Sarbanes-Oxley Five Years Later: A Canadian Perspective

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I. INTRODUCTION

For the first time in history, the majority of the largest international initial public offerings ("IPOs") are taking place in London rather than New York. New York City Mayor Michael Bloomberg and New York Senator Charles Schumer have blamed this shift primarily on America's over-regulation of capital markets.[1] While the dominant discourse had assumed an international convergence on the American model of corporate and securities law,[2] more recently American commentators and regulators are starting to ask what they can learn from other jurisdictions.

In Canada, where securities regulation is a provincial matter, the entire Canadian securities system has been shifting away from the historical American template to a UK-style principles-based approach.[3] At a general level, the UK approach places emphasis on normative guidelines rather than detailed rules. However, Canadian firms have also been directly impacted by American regulation. This article offers a beginning point for discussion by considering the issues from a Canadian perspective. Specifically, it examines the effect of the U.S.

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1. MICHAEL BLOOMBERG & CHARLES SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP ii (January 2007), *available at* http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.

2. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001).

3. Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1, 2–3 (2008); *see also* CRAWFORD PANEL ON A SINGLE CANADIAN SECURITIES REGULATOR, BLUEPRINT FOR A CANADIAN SECURITIES COMMISSION: FINAL PAPER 12 (2006), *available at* http://www.crawfordpanel.ca/Crawford_Panel_final_paper.pdf (advocating as much principles-based regulation as possible). *See generally* TASK FORCE TO MODERNIZE SECURITIES REGULATION IN CANADA, CANADA STEPS UP (2006), *available at* http://www.tfmsl.ca/ (examining Canadian securities regulation).

implementation of the Sarbanes-Oxley Act ("SOX") of 2002 on Canadian issuers.[4] Part II offers an analysis of the net economic impact of SOX, specifically focusing on delisting activity and stock performance.[5] After concluding that the net economic impact of SOX has been negative, this Article critically compares and evaluates the Canadian response to consider what lessons may be drawn in the wake of current American initiatives to roll back SOX.[6] Part III traces the response to SOX in Canada with reference to the following legislation: Multilateral Instruments 52–109 (MI 52–109)[7] and 52–110 (MI 52–110),[8] and National Instruments 52–108, 58–101, and 58–201. Part IV concludes by considering both the upside and the particular challenges facing the Canadian response to SOX from a regulatory and risk management standpoint.[9]

II. ECONOMIC IMPACT OF SOX ON CROSS LISTED COMPANIES

In considering the impact of SOX on Canadian companies and on similar, but different, Canadian legislative reforms, it is essential to first discuss SOX's net effect on the capital markets generally. A number of recent studies explored SOX's economic impact and attempted to weigh the potential benefits of stricter corporate governance regulation against the cost of implementing and maintaining these new standards. Academics expected SOX to help restore confidence in the U.S. corporate governance system, but it was not clear if the net effect would be positive or negative.[10] This is of particular concern for smaller companies because the additional costs of complying with SOX are fixed rather than variable. It has been hypothesized that its effects on smaller companies will be more negative in comparison to larger

4. *See infra* Part II (discussing how Canada implemented corporate governance regulation to compete with America); *see also* 15 U.S.C.A. §7245 (West 2002).

5. *See infra* Part II (concluding that there is a negative relationship between SOX and cross-listed company market values).

6. *See infra* Part III (arguing that Canada balanced the need to harmonize with SOX and keep a principles-based model of governance with the American rules-based model).

7. *See infra* Part III (discussing Multilateral Instrument 52–109 Certification of Disclosure in Issuers' Annual and Interim Filings). A Multilateral Instrument is one that has been adopted by a number of provinces but not all provinces. In contrast, a National Instrument is one that has been adopted by all provinces.

8. *See infra* Part III (discussing Multilateral Instrument 52–110).

9. *See infra* Part IV (concluding that there appears to be no requirement to implement new control procedures in Canada but that most managers will be motivated by the certification process to implement justifiable processes).

10. *See* Bengt R. Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 15:3 BANK OF AM. J. APPLIED CORP. FIN. 8, 17 (2003).

companies.[11]

SOX has an extraterritorial application in that it applies to all publicly traded companies on U.S. stock exchanges, notwithstanding their status as cross-listed foreign issuers. Several studies have utilized cross-listed companies to analyze the net effect of SOX on the capital markets.[12] The underlying theory is that foreign issuers list on U.S. exchanges primarily to increase their share value and reduce their cost of capital. These benefits are theoretically created due to the greater pool of capital supply in the United States, higher share liquidity in U.S. markets, and greater analyst coverage.[13] An additional rationale for the decreased cost of capital in listing on U.S. exchanges is the value imputed to the firm for adopting the higher shareholder protections and corporate governance standards required in the U.S. market.[14] This latter factor has been described as the "bonding effect" but is difficult to explicitly measure since it is imbedded within many other factors that explain foreign listings in the United States.[15]

The introduction of SOX provided an opportunity for several scholars to evaluate the efficacy of the bonding hypothesis and to measure the market reaction to the new legislative scheme.[16] These studies indirectly evaluate the market's anticipation of the effect of SOX on Canadian cross-listed firms. They are consistent in finding that the capital markets generally perceived SOX as imposing higher costs than benefits to foreign issuers from countries, like Canada, which already boast strict corporate governance, accounting, and securities regulation regimes.[17] Companies that originate in jurisdictions with weaker

11. *Id*.; CHARLES RIVER ASSOCIATES CANADA LTD., THE COST AND BENEFITS OF MANAGEMENT REPORTING AND AUDITOR ATTESTATION ON INTERNAL CONTROLS OVER FINANCIAL REPORTING 13 (2004), http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20050204_52-111_costandbenefits.pdf [hereinafter CRA].

12. Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US*, 13 J. CORP. FIN. 195, 195 (2007); Geoffrey Peter Smith, Sarbanes-Oxley and the Foreign Issuer: A Test of the Bonding Hypothesis 1 (Apr. 15, 2005), http://www.terry.uga.edu/finance/research/seminars/papers/smith2.pdf; Philip G. Berger, Feng Li & M.H. Franco Wong, The Impact of Sarbanes-Oxley on Cross-listed Companies 2 (Jan. 8, 2005), http://w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Wong_SOX_and_ADRs_010805_updated.pdf.

13. Smith, *supra* note 12, at 1.

14. *Id*. For example, before U.S. firms can go private, they must file with the SEC and allow the SEC to determine whether the proposed change would be fair to minority shareholders. *Id.*

15. John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641, 647 (1999) (explaining the law, desire for liquidity, and foreign listings in the United States).

16. Smith, *supra* note 12, at 1; Berger, Li & Wong, *supra* note 12, at 2; Litvak, *supra* note 12, at 195.

17. Smith, *supra* note 12, at 1; Berger, Li & Wong, *supra* note 12, at 2; Litvak, *supra* note 12,

regimes are expected to accrue greater benefits from the new rules, presumably because shareholders feel that risk of agency problems and inaccurate reporting is significantly reduced when foreign corporations opt into the U.S. regime. The general conclusion of these studies is that the negative relationship between SOX and cross-listed company market value is attributable to the fact that the additional cost of U.S. compliance outweighs the marginal bonding benefit relative to the existing regulatory system. The following section will explore the results of these studies.

A. Delisting Activity Post-SOX Announcements

In a 2005 study, Geoffrey Smith utilized the implementation of SOX as an opportunity to evaluate the bonding hypothesis.[18] He analyzed the stock performance of cross-listed firms in the capital market response to news announcements of SOX.[19] Smith also analyzed delisting behaviors of non-U.S. firms in response to SOX.[20] The primary objective of the study was to analyze the relationship between the strength of accounting standards and shareholder protection laws in the foreign country and the capital market response to news announcements of SOX's applicability to foreign issuers (i.e., the market expectation of the net benefit or cost of SOX on foreign issuers).[21] The study also compared the delisting activities of foreign issuers before and after the implementation of SOX to test the hypothesis that firms (smaller firms in particular) would delist to avoid the higher costs of the regulatory structure.[22]

The level of accounting standards and shareholder protection laws for the Smith study was based upon an earlier study by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny.[23] Their study posits that strong shareholder protection laws are demonstrated through legislation that ensures minority shareholders are not unfairly subjugated to the rule of a controlling shareholder.[24] More specifically, the La Porta et al. study identified the following

at 195.

18. Smith, *supra* note 12, at 2.

19. *Id.*

20. *Id.* (finding the bonding hypothesis largely true for firms with mid-level accouting standards and shareholder protections).

21. *Id.* (finding no increase in the overall listing activity of such firms).

22. *Id.*

23. *Id.* at 23.

24. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1127–28 (1998) [hereinafter *Law and Finance*].

characteristics as beneficial for minority shareholders: 1:1 share of voting rights, facilitation of minority shareholder voting (e.g., via mailing proxy rather than in person), maintenance of liquidity of voting shares (e.g., no requirement to deposit securities prior to voting), mechanisms for proportional representation on the board of directors (such as cumulative voting), oppression and derivative remedies, pre-emptive purchase rights, ability to call extraordinary shareholders' meetings without a high percentage of ownership, and mandatory dividends.[25] Similarly, the La Porta et al. study identified ninety items in financial statements that may be legally required to be included in financial statements.[26] In both accounting standards and shareholder protection laws, Canada was ranked very highly.[27]

The Smith study showed that firms headquartered in countries with already high-level accounting standards and shareholder protection laws reacted unfavorably to new events leading up to SOX's eventual enactment while firms from countries with only mid-level accounting standards and shareholder protection laws reacted favorably to the same events.[28] The study thus demonstrated that the bonding hypothesis is true for firms from poorly regulated countries where SOX creates positive marginal share value by decreasing market risk, through shareholder protection and accounting standards, by more than the cost of implementation.[29] By contrast, an avoiding hypothesis could be drawn from the negative impact to firms from highly regulated countries.

Notably, the Smith study did not find a general increase in delisting activities after July 25, 2002.[30] However, the study found a relationship between the size of the firms and the decision to delist, with larger firms more likely to delist.[31] This result is contrary both to the general academic expectation, and to an Ontario Securities Commission ("OSC") cost-benefit analysis that suggested that small firms would be disproportionately affected by the fixed costs of SOX implementations and thus would be more likely to delist.[32]

It is significant that the Smith findings with respect to delisting

25. *Id*. at 1126–28.

26. *Id.* at 1125.

27. *Id*. at 1130, 1142.

28. Smith, *supra* note 12, at 27.

29. *See id.* (finding that SOX's effect was positive in poorly regulated countries).

30. *Id.* at 40.

31. *Id*. at 16–17 (basing the prediction on Holmstrom and Kaplan's conclusion that small firms will have a harder time accommodating SOX's expenditures).

32. Holmstrom & Kaplan, *supra* note 10, at 17; CRA, *supra* note 11, at 34.

activity contrast with the findings of similar studies that did not focus on foreign issuers. In a 2006 study, Christian Leuz, Alexander J. Triantis, and Tracy Yue Wang found both an increase in "going dark" transactions, where firms delist but continue to trade on the over-the-counter markets, and a higher proportion of small firm delistings after the implementation of SOX for U.S. companies.[33] In another study, Ellen Engel, Rachel M. Hayes, and Xue Wang also found an increase in the frequency of going private decisions and that a greater proportion of these transactions related to small firms.[34] Similarly, Ehud Kamar, Pinar Karaca-Mandic, and Eric Talley found an increase in the proportion of small firms being acquired in going private transactions concentrated after the announcement of SOX.[35] A possible explanation for this discrepancy for foreign issuers is that "going dark" is a more onerous task for a cross-listed firm because Rule 12g3–2, which applies to the deregistration of foreign companies' securities, looks to beneficial owners, counting the number of separate accounts for which brokers, dealers, or banks hold the securities whereas Rule 12g5–1, applicable to domestic issuers, only examines legal ownership.[36]

B. Performance of Stock Post-SOX Announcements

In addition to tracing delisting activity of firms' post-SOX announcements to test the bonding hypothesis, other studies have evaluated stock performance following SOX announcements. In 2005, Philip G. Berger, Feng Li, and M. H. Franco Wong reported on a study examining the impact of SOX on cross-listed firms to test whether an exogenous improvement in investor protection affects shareholder wealth and the firm's monitoring and disclosure environment.[37] In line with the earlier studies testing the bonding hypothesis, Berger et al. concluded that for the average foreign issuer, the incremental bonding benefit provided by SOX was exceeded by SOX's incremental

33. Christian Leuz, Alexander J. Triantis & Tracy Yue Wang, *Why do Firms go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* 16–17 (Robert H. Smith Sch. Research Paper No. 06–045, 2006), *available at* http://ssrn.com/abstract=592421.

34. Ellen Engel, Rachel M. Hayes & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going-Private Decisions* 1, 3 (May 6, 2004), *available at* http://ssrn.com/abstract=546626.

35. Ehud Kamar, Pinar Karaca-Mandic & Eric L. Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* 3 (U.S.C. Law Legal Studies Paper No. 06-10), *available at* http://ssrn.com/abstract=901769; *see also* András Marosi & Nadia Massoud, *Why Do Firms Go Dark?* (Univ. of Alberta, Working Paper, 2004), *available at* http://ssrn.com/abstract=570421 (explaining that firms are exploiting a loophole which allows them to deregister).

36. Kamar, Karaca-Mandic & Talley, *supra* note 35, at 38.

37. Berger, Li & Wong, *supra* note 12, at 2.

compliance costs.[38] However, the Berger et al. study also evaluated the relationship between the strength of private and public enforcement of investor protection of the firms' home country and the performance of the stock after SOX announcements, demonstrating an impact on stock performance where private investor protection is weak.[39]

For the Berger et al. study, the strength of private and public enforcement of investor protections was based upon a study by La Porta, Lopez-de-Silanes, and Shleifer.[40] That study found that private enforcement mechanisms reduce the cost of private litigation by providing specific duties and establishing the standard of care required by market participants.[41] More specifically, the La Porta et al. study evaluated the requirements in securities laws for (1) the delivery of a prospectus to investors prior to the sale of securities; (2) the disclosure of insiders' compensation, ownership by large shareholders, inside ownership, contracts outside the normal course of business, and transactions with related parties and all material information necessary to evaluate the value of the offered securities; and (3) the liability regime (i.e., standard tort negligence, gross negligence, strict liability with reliance or causality, and strict liability without reliance or causality).[42] Public enforcement mechanisms were evaluated based on characteristics of the supervisory body.[43] These characteristics include the independence of the supervisory body from the executive body (political influence), the investigative powers of the supervisory body (the ability to command production of information), and the ability to impose non-criminal and criminal sanctions upon securities market actors for violations.[44]

The La Porta et al. study concluded that strong private enforcement mechanisms were correlated with higher capital market growth whereas public enforcement mechanisms had a much weaker relationship.[45] In the La Porta et al. study, Canada ranked very highly for both public and

38. *Id*. at 21.

39. *Id*. at 23.

40. *See generally* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?* 61 J. FIN. 1 (2006) (examining the effect of securities law on stock market development in forty-nine countries).

41. *Id.* at 28 (concluding that the benefit of common law in the area of stock market development is that it promotes market discipline and private litigation).

42. *Id*. at 10–11.

43. *Id.* at 11–12.

44. *Id*. at 12 (also evaluating the basic attributes of the supervisor and whether the supervisor should have the power to regulate securities markets).

45. *Id.* at 27–28 (explaining that several aspects of public enforcement made no difference).

private enforcement.[46]

Using the La Porta et al. study as a benchmark, the Berger et al. study concluded that there was a strong negative relationship between the strength of private enforcement investor protection of a foreign country and the performance of the stock after an announcement of SOX applicability to foreign issuers.[47] The study found no relationship between the strength of public enforcement mechanisms and the performance of the stock value, which is consistent with the conclusion of La Porta et al.[48] The analysis also showed no correlation of performance to the market value of the firms, which is once again inconsistent with the general expectation detailed above.

In a recent study, Kate Litvak also performed an analysis of cross-listed firms relative to non-cross listed firms from the same country to isolate the effects of SOX while controlling for broader economic and political trends within those countries.[49] Consistent with the Berger et al. study, her research found that the market value of cross-listed companies subject to SOX reacted strongly and negatively to the news of the applicability of SOX.[50] When looking to country-level effects of SOX, Litvak's results are consistent with the view that companies operating in a high-level disclosure regime suffered larger net costs than companies from countries with lower-quality disclosure.[51] Negative reactions were strongest in countries likely to be relatively well governed (most of Europe and Canada).[52]

Taken together, both the Berger and Litvak studies are consistent in concluding that SOX had a net negative impact upon foreign cross-listed firms.[53] The incremental bonding benefits appear to be outweighed by the increased cost of corporate governance.[54] These negative impacts are especially acute for firms that are already subject to a high level of investor protection regimes in their home country.[55]

46. *Id*. at 15.
47. Berger, Li & Wong, *supra* note 12, at 23.
48. *Id.*
49. Litvak, *supra* note 12, at 213–15, 226.
50. *Id.*
51. *Id*. at 226.
52. *Id*. at 215.
53. Berger, Li & Wong, *supra* note 12, at 29; Litvak, *supra* note 12, at 213–15, 226.
54. Berger, Li & Wong, *supra* note 12, at 29–30; Litvak, *supra* note 12, at 213–15, 226.
55. Berger, Li & Wong, *supra* note 12, at 29; Litvak, *supra* note 12, at 213–15, 226.

III. REGULATORY RESPONSE TO SOX IN CANADA

The United States responded to the high-profile corporate scandals of Enron, Worldcom, Global Crossing, and others with SOX. Not immune to failures in corporate governance, Canada witnessed similar financial scandals such as Nortel, Livent, and Cinar Corporation.[56] The combination of internal failures and U.S. pressure to implement reforms resulted in significant debate and eventual action on the part of Canadian securities regulators to implement corporate governance regulations. The overwhelming influence of U.S. markets on international capital markets has forced all other markets to evaluate their own corporate governance legislation to remain competitive.[57] Canada was uniquely concerned about the potential repercussions of failing to match U.S. regulations because of the existence of the Multi-Jurisdiction Disclosure System ("MJDS") that allows Canadian issuers, already subjected to Canadian securities regulations, to list in the U.S. markets with reduced regulatory costs.[58] If Canada was not seen to be providing a similar level of disclosure scrutiny as the United States, it was possible that MJDS would be imperiled. Canadian regulators were thus forced to weigh the costs and benefits of harmonizing their securities laws with SOX and assess the efficacy of the traditional principles-based model of corporate governance against the rules-based U.S. model.[59]

A. Canadian Regulatory Response: The Analysis

Canadian securities regulators considered implementing key elements of SOX, such as: (1) the establishment of the Public Company Accounting Oversight Board ("PCOAB"),[60] (2) the registration requirement of accounting firms which audit public companies,[61] (3) the

56. Christopher Nicholls, The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to Sarbanes-Oxley 177 (June 2006), http://www.tfmsl.ca/docs/V4(3A)%20Nicholls.pdf.

57. *See, e.g.*, Sukanya Pillay, *Forcing Canada's Hand? The Effect of the Sarbanes-Oxley Act on Canadian Corporate Governance Reform*, 30 MAN. L.J. 285, 300 (2004); *see also* Nicholls, *supra* note 56, at 177–78 ("Many Canadian regulators and legislators . . . expressed concern about the need for a Canadian response to SOX that would signal to capital market participants that Canadian market regulation was just as strong and protective of investors' interests as American regulation.").

58. CRA, *supra* note 11, at 8; Andrew J. Beck, *Under Scrutiny: Governance in Canada*, DIRECTORS & BOARDS, Fourth Quarter 2004, at 59.

59. Pillay, *supra* note 57, at 300.

60. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, § 101, 116 Stat. 745, 750 (2002).

61. *Id.* § 102.

subjection of these accounting firms to the standards set by PCOAB,[62] (4) the subjection of these accounting firms to periodic inspection by PCOAB[63] and investigation of possible violations of SOX by these accounting firms,[64] (5) the requirement for an independent audit committee,[65] (6) the requirements for the CEO and CFO to certify financial statements,[66] and (7) the requirement for reporting of internal controls.[67] The SOX requirements for internal control reporting were particularly scrutinized by the OSC.[68] This final section was considered particularly onerous because it required the reporting of the internal control system, the certification of the system by management, and the attestation by an external auditor that the management certification was appropriate.

A cost-benefit analysis was prepared for the OSC by Charles River Associates Canada ("CRA") to evaluate the appropriateness of implementing similar measures in Canada and in particular the requirement for reporting internal control section 404 of SOX.[69] The CRA paper estimated the costs and benefits of such implementation through surveys of issuers and accountants.[70] These surveys revealed that the expected primary drivers of costs in internal control reporting are documenting procedures and initial testing.[71] Most participants estimated that the SOX requirement of an external auditor attestation of the control systems accounted for forty to seventy percent of the cost of compliance, primarily because of the cost of more thorough documentation and testing.[72] Benefits were identified as being internal and external. The former include more efficient financial reporting processes and improved management understanding of corporate risks.[73] The latter refer to the capital market response to more accurate financial reporting and decreased risk of misstatements, including higher share values (decreased cost of capital), increased liquidity, and increased competition of Canadian securities markets.[74] The

62. *Id.* § 103.
63. *Id.* § 104.
64. *Id.* § 105.
65. *Id.* § 301.
66. *Id*. § 302.
67. *Id*. § 404.
68. *See generally* CRA, *supra* note 11 (detailing the costs and benefits of SOX leglislation).
69. *Id*.
70. *Id.*
71. *Id.* at 21.
72. *Id*. at 5, 9.
73. *Id*. at 23–24.
74. *Id*. at 28.

measurable net effect of implementing internal control reporting was expected to be negative for all firms, though CRA acknowledged that there are gaps and inaccuracies in the quantification process, particularly for the benefits.[75] The CRA estimates indicated that smaller issuers would be subjected to a greater proportion of both the costs (economies of scale) and benefits of internal control reporting.[76] However, the net impact upon smaller firms was expected to be significantly more negative than for larger firms.[77] The CRA canvassed the possibilities for providing relief to small issuers from some or all of the regulatory burden. These possibilities included an exemption from the costly external auditor attestation requirement, complete exemption for companies listing on the TSX Venture Exchange, or exemptions based on issuer size.[78] Neither the reporting of internal controls nor the external auditor attestation requirement were included as part of the new corporate governance regime in Canada.

B. Canadian Regulatory Response: The Instruments

The result of the Canadian debate and analysis was the implementation of the Keeping the Promise for a Strong Economy Act in Ontario,[79] Multilateral Instrument 52–109 (CEO and CFO Certifications),[80] Multilateral Instrument 52–110 (Audit Committees),[81] National Instrument 52–108 (Auditor Oversight),[82] National Instrument 58–101 (Disclosure of Corporate Governance Practices),[83] and National Instrument 58–201 (Corporate Governance Guidelines).[84] Initially, every Canadian securities regulator agreed to these reforms except British Columbia, which attempted to implement an approach that was more consistent with a "principles-based" corporate governance reform.[85] The B.C. reforms were eventually shelved and British

75. *Id*. at 6–7.

76. *Id*. at 10–12, 48.

77. *Id*. at 48.

78. *Id*. at 53–54.

79. Keeping the Promise for a Strong Economy Act (Budget Measures), 2002, S.O. 2002, ch. 22-bill 198 (Can.).

80. Multilateral Instrument 52–109: Certification of Disclosures in Issuers' Annual and Interim Filings, 27 O.S.C.B. 3,230 (2004) (Can.).

81. Multilateral Instrument 52–110: Audit Committees, 27 O.S.C.B. 3,252 (2004) (Can.)

82. National Instrument 52–108: Auditor Oversight, 27 O.S.C.B. 3,227 (2004) (Can.).

83. National Instrument 58–101: Disclosure of Corporate Governance Practices, 28 O.S.C.B. 5,377 (2005) (Can.).

84. National Policy 58–201: Corporate Governance Guidelines, 28 O.S.C.B. 5,383 (2005) (Can.).

85. Pillay, *supra* note 57, at 309–10.

Columbia has since adopted all of these instruments and policies except Bill 198 (secondary market liability), MI 52–110, and portions of NI 52–108, which is also not applicable to Alberta and Manitoba.

Multilateral Instrument 52–111, the Canadian equivalent of section 404 of SOX, was not implemented although the requirement for management certification of internal controls was inserted into MI 52–109, which encapsulates the certification requirements of section 302 of SOX.[86] Similarly, MI 52–110 substantively encapsulates the requirements for an independent audit committee as required in section 302 of SOX, with the exception that each audit committee is not required to have a "financial expert," although it does require that each member be financially literate or become financially literate within a reasonable period of time.[87]

National Instrument 52–108 is similar to sections 101 to 105 of SOX in requiring that only accounting firms that have registered with the Canadian Public Accountancy Board ("CPAB") perform audits of public companies.[88] However, there are some significant differences between the function of CPAB and PCOAB due to the legislative frameworks within which they operate.[89] Most notably, CPAB is not subject to direct regulatory oversight, possibly due to the lack of a federal regulator, and the scope of CPAB's mandate is not specifically defined through legislation. CPAB creates its own mandate subject to the authority of the Canadian Institute of Chartered Accountants ("CICA"), the Federal Superintendent of Financial Institutions and the various provincial securities regulators who created CPAB through a memorandum of understanding.[90] The authority for CPAB to govern the registered firms is created through the statutorily mandated contractual relationship between CPAB and the accounting firms, as opposed to the direct statutory authority of SOX.[91]

This contractual relationship means CPAB lacks the powers and

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86. Multilateral Instrument 52–111: Reporting on Internal Control Financial Reporting, 28 OSCB 1302 (2005) (Can.); Multilateral Instrument 52–313: Canadian Securities Administrator Notice, 29 OSCB 2011 (2006) (Can.).

87. Multilateral Instrument 52–110: Audit Committees, 27 O.S.C.B. 3,252 (2004) (Can.).

88. National Instrument 52–108: Auditor Oversight, 27 O.S.C.B. 3,227 (2004) (Can.).

89. Stephanie Ben-Ishai, *Corporate Gatekeeper Liability in Canada*, 42 TEX. INT'L L.J. 441 (2007); Adam C. Pritchard & Poonam Puri, *The Regulation of Public Auditing in Canada and the United States: Self-Regulation or Government Regulation?*, Fraser Institute Digital Publication, Feb. 2006, http://www.fraserinstitute.org/COMMERCE.WEB/product_files/Public%20Auditing2.pdf.

90. Pritchard & Puri, *supra* note 89, at 16.

91. National Instrument 52–108: Auditor Oversight, 27 O.S.C.B. 3,227 (2004) (Can.).

protections that are normally provided to government regulators, including access to confidential information and protection for its directors, officers, and staff.[92] In contrast to the SOX model, CPAB does not directly set standards for auditors. Instead, the provision of accounting standards remains within the purview of the CICA.[93] Finally, inspection of accounting firms by CPAB is not statutorily mandated, and CPAB has allowed the provincial accounting self-regulatory bodies to inspect smaller firms subject to CPAB rules and procedures.[94]

The following chart provides a brief comparison of the Canadian and American regulatory schemes:

United States	**Canada**
Section 404 (Internal Controls) • Reporting of internal controls and auditor attestation	**Multilateral Instrument 52–109** (CEO and CFO certification) • Requirement for management certification of internal controls inserted into MI 52–109 • Does not include reporting of internal controls or auditor attestation
Section 302 • Requires CEO and CFO to certify financial statements	**Multilateral Instrument 52–110** (Audit Committees) • Encapsulates certification requirements of section 302 • Substantively encapsulates the requirements for an independent audit committee, although each independent audit committee is not required to have a “financial expert”
Section 101 • Established the PCAOB **Section 105** • Allows the investigation of possible violations of SOX by registered accounting firms	**National Instrument 52–108** (Auditor Oversight) • Requires audits of public companies to be performed by accounting firms who have registered with the CPAB

92. Pritchard & Puri, *supra* note 89, at 17.
93. *Id*. at 27.
94. *Id*. at 30.

It is also important to note that National Instruments 58–101 and 58–201 are not strict rules approximating the SOX approach. Instead, they provide guidelines for appropriate corporate governance practices and require disclosure of variations from these guidelines.[95] As such, the Canadian approach has been described as an attempt to avoid strict rules and instead allow "the capital markets, and hence ultimately the investing shareholders, to be the judge of the effectiveness of a firm's corporate governance policies."[96] The principles-based approach may be justified by the differences between the Canadian and U.S. capital markets such as the greater number of "small-cap" firms for which the cost of compliance may be proportionally higher, the greater number of closely held firms, and the smaller number of suitable candidates for independent board membership in Canada.[97] In addition, it has been argued that "the principles-based approach is more effective in establishing a culture of compliance with corporate governance principles rather than simply compliance with bright-line tests found in a rules-based system" and that "the principles-based approach imposes the onus of implementing governance standards on the capital markets and its participants, rather than on the legislators and regulators as under the rules-based approach."[98] Similarly, it has been argued that "[w]e cannot build investor confidence by adding rules that make regulation more complex and burdensome but don't really improve investor protection. Indeed, this approach could backfire if investors were to relax their vigilance, assuming the new rules had made the markets safer."[99]

The new Canadian instruments should also be considered within the context of shareholder protections in *both* Canadian corporate and securities law. The securities law reforms outlined above increase the checks on managerial discretion through enhanced requirements for independent directors and increased exposure of managers to litigation liability through certification requirements and the broadening of liability for securities law breaches. However, recent corporate law

95. *Id.*

96. Erinn B. Broshko & Kai Li, *Playing by the Rules: Comparing principles-based and rules-based corporate governance in Canada and the U.S.*, CAN. INVESTMENT REV., Winter 2006, at 18–19.

97. *Id*.

98. *Id*. at 23.

99. Douglas M. Hyndman, Chair, British Colom. Sec. Comm'n, Submission to the Standing Senate Comm. on Banking Trade and Commerce, What Kind of Securities Regulation for Canada? 5 (May 23, 2003) (transcript available at http://www.bcsc.bc.ca/uploadedFiles/Hyndman_2003-05-23.pdf) [hereinafter Hyndman].

reforms, such as the required level of shareholdings to submit a shareholder proposal, tilt the scale in the opposite direction. In particular, under the recently revised Canada Business Corporations Act ("CBCA"), a shareholder's eligibility to submit a proposal is determined by a combination of section 137(1.1) of the revised CBCA and section 46 of the accompanying regulations. To be eligible to submit a proposal, a shareholder must:

> (1) be a registered holder or beneficial owner for at least the prescribed period (i.e. six months immediately prior to the date of submission); and
>
> (2) own at least the prescribed number of outstanding shares of the corporation (i.e., either one percent of the total outstanding voting shares as of the date of submission, or shares with a fair market value of at least two thousand dollars at the close of business on the day before submission).[100]

It has been argued that this shift in oversight power to large investors enhances their ability to influence corporate governance.[101] Janis Sarra cautions that utilizing the large players in capital markets to indirectly regulate corporate conduct (as discussed above in relation to the principles-based approach to corporate governance) implicitly assumes their reactions are an appropriate proxy for all investors and that all costs are effectively encapsulated in the current financial disclosure requirements.[102] Arguably, these assumptions marginalize the small investor who has different risk exposures relative to the larger investors.

IV. THE UPSIDE AND CHALLENGES OF THE CANADIAN RESPONSE

A. Calls to Roll Back SOX

The current focus on amending or rolling back SOX is centered upon section 404, which deals with internal controls. Section 404 has become "one of the most controversial and criticized sections of

100. Canada Business Corporations Act, 1985 R.S.C., c. C-44, § 137(1.1) (Can.), *available at* http://www.canlii.org/ca/sta/c-44/sec137.html; Canada Business Corporations Regulations, SOR/2001-512, § 46 (Can.), *available at* http:/www.ic.gc.ca/epic/site/cd-dgc.nsf/en/cs01376e.html#part6.

101. Some commentators have questioned the necessity of this threshold requirement and have argued that it "will only serve to exclude small investors." Aaron A. Dhir, *Realigning the Corporate Building Blocks: Shareholder Proposals as a Vehicle for Achieving Corporate Social and Human Rights Accountability*, 43 AM. BUS. L.J. 365, 386 (2006); *see* Janis Sarra, *The Corporation as Symphony: Are Shareholders First Violin or Second Fiddle?* 36 U.B.C.L. REV. 403, 440–41 (2003) (explaining the benefit to large investors and danger to smaller investors).

102. Sarra, *supra* note 101, at 434, 441.

[SOX]."[103] This section has two primary focuses: (1) the requirement that corporate managers report, in a company's yearly and quarterly filings, the state of the company's internal accounting controls, and (2) the requirement that an independent outside auditor attest to the effectiveness of such internal controls.[104]

Many commentators have noted the high cost of compliance with section 404[105] and in particular its adverse impact on smaller public companies.[106] Because some costs of compliance are fixed, smaller companies may be more likely to experience negative effects than larger companies. In other words, critics have argued that the requirements overburden small companies because they must divert their resources to ensuring compliance with the securities regulatory system to the detriment of pursuing business initiatives.[107] As the president of the Competitive Enterprise Institute stated, "[t]o deal with the problem of a few big business bad apples, Congress created a web of costs and mandates that are shackling innovation. These rules disproportionately hurt the innovative entrepreneurs who run small public companies."[108] A consequence of the higher costs facing smaller companies is that greater numbers are either listing abroad or choosing to go private.[109]

Other problems cited with section 404 include the lack of guidance for management to determine whether internal control over financial reporting is effective, the fact that the regulations are not scaled to take into account the specific manner in which smaller companies operate, and the rigid, prescriptive audits resulting from the application of

103. Timothy L. Weston, *Sarbanes-Oxley Section 404 Under Siege: Solutions for Solving the Problems of Implementing Section 404*, 60 CONSUMER FIN. L.Q. REP. 86, 86 (2006).

104. *Id.*

105. *Id*. at 88; Douglas M. Branson, *Too Many Bells? Too Many Whistles? Corporate Governance in the Post-Enron, Post-WorldCom Era*, 58 S.C. L. REV. 65, 71 (2006); Peter Ferola, *Internal Controls in the Aftermath of Sarbanes-Oxley: One Size Doesn't Fit All*, 48 S. TEX. L. REV. 87, 113–18 (2006); Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 255 (2005).

106. Ginger Carroll, *Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes-Oxley Act*, 58 ALA. L. REV. 443, 452–53 (2006); Ferola, *supra* note 105, at 118–20; Scott Harshbarger & Goutam U. Jois, *Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance*, 40 AKRON L. REV. 1, 23 (2007); Neal L. Wolkoff, *Sarbanes-Oxley Is a Curse for Small-Cap Companies*, WALL ST. J., Aug. 15, 2005, at A13.

107. Carroll, *supra* note 106, at 453 (citing Mallory Factor, *Two Cheers for Nancy Pelosi*, WALL ST. J., March 18, 2006, at A9).

108. Weston, *supra* note 103, at 87 (quoting Stephen Taub, *What's Next for Section 404?*, CFO.COM, April 14, 2005, http://www.cfo.com/article.cfm/3880361?f=home_breakingnews).

109. Ferola, *supra* note 105, at 115–16.

Accounting Standard No. 2 (the standard developed by the PCAOB for auditor attestation of management review of internal controls).[110] Some have critiqued the regulatory watchdog PCAOB as altering auditor behavior and diminishing professional judgment.[111] Trade groups and securities law professors have complained that "boards and accountants spend too much time meeting meaningless criteria rather than getting to the root of more insidious problems."[112] A similar argument based on the "crowding-out effects" of the regulation questions whether the commitment of resources to section 404 implementations diverts "management attention from higher-return activities."[113]

Several commentators have called for amendments to section 404, including exempting small companies from the attestations requirement.[114] Others have called for reforms to tailor the regulations to fit the needs of companies based on their various sizes.[115] In the past two years, various committees have proposed regulatory changes to SOX provisions, specifically to those pertaining to internal controls. A Securities and Exchange Commission (SEC) advisory committee, established to assess the regulatory system for smaller companies under U.S. securities laws, concluded in its final report that the costs imposed on smaller public corporations by a number of SOX provisions significantly exceeded any benefit the provisions provided to investors.[116] The committee recommended scaling back SOX for smaller public corporations and exempting altogether certain smaller classes of public companies from section 404.[117] In a May 2006 press release, the SEC responded by announcing that the Commission would be seeking views on guidance for management "to ensure that the guidance [of] the Commission . . . addresses the needs and concerns of

110. ADIVSORY COMM. ON SMALLER PUB. COS., FINAL REPORT TO THE UNITED STATES SECURITIES EXCHANGE COMM'N 30–32 (2006), http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf at 30-32 [hereinafter ADVISORY COMM.].

111. *Id.* at 32.

112. Carrie Johnson & Ben White, *Opportunity for Corporate Fraud Has Shrunk—But It's Still There*, WASH. POST, Jan. 26, 2006, at D1.

113. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT 130 (2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportsREV2.pdf [hereinafter COMM. ON CAPITAL].

114. Branson, *supra* note 105, at 75 (citing Nathan Wilda, *David Pays for Goliath's Mistakes: The Costly Effect Sarbanes-Oxley Has on Small Companies*, 38 J. MARSHALL L. REV. 671, 692 (2005)); *see also* Harshbarger & Jois, *supra* note 106, at 22 (arguing for exemption of small companies from the primary provisions of section 404, but not exempting them altogether).

115. Carroll, *supra* note 106, at 467.

116. ADVISORY COMM., *supra* note 110, at 135; *see also* Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure*, 2:1 CORP. GOV. L. REV. 69, 93 (2006).

117. *See* Ferola, *supra* note 105, at 118–19.

all public companies."[118] The SEC rejected the advisory committee's recommendation to exempt smaller public companies as defined in its report.[119]

In September 2006, Harvard Law professor Hal S. Scott formed the Committee on Capital Markets Regulation. In general, this group of business leaders and academics recommended a risk-based and principles-based approach to capital markets regulation "rather than the current regime of detailed prescriptive rules."[120] The committee recommended no statutory changes to SOX, but rather suggested reforms to the implementation of section 404—"a redefinition of materiality, more guidance from the PCAOB, and multi-year rotational testing permitted with an annual attestation."[121] If the costs of compliance with section 404 are found to be too high for small companies, the committee's report recommended that the SEC ask Congress to exempt small companies from the auditor attestation requirement while changing the manager certification requirement to a standard of "reasonable belief in the adequacy of internal controls."[122] Similarly, Senator Charles Schumer and New York City Mayor Michael Bloomberg, in their January 2007 report, recommended clearer guidance for implementing SOX, a risk-based audit of internal controls, and permitting smaller companies to opt-out of the more onerous provisions, provided that full disclosure to investors is met.[123]

In response to the many criticisms of section 404, the SEC has postponed the date by which smaller companies must comply to fiscal years ending on or after December 15, 2007.[124] It also extended the deadline for the auditor attestation requirement for smaller companies, which must comply with the requirement in their annual reports filed for fiscal years ending on or after December 15, 2008.[125] In addition, in December 2006, the SEC published for comment its proposed interpretive guidance for management regarding the implementation of

118. Press Release, Sec. & Exch. Comm'n, SEC Announces Next Steps for Sarbanes-Oxley Implementation (May 17, 2006), *available at* www.sec.gov/news/press/2006/2006-75.htm.

119. *Id.*

120. COMM. ON CAPITAL, *supra* note 113, at xii, 8.

121. *Id.* at xiii, 19–20.

122. *Id.* at 20.

123. BLOOMBERG & SCHUMER, *supra* note 1, at 19–20.

124. Internal Control Over Financial Reporting, Exchange Act Release Nos. 33–8760, 34–54,942, 71 Fed. Reg. 76,580, 76,581 (Dec. 15, 2006); Jason Green, *Sarbanes-Oxley Changes Should Help Small Public Companies*, 9 LAW. J. 6, 6 (2007).

125. *See* Green, *supra* note 124, at 6; *see also* Internal Control Over Financial Reporting, 71 Fed. Reg. at 76,581 (discussing when a non-accelerated filer must file the auditor's attestation report).

internal control over financial reporting.[126] The guidance is intended to allow companies to scale and tailor their evaluation procedures to fit their particular circumstances.[127] "The proposed guidance focuses companies on (a) controls necessary for the prevention or detection of material misstatements in financial statements, and (b) performing their evaluation with a risk-based approach."[128] It will allow auditors to employ a "material risk" standard: "The proposed guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement in its financial statements. There is no requirement in [the] guidance to identify every control in a process or document the business processes impacting ICFR."[129] At the same time, the PCAOB published, for comment, its proposed new Auditing Standard 5, which superseded the existing Auditing Standard 2 by simplifying and shortening the standard.[130] The period for comments ended on February 26, 2007.[131] The SEC argues that the proposed guideline will address the particular needs and operations of smaller companies. "As smaller public companies generally have less complex internal control systems than larger public companies, this top-down, risk-based approach should enable [them] in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances."[132] Most recently, on April 24, 2007, the U.S. Senate set aside an amendment to SOX that would make compliance with section 404 optional for companies with total market value of less than seven hundred million dollars.[133]

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126. Management's Report on Internal Control, Exchange Act Release Nos. 33–8762, 34–54,976, 71 Fed. Reg. 77,635, 77,636 (Dec. 20, 2006).

127. Press Release, Sec. & Exch. Comm'n, SEC Votes to Propose Interpretive Guidance for Management to Improve Sarbanes-Oxley 404 Implementation (Dec. 13, 2006), *available at* www.sec.gov.news/press/2006/2006-206.htm.

128. CANADIAN SEC. ADMIN'S, NOTICE AND REQUEST FOR COMMENTS: PROPOSED REPEAL AND REPLACEMENT OF MI 52–109 (2007), www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20070330_52-109_cert-of-disc.pdf [hereinafter CANADIAN SEC. ADMIN'S]; *see also* Management's Report on Internal Control, 71 Fed. Reg. at 77,639–40 (reviewing the proposed guidelines' main principles).

129. Management's Report on Internal Control, 71 Fed. Reg. at 77,640.

130. CANADIAN SEC. ADMIN'S, *supra* note 128; *see also* Pub. Co. Accounting Oversight Bd., Proposed Auditing Standard (2006), http://www.pcaob.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf (proposing the new auditing standard).

131. CANADIAN SEC. ADMIN'S, *supra* note 128.

132. Management's Report on Internal Control, 71 Fed. Reg. at 77639–40.

133. *Senate Rejects Sarbanes-Oxley Change*, http://www.insidesarbanesoxley.com/2007/04/senate-rejects-sarbanes-oxley-change.asp (Apr. 29, 2007).

B. Recent Canadian Proposals for Reform

In Canada, with the implementation of MI 52–109, each CEO and CFO of an issuer company is required to file a separate annual certificate stating that she has "reviewed the annual filings," has no knowledge of any material misrepresentation, that the "annual filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer," and that she is "responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer . . . ."[134] While these controls are defined, MI 52–109 does not provide a standard to which the issuer must comply. In addition, there is no requirement to disclose any details of the control framework chosen by management. The companion policy to MI 52–109 indicates that this ambiguity was deliberate to allow management to identify the appropriate standard for the company "based on various factors that may be particular to an issuer, including its size, the nature of its business and the complexity of its operations."[135]

In response to the SEC's proposed guidance for internal control reporting requirements, the Canadian Securities Administrators ("CSA") published for comment the proposed repeal and replacement of MI 52–109 (released March 30, 2007).[136] In the notice and request for comments, the CSA confirms its approach of not requiring an audit opinion regarding management's assessment of the effectiveness of internal controls:

> We propose to require management to evaluate an issuer's ICFR [internal control over financial reporting] and provide MD&A disclosure about their conclusions about the effectiveness of ICFR based on such evaluation. We do not propose requiring an issuer to obtain from its auditor an internal control audit opinion concerning management's assessment of the effectiveness of ICFR. We think our proposal will balance the costs and benefits associated with internal control reporting requirements, while increasing management's focus on, and accountability for, the quality of ICFR.[137]

Under the proposed changes, Part 1 of MI 52–109 would include a definition of "reportable deficiency," which is a deficiency "in the design or operation of one or more controls that would cause a

134. Multilateral Instrument 52–109: Certification of Disclosures in Issuers' Annual Interim Filings, 27 O.S.C.B. 935, 939 (2004) (Can.).

135. *Id.* at 27 O.S.C.B. 944.

136. CANADIAN SEC. ADMIN'S, *supra* 128.

137. *Id.*

reasonable person to doubt that the design operation of ICFR provides reasonable assurance regarding the reliability of financial reporting or the preparation of financial statements for external purposes in accordance with the issuer's [] GAAP."[138] A deficiency deemed a reportable deficiency would have to be disclosed in an issuer's MD&A.[139] Part 2 would require issuers to cause their certifying officers to design or supervise the design of the disclosure controls and procedures and internal control over financial reporting.[140]

The existing ambiguity in MI 52–109 appears to leave managers without any legal requirement to implement new control procedures. However, the creation of personal liability for the CEO and CFO through the certification process, in most cases, will motivate managers to implement processes that can be reasonably justified. Although MI 52–111 was not implemented, it does provide some insight into the standard anticipated by the securities regulatory authorities. The companion policy for MI 52–111 identified three existing control frameworks against which a manager could evaluate the effectiveness of internal control processes:

> (a) the Risk Management and Governance (formerly: Guidance of the Criteria of Control Board) published by The Canadian Institute of Chartered Accountants;
>
> (b) the Internal Control—Integrated Framework published by The Committee of Sponsoring Organizations of the Treadway Commission [("COSO")]; and
>
> (c) the Turnbull Report published by The Institute of Chartered Accountants in England and Wales.[141]

The second of these frameworks, COSO, was also recommended by the SEC for use in conjunction with SOX requirements.[142] Thus, prudent corporate managers who wish to minimize their potential liability under the certification requirements of MI 52–109 would be encouraged to implement COSO or similar control processes unless they have a reasonable justification to do otherwise.

Without a requirement to disclose the form of an issuer's internal control system, no information is available for the capital markets to

138. *Id*.

139. *Id.*

140. *Id*.

141. Multilateral Instrument 52–111: Reporting on Internal Control Over Financial Reporting, 28 O.S.C.B. 1312–13 (2005) (Can.).

142. Michelle L. Kaarst-Brown & Shirley Kelly, *IT Governance and Sarbanes-Oxley: The Latest Sales Pitch or Real Challenges for the IT Function?*, PROC. 38TH ANN. HAW. INT'L CONF. SYS. SCI. 1, 8 (2005).

respond to and influence issuers' control management decisions on an ex-ante basis. However, the retention of the certification requirement by the CEO and CFO creates potential civil liability for the key decision makers of the corporation, thus allowing for private enforcement ex-post. The Canadian approach appears to utilize private enforcement mechanisms to influence decisionmakers into implementing stringent corporate governance regimes, including internal control systems. This approach provides Canadian firms with flexibility to accommodate individual issues, such as the complexity and size of the business. It is also arguably more in line with the Canadian "principles-based" corporate governance model. Issuers will not be able to merely comply with specific rules and regulations while ignoring the fundamental principles of maintaining effective control systems to provide accurate and fair reports of a corporation's financial well being. However, without any ex-ante enforcement mechanisms in place, it is arguable that the Canadian regulatory regime does less to mitigate the risk of financial misrepresentations. It has yet to be determined if this model of corporate governance regulation will provide greater net benefits to the capital markets.

V. CONCLUSION

The Canadian response to SOX outlined in this article has been described as an attempt to avoid strict rules and instead allow "the capital markets, and hence ultimately the investing shareholders, to be the judge of the effectiveness of a firm's corporate governance policies."[143] The current calls to roll back SOX and the proposed reforms suggest that the United States may be moving in the Canadian direction, but with different justifications. In Canada, the principles-based approach may be justified through the differences between the Canadian and U.S. capital markets such as the greater number of "small-cap" firms for which the cost of compliance may be proportionally higher, the greater number of closely held firms, and the smaller number of suitable candidates for independent board membership in Canada.[144] A rationale for the Canadian approach that is also applicable in the U.S. is that "the principles-based approach is more effective in establishing a culture of compliance with corporate governance principles rather than simply compliance with bright-line tests" and that "the principles-based approach imposes the onus of implementing governance standards on the capital markets and its

143. Broshko & Li, *supra* note 96, at 19.

144. *Id.*

participants, rather than on the legislators and regulators . . . ."[145] Similarly, it has been argued that "[w]e cannot build investor confidence by adding rules that make regulation more complex and burdensome but don't really improve investor protection. Indeed, this approach could backfire if investors were to relax their vigilance, assuming the new rules had made the markets safer."[146]

This Article does not suggest that the Canadian model is without its own challenges. The new Canadian instruments need to be considered within the context of shareholder protections in both Canadian corporate and securities law. While the securities law reforms outlined in this Article increase the checks on managerial discretion, recent corporate law reforms shift oversight power "to large investors and their ability to influence corporate governance."[147] The key challenge facing Canadian regulators is how to address the impact of utilizing the large players in capital markets to indirectly regulate corporate conduct. This approach implicitly assumes their reactions are an appropriate proxy for all investors and that all costs are effectively encapsulated in the current financial disclosure requirements.[148] Arguably, these assumptions marginalize the small investor who has different risk exposures relative to the larger investor.

145. *Id.* at 23.
146. Hyndman, *supra* note 99, at 5.
147. Sarra, *supra* note 101, at 440.
148. *Id.* at 434, 440–41.