The crisis in American corporate governance raises a number of important questions for Canadian policymakers. Should governance matter to policymakers? Does Canada have a serious governance problem? What are the policy options? What criteria should drive policy choice? What should Canada do? One thing is certain: in policymaking, the best bet is a process rooted in the focus and discipline of a problem-options-criteria-choice sequence.

The word crisis, in the Oxford sense of a turning point or a vitally important or decision stage, is much overused. But it may apply to what has been going on in corporate America. So numerous, well-publicized, high profile and serious are the investigations, allegations, charges, settlements, fines and verdicts that it has literally put every big American enterprise and American capitalism itself under a microscope of suspicion, doubt and distrust. Consider just some of the names: Arthur Andersen, Enron, WorldCom, Qwest, Dynegy, Global Crossing, Waste Management, Adelphia, Tyco, ImClone, Sotheby’s, Williams, Halliburton, El Paso, AOL Time Warner, Merrill Lynch, Piper Jaffray, Kmart, PNC Financial Services, and Xerox. Many of these are world-class companies. The shenanigans cover the waterfront: fraud, obstruction of justice, perjury, insider trading, illegal trading, tax evasion, price fixing, conflict of interest, non-disclosure, stock manipulation, breach of trust and accounting malfeasance.

Even President George W. Bush is personally touched. In 1990, prior to being president, he allegedly sold a large block of Harken Energy shares shortly before the company announced major writedowns that hammered the stock. The president’s problem is that he was not only a member of Harken’s board but also served on its audit committee. The audit committee has oversight responsibility for an enterprise’s financial affairs. For the president, the question is what he knew and when. But regardless of the answer, he does not look good. If he knew of the writedowns and dumped the stock ahead of the announcement, that is insider trading; if he did not know, what does that say about his oversight obligation? Vice-President Dick Cheney has problems too. He is being sued over alleged accounting fraud from his days at his former firm, oil services giant Halliburton.

Accounting can produce a tale of misconduct and misbehavior all its own: inflated profits, understated losses, pro forma gymnastics, misclassified expenses, improper capitalization, non-collection of booked revenues, accelerated revenue recognition, round-trip trading, failure to use market prices, faulty record keeping, offbalance-sheet improprieties, improper use of special purpose entities and inadequate notes to financial statements. In the last five years, over 1,000 US companies have restated their accounts with the topper being WorldCom, which recently came clean on $3.8 billion US in maintenance expenses that were misclassified as capital to be written off over time. Should anyone be surprised that the subpoenas are flying and indi-
The idea that ethics and integrity are a necessity if a market economy is to work properly is not a post-Enron insight. It was the 18th century economist Adam Smith's view and is repeated often in the thoughtful literature on the market economy since. (...) A market economy cannot lie, cheat and steal its way to enduring prosperity. Should governance matter to policymakers? The answer is a categorical yes. These are the linkages: a properly functioning corporate sector is absolutely crucial to the kind of high performance, high standard of living economy we want; the corporate sector cannot function properly without access to great quantities of reasonably priced capital; reasonably priced capital will not flow freely if investors are not rock-solid confident that the game is fair and honest; rock-solid investor confidence depends crucially on corporations being properly governed. It is simple: good governance creates confidence; confidence inspires investors to let businesses use their savings to grow, innovate and compete; investment multiplies its way through the economy creating jobs and profits, raising productivity, increasing standards of living and giving governments the tax revenues to provide more and better public services. The idea that ethics and integrity are a necessity if a market economy is to work properly is not a post-Enron insight. It was the 18th-century economist Adam Smith's view and is repeated often in the thoughtful literature on the market economy since. For example, here is what history's greatest financier, John Pierpont Morgan, said before the Pujo Congressional Committee looking into corporate power in 1912. When asked whether commercial credit granting was based largely on money and property, Morgan answered, "No sir, the first thing is character...That is the rule of business...A man I do not trust could not get money from me on all the bonds in Christendom" (New York Times, 1912). Put another way, a market economy cannot lie, cheat and steal its way to enduring prosperity.

What our policymakers should do depends on their judgement about whether Canada has a serious governance problem. My sense is that we have problems with corporate governance, but they are not nearly as serious as the American problems. Certainly we have had our share of episodes: Bre-X Minerals, YBM Magnex, Phillip Services, Laidlaw, Cinar and Castor Holdings to name a few. But comparing the number of incidents and dollar volumes to what has happened in corporate America, we seem minor leaguers, even taking into account the size of the two economies. Critics might say that in Canada the problem is only beginning and they may be right; they might also say our corporations are more artful at hiding wrongdoing. A few anecdotes are not compelling evidence for either view. If we had an American-size governance problem, the incident report would surely be much fuller.

There are several reasons why the Canadian corporate sector blotter seems to be cleaner than that of the US corporate sector.

- First, the Canadian accounting and auditing profession is very conservative. I saw first hand over 15 years of teaching budding CA's in my home province of Manitoba how ethics, integrity, honesty, proper procedure and independence are pounded into them both at school by their professors and in their apprenticeship by their mentors.
- Second, Canadian executive compensation is on average way below the US. Bluntly, this means the payoff for misbehavior can be far greater in the US.
- Third, the Canadian tax structure reduces the incentive to misbehave corporately even further. In the US, you keep much more of your ill-gotten gains.
- Fourth, there is pressure on Canadian executives to increase quarterly earnings but it seems considerably less than in the US. The
What are the policy options? At one extreme is to do nothing, prepare contingency plans for the future should things go badly and run a comprehensive monitoring brief that hopefully will continue to show no serious problem. As part of this option, authorities might formally, forcefully and regularly communicate that American-class abuses will not be tolerated and will be met with the full weight of the law.

At the other extreme is a radical menu of interventions that might include legislated limits on executive compensation; lengthy suspensions from corporate practice for executives who commit serious governance violations; greatly increased prison terms for executive wrongdoing; requiring executives to give back all personal gains associated with financial re-statements and any other wrongdoing; a wholesale revamping of the securities industry to eliminate potential conflicts of interest between investment banking and research; and even government taking over accounting standards setting and corporate auditing.

In the middle ground are proposals like establishing a national securities commission to regulate, control and monitor the Canadian capital market (Canada is very much in the minority among major developed countries in not having such a national body); more funds for regulation and to investigate wrongdoing; codes of conduct to guide executives, auditors and accountants; and rules that would clearly define issues like the client-auditor relationship with respect to non-audit services, whether the chairman and the CEO can be the same person and how a number of complex transactions including those involving stock options and derivatives should be accounted for in financial statements.

Criteria for policymaking are key. If the criteria for choice among policy options are flawed or fuzzy, it will be more a matter of good luck than good management if there is a good result. So, a good place to start is with that ancient Latin medical dictum, primus non nocere—first, do no harm. Policy that leaves matters worse off than they were before is no help.

Nor is policy that fixes a problem that does not exist or at least is not material. And in policymaking, it is always wise to heed what is called the Law of Unintended Negative Consequences. The consequences of policy are never entirely predictable; too often benefits do not materialize as advocates had predicted while all kinds of bad things happen that no one thought of.

A non-governance example of the Law of Unintended Negative Consequences is the prediction that the widespread availability of sugar-free and fat-free foods would lower obesity rates. What happened? Obesity rates shot up as people took low-calorie to mean they could eat huge quantities without consequence.

Here is a more general advice to policymakers: Think policy through thoroughly ahead of time; take your time if you have that luxury; be humble; do not oversell policy; and always have an exit strategy.

There are six criteria for setting policy on corporate governance. They are:
1. Stop the wrongdoing.
2. Restore confidence.
3. Do not do anything that impedes the flow of reasonably priced capital to good businesses.
4. Do not adversely affect the economy.
5. Preserve access to the US capital market.
6. Do not do things that make competent, experienced, responsible, honest, ethical people refuse to become directors and executives.

There is an old baseball adage that applies to governance policymaking: When rebuilding a team, it is less important that the first step be big than that it be in the right direction.

What to do? For the moment, my instincts lean to doing very little. In the continuum of policy options described earlier, I prefer the non-intervention extreme with possibly some well-thought-out initiatives from the middle ground. The recently announced Canadian Public Accountability Board is aimed at the accounting...
We seem to have the luxury of time and I would make maximum use of it to get clarity, precision and definition around the scale of the problem and the options available.

The Canadian corporate sector has served Canada well for many years. The machinery that governs our corporations is crucial to that continuing. It may, indeed, need to be torn up but not until much more evidence is in and the options and tradeoffs have been thoroughly developed and analyzed. Getting this done right is far more important than getting it done fast!

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