concentrate on substance rather than process. We recognize that this is difficult to attain. Process is the outward and visible sign of substance: one cannot successfully legislate good motivations but one can dictate a process environment in which good motivations have an opportunity to flourish. That being said, we strongly believe policy proposals should avoid elevating process over substance. Even prior to Sarbanes-Oxley, check-lists used to confirm compliance with each of a multitude of process rules loomed large in the governance process. A cottage industry has already emerged in the publication of more ambitious check-lists to verify compliance with Sarbanes-Oxley and other post-Enron requirements. If these requirements, introduced with such cost and fanfare, result only in compliance with a series of check-lists rather than in substantive improvement, a golden opportunity will have been lost.

The following paragraphs summarize the policy objectives we derive from the discussion in preceding sections.

First, as to i**ndependent directors**. We regard this as a key corporate governance tool upon which substantial reliance should continue to be placed. But we think the corporate governance environment in which independent directors operate should be designed so that they are not incented to expand their responsibilities from supervision into management, or to encroach unduly on the legitimate roles of other stakeholders. Further, they should not be subject to disincentives that might dissuade them from continuing to perform their responsibilities when the corporation encounters serious financial difficulties. And the regime should be designed so as to avoid elements that will dissuade qualified persons from becoming directors, or that might persuade them to resign prematurely.

Secondly, as to the **audit committee.** We believe the notion that audit committees should be comprised of independent directors is well founded and provides assurance of a thorough and non-conflicted review of financial statements. But we think it dangerous to delegate an undue amount of responsibility to the audit committee on its own authority. It is, after all, a committee of the board of directors and the very fact that all of its members are independent of management means that they lack the depth of knowledge concerning the company that management possesses. When they come to grips with fundamental issues of disclosure and accounting practice, they might well reach a less-informed decision than would the full board of directors, in which executive management participates.

Thirdly, as to **external auditors**. We think the changes made during the past couple of years have been generally constructive. Our principal concern links to the comments about audit committees. As mentioned, we have serious reservations as to whether the elaborate regime imposed by Sarbanes-Oxley on audit committees and external auditors for the review of internal controls will produce benefits that justify the very substantial expenditures involved. An attendant concern is potential impact on willingness to take entrepreneurial risk, given the motivation potentially introduced by the new environment towards conservatism in judgments. Indeed, the practical application of these requirements seems to us to involve a danger of providing a textbook example of the exaltation of form over substance.

Fourthly, as to **equity-based compensation**, particularly stock options. In dealing with the other topics outlined above, we think further analysis might conclude that recently-made changes are insufficiently nuanced and perhaps more far-reaching than appropriate. But as to equity-based compensation, we think the changes might not go far enough. A key question is whether the other regulatory changes will address this fraught topic by changing the environment to the point where boards of directors will be motivated to deal with it without necessity for restrictive rules. We are optimistic this will happen over time, but we think some legislative intervention may be necessary now because of the seriousness and urgency of the topic.

We think that the demands of talented individuals for remuneration commensurate with the returns their talents generate will continue. Indeed, on present trends we think these demands will gain momentum. The quest of many senior executives (although far from all) in a position to demand high compensation seems often to be maximum compensation, rather than reasonable compensation: to be at the top of the league tables. This is probably attributable to a variety of causes. Mandatory publication of remuneration information and the brevity of the periods for which many senior executives hold their high offices are likely among the causes. But whatever the cause, the trend puts boards under enormous and increasing pressure. Stock options and other equity-linked compensation are likely to be a key ingredient in the compensation package they provide. Our concern is that, unless there is some policy innovation going beyond the simple expensing of stock options, there is a real prospect for the repetition of the bad experience that, in our view, underlay so much of the dot com boom and bust.

Fifthly, as to **corporate culture**. The Holy Grail of corporate governance is to arrive at a corporate culture in which unethical activity is simply unacceptable. Such a culture characterizes, in our experience, the majority of public corporations, but experience indicates there are some in which executive management is motivated more by remuneration maximization than by fiduciary obligations. Enhanced liability provisions will conduce to this objective, but the objective is of such paramount importance that we think consideration should be given to whether there is some tool by which it could be more directly encouraged.

Suggestions for Consideration -- (2) Proposals for Consideration

In the context of **independent directors**, we think that consideration should be given to the use of different definitions of "independence" in its application to board membership from its application to audit committee membership. The trend towards a more rigorous definition seems to us appropriate in the distinctive context of the audit committee, but unnecessarily restrictive in the wider context of board membership. For example, under the NASDAQ rules, a representative of a non-controlling investor who owns an equity position in excess of 20 per cent would not be classed as independent. At the board level, we think this might deny the benefit of a valuable contribution. Of course, the individual who represents a major shareholder would need to be divorced from any participation in investment decision-making within the investor, in order to avoid problems of insider trading and confidentiality of information. There are probably other examples of situations where greater flexibility in the definition of "independent" would be desirable, particularly at the board level.

While we recognize that a more rigorous definition of independence is appropriate in the audit committee environment, that very fact makes us sceptical as to the merits of providing independent decision-making authority to the audit committee. Decisions as to matters of accounting practice, and particularly as to the selection of external auditors, seem to us to have corporate-wide implications that make it inappropriate for the audit committee to have sole decision-making authority. By definition, the committee will be comprised of individuals who lack knowledge of the day-by-day operation of the corporation. If further analysis concludes that this delegation of authority to the audit committee is necessary in policy terms, then at the least we think consideration should be given to a requirement that audit committee decisions be canvassed initially with the full board of directors in order to obtain the directors' input before the final decisions are made by the audit committee.

We also think it essential that there be an analysis of the extent of directors' liability. A carefully-struck balance is essential. Independent directors must be incented to take their responsibilities seriously, but not exposed to liabilities that will cause them to move from supervision into management. And the liability regime should not be so onerous as to disincent qualified candidates from accepting board positions. In Canada, the regime of statutory liability for directors seems to us to loom increasingly important: it also seems to us an unfair concept that will increasingly affect individuals in their decision about acceptance of directorates. An incidental benefit of recommendations emerging from the analysis we propose is that they might slow down the escalating cost spiral for D & O insurance policies. This latter is a development whose importance (particularly for smaller corporations) is, we believe, not generally appreciated.

As to **audit committees**, the concerns expressed above as to the delegation of independent responsibilities to the audit committees is, perhaps, our most significant point. We think the requirement for CEO/CFO certification of financial statement is meritorious, particularly because of the systems of internal supporting reports being put in place by most public corporations to provide back-up for the CEO/CFO certifications. But, as mentioned above, we think experience might well demonstrate that the Sarbanes-Oxley requirement for the review of internal controls by the external auditor will involve costs that far outweigh the benefits to be derived. In general terms, we think the greater emphasis on the work of audit committees and of external auditors is desirable, but we caution that the details of the regulatory environment should be designed so as to satisfy the criteria set out above as to the directors' liability regime and also so as to avoid undue emphasis on process at the expense of substance.

We turn now to the next topic of **compensation in the form of equity**, whether through stock or stock options. The summary article prepared by Roger Martin that is attached to this paper develops the theme of the difference between the “real market” and the “expectations market” that we feel is at the root of the fundamental market issues which arose in the late 1990s and continue to plague the marketplace, arising primarily from the use of stock options. However, we recognize that the proposal in the attached summary article, that such compensation should be abolished, is very far-reaching and unlikely to be implemented. Further, in legal terms, its implementation would involve very far-reaching requirements and great complexity. We think that the further analysis recommended in this paper should develop alternative techniques to address these issues.

We put forward for consideration two proposals as to policy requirements that would, we suggest, merit being implemented by legislation. The first would be a mandate for the use of long vesting periods for all types of stock-based compensation -- not only stock options. We have not developed the details of this: how long the vesting period would be, whether there would be focussed exceptions from the general rule, and similar issues should be left for further analysis. But our repugnance at the market impact of short-term grants and the discrepancy they introduce within some corporations between the motivations of executive management and of stockholders at large is so great that we think this requirement may well merit more forceful implementation than a simple admonition to corporate compensation committees. Some might be concerned that the use of longer vesting periods might diminish significantly the value of stock options as a compensation tool. This concern would not lead us to abandon the proposal.

Perhaps even more importantly, we seriously question the adequacy of the existing insider trading regime. The notification, sometimes more than a month after the event, that an insider has sold his or her shares seems to us inadequate to carry out the underlying policy objectives of these rules. By that time, the profit is often reaped and common shareholders who believed that executive management shared their enthusiasm about corporate prospects are left with shares that may have far less value. To our mind, the special privileges involved in holding executive management positions and being granted stock options and other equity compensation justify the obligation to notify the marketplace of proposed sales ***before*** the sales are made. Advance notice to the marketplace of an insider's intention to sell would, we suggest, convey a very valuable message and be a healthy purgative for the problems discussed in Roger Martin's summary article.

While, as to the two points above (a mandate for long vesting periods and a mandate for advanced notice of insider transactions), we go beyond the Blue Ribbon Commission and the Winter Report, we are otherwise in agreement with their general approaches[*]. We believe, however, that in the implementation of those recommendations, particular emphasis should be given to two points. First, we believe that it would generally be desirable where shares (as distinct from stock options) are issued as equity compensation, that they be retained by the individual until the point of retirement or exit from the corporation. This would reduce the problems consequent upon the division between the real market and the expectations market discussed in Roger Martin's summary article. It is noteworthy that in Canada a very substantial portion of shares issued as remuneration are held under DSUs -- deferred share units -- which

[*] See page ■.

have exactly this feature, dictated for income tax reasons. So far as we are aware, the use of DSUs has not been significantly restricted by their illiquid nature until retirement or exit.

The second addition that we would make to the Blue Ribbon and Winter Commission approaches is to advocate (but without mandating) that where equity compensation is given, it be in the form of stock rather than stock options. Again, this links to our concern with the gap between the real market and the expectations market. The incentive to stoke the expectations market is we believe, stronger in the context of stock options than in the context of direct stock ownership.

We turn now to the issue of **corporate culture.** Clearly, this is a difficult topic to address through any legislative or policy requirement. But it is, in our view, of such transcendent importance that we should not abandon at the outset any possibility of legislative techniques to enhance the prospect of a corporate culture in which unethical activity is simply unacceptable. The aspect of corporate governance we have identified as the most likely vehicle by which to have this type of impact is through means of the expanding acceptance of the concept that a public corporation should have an independent non-executive chair, separate from the CEO.

Parenthetically, we are well aware that this notion has not been universally adopted. It is a corporate governance technique that seems to have received wider acceptance in Canada than in the United States. There are many Canadians, involved with multi-national corporations, who believe that the adoption of this as a requirement in Canada could put international Canadian public corporations at a competitive disadvantage by comparison with their peers in the United States and other countries. This would arise from the lesser prestige of a CEO who is not also a chair, by comparison with the CEO who carries both titles. While we are sceptical about these concerns, we recognize that the concerns justify policy analysis. The recommendations that follow in this paper are focussed on the situation where the chair is separate from the CEO, but if further policy analysis of that topic were to conclude that this separation should not be mandatory, the recommendations below could apply equally to the lead director position.

Ideally, the independent chair should have a beneficial impact on the corporation going far beyond his or her involvement in the dynamics of decision-making by the board of directors. The chair can communicate a feeling of reassurance to investors and other stakeholders and investors. And the chair can be the embodiment of corporate culture, communicating within the corporation the high standards to which all of its employees should aspire. It is these ancillary, but essential, responsibilities that give rise to the suggestion we here put forward for consideration.

The core of the suggestion is that the independent chair should be selected, not as part of the general slate of directors voted on at the annual meeting, but rather through a special vote dependent for success on carrying “a majority of the minority”. In a widely-held corporation, this would be the same as a majority of all of the shares voted, but in a controlled corporation it would require the support of a majority of the shares held by investors other than the controlling shareholder. In Canada, there has been extensive experience with the concept of a “majority of the minority” vote, and we think that experience could be readily adapted to this new environment.

We believe this possibility merits analysis because of the enhanced credibility of the independent chair that would result from this election process. It would be clear that the individual carries the support not only of the major investor, but also of shareholders at large. The individual would be nominated by the full board, but the board would be cognizant in the selection of the nominee that the individual must obtain majority of the minority approval. Accordingly, the board would select as its candidate an individual who carries the confidence of the full board, but can also be reasonably be expected to carry a wide degree of confidence in the community at large. Such an individual would be well positioned to carry out the responsibility within the corporation of communicating a high ethical sense and of assisting to imbue a corporate culture that recognizes the ethical standards to which all employees should aspire. Of course, the CEO will carry an even greater responsibility in this connection, but we believe the CEO/chair dynamic would be beneficially influenced through this process of selecting the chair.

We recognize that many technical problems must be addressed to implement this proposal. If, for example, the person nominated as chair fails to attain the requisite majority of the minority approval, then a process must be developed whereby an alternative nominee could be put forward at a shareholders' meeting to be held shortly thereafter. Also, we do not think it would be desirable for the minority shareholders to be able to put forward an independent nominee who might not be acceptable to the other directors. We believe that a board is most effective when its members work well together, and the notion of "parachuting" in a chair who might be unacceptable to the other directors is, we believe, not an appropriate one. These and other technical issues could, we believe, be surmounted. The principal question for further analysis is whether our fundamental notion that an independent chair, whose election is supported by a majority of the minority shareholders, would be a desirable addition to the tools of corporate governance in the interest of maintaining an excellent corporate culture.

An initiative along the lines put forward above should give rise to an important incidental benefit. At a time when, we think, the pool of persons qualified and available to carry out the critical role of independent directors may be diminishing, this proposal would impose a discipline to ensure that the director who will be board chair is well qualified. Otherwise, his or her candidacy might be voted down. In some corporations, this discipline might produce very desirable results.

Again, we stress that the above comments are tentative. Our principal submission is that innovative additional analysis is needed to address corporate governance issues in these challenging times. We trust that this paper will make some contribution towards the discussion at the Ditchley conference, which might have a more widely-ranging impact.

Roger Martin Jim Baillie