Chartered Accountants of Canada

20 Questions Directors Should Ask about **Responding to Allegations of Corporate Wrongdoing**

WRITTEN BY
Carol Hansell, MBA, LL.B.
Beth Deazeley, LL.B.

20 QUESTIONS

How to use this publication

Each "20 Questions" briefing is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors, which includes asking management — and themselves — tough questions.

The questions are not intended to be a concise checklist, but rather a way to stimulate discussion and learn from public examples of corporations which have faced allegations of corporate wrongdoing. The comments that accompany the questions provide directors with some recommended practices for critically assessing and effectively responding to such allegations.

WRITTEN BY

Carol Hansell, MBA, LL.B.
Davies Ward Phillips & Vineberg LLP

Beth Deazeley, LL.B.
Principal, Risk Management and Governance
CICA

PROJECT DIRECTION

Gigi Dawe
Principal, Risk Management and Governance
CICA

INSTITUTE OF CORPORATE DIRECTORS

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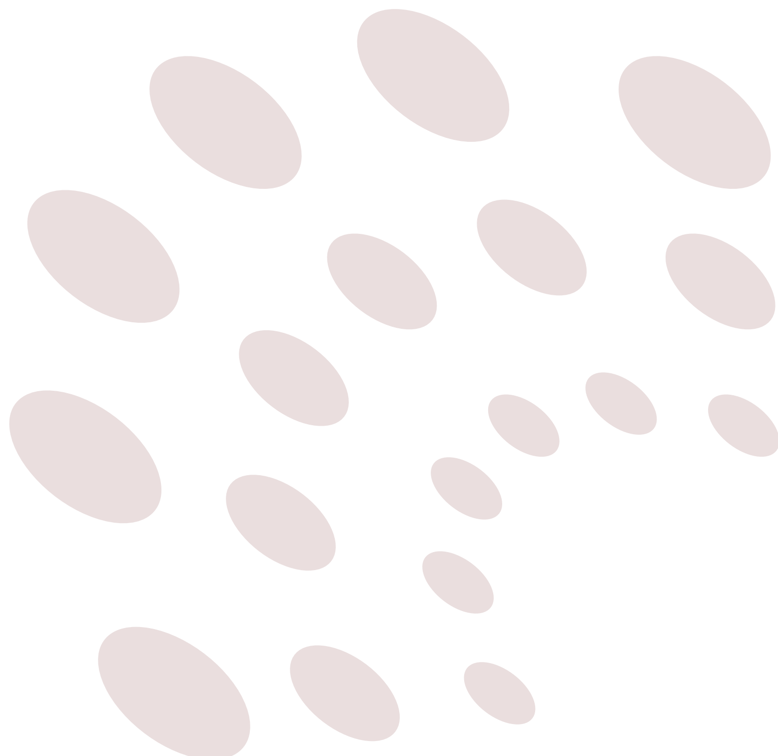

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Preface

The Risk Management and Governance Board (RMGB) of the Canadian Institute of Chartered Accountants has commissioned this briefing to prepare boards of directors to deal with situations in which corporate wrongdoing has been alleged against the company or its employees, officers, or directors.

Board response to an allegation of corporate wrongdoing can determine the company's ability to recover from a crisis triggered by such an allegation. A thoughtful process, overseen by the board as appropriate, can not only resolve the problem but preserve and promote the company's relationships with regulators, stakeholder confidence, and reputation.

This briefing provides questions a director should ask about the company's response to allegations of corporate wrongdoing. The issue that gives rise to each question is explained in detail and is accompanied by a description of recommended practices. In addition, the document relates a number of public examples of corporations which have faced allegations of corporate wrongdoing, and dealt with them with varying degrees of success.

This document is written to be of assistance to organizations and their boards in both the private and public sector and not for profit organizations. Although certain comments (relating to public disclosure and securities regulators, for example), may only be applicable to public companies, most of this document will be of assistance to all types of organizations.

The RMGB acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, Carol Hansell and Beth Deazeley who wrote this document under their guidance, and the CICA staff who provided support to the project.

Brian Ferguson, CA
Chair, Risk Management and Governance Board

Introduction

Most companies face issues relating to corporate wrongdoing at one time or another. The wrongdoing in question may be intentional (an employee concealing losses incurred through unauthorized trading) or the result of sloppy business practices (the company fails to complete regulatory filings correctly or on a timely basis). In some cases, it may be a matter of poor judgment or simply a mistake (disclosing material information to the wrong people). The potential consequences for the organization, the board and the individuals implicated range from economic harm to regulatory penalties, criminal prosecutions, class action lawsuits, loss of market share, and reputational damage.

The board of directors bears a significant responsibility for preventing instances of corporate wrongdoing. However, in cases where preventative efforts fail and corporate wrongdoing is alleged to have occurred, the board has another important duty—ensuring that the allegations are appropriately addressed.

While many instances of corporate wrongdoing arise and are handled by management in the ordinary course, some situations rise to a different level. Where senior members of management are implicated or when the nature or scope of the misconduct has the potential to have a material impact on the organization, the board must play a more active role. Such issues usually arise without warning and escalate with alarming speed. If they are not quickly addressed by appropriate action, they can become franchise-threatening.

What Can a board Do to Prepare?

Advance consideration of the role of the board in responding to allegations of corporate wrongdoing can help to prepare directors to respond effectively should such an issue arise. The following considerations will have an impact on the ability of a board to respond effectively:

- Whether the conduct that has been alleged or discovered should be investigated by management or whether it needs to be overseen by the board.
- Whether the board is constituted with enough directors who are independent of management and of any obvious influential stakeholders (such as a controlling shareholding) that a special committee can be formed.
- Whether the board is conversant with the steps that would need to be taken if a board-led investigation were necessary. However, boards should not be overly anxious to use their new "tool kit". A board-led investigation attracts a great deal of attention, is time-consuming for the board and can be expensive. Careful consideration should be given to the range of options available in dealing with the crisis (including, for example, a management-led investigation). Where board involvement is called for, though, the board should act decisively in forming a special committee and charging that committee with the appropriate authority.
- Whether the board knows to whom it will reach out for advice. Since the corporation's regular outside counsel will likely not be independent for the purposes of the investigation, the board will need to identify other counsel to provide it with advice. That counsel should be experienced in board investigations and be capable of winning the confidence of the special committee and of the regulators.

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Part I — The Nature and Impact of Corporate Wrongdoing

1. What is "corporate wrongdoing" and what kind of allegations might we face?

The range of possible corporate wrongdoing is limited only by the capacity of people to make mistakes and by the imaginations of people inclined to intentional wrongdoing. However, effective management teams overseen by engaged boards manage the problems that can be anticipated and equip themselves to deal with the unanticipated.

In some cases, corporate wrongdoing may involve an employee or some other person engaging in some conduct that harms the corporation (such as embezzlement). In other cases, the allegation may be that the corporation itself has done something illegal. The types of corporate wrongdoing that pose the greatest risks to a particular organization will depend on the nature of its business and the jurisdictions within which it operates. However, many of the issues raised by corporate wrongdoing will fit within the following groupings:

- *Legal problems* — Every organization is subject to a myriad of laws and regulations. Among the potentially most sensitive are: environmental, occupational health and safety, money laundering, foreign corrupt practices and securities law offences. Well-run organizations catalogue the legal requirements to which they are subject and put processes in place to ensure compliance. They also remain sensitive to compliance issues that attract the attention of regulators, courts or the press. For example, in view of the level of regulatory and judicial interest in option backdating, many public companies have engaged in reviews of the administration of their stock option plans.

- *Operational problems* — Organizations typically put in place policies and procedures that govern the conduct of employees, officers, directors, and even outside advisors and other suppliers. These policies and procedures may incorporate relevant legal requirements, but should go further. They should establish rules to support the operations of the company in a manner that produces value for shareholders within the ethical framework established by management and approved by the board. "Corporate wrongdoing" may arise, for example, if quality control procedures fail (resulting in product contamination) or if workplace policies are violated (leading to accusations of harassment or discrimination). The corporation's internal control environment helps management to determine whether these rules are being followed. Some of the most famous examples of corporate wrongdoing result from inadequate internal controls or from employees being able to successfully circumvent those controls.
- *Judgment and ethical problems* — Whether or not any law or corporate policy has been breached, many instances of corporate wrongdoing arise from poor judgment on the part of those in positions of authority in the organization. In other cases, it may be more than simply poor judgment, and a corporate crisis may reflect issues in the overall culture of the organization.

2. What are the potential consequences of an allegation of corporate wrongdoing?

Corporate wrongdoing can give rise to a host of consequences — some tangible and some intangible. Some may be immaterial, while others can compromise the corporation and the careers of the individuals associated with the issue, sometimes fatally. Some of the most dramatic examples of damage arising from corporate wrongdoing are set out below. Although most corporations deal with situations that are far less significant than the examples cited below, these examples provide useful illustrations of how serious the implications can be.

a) Financial Loss

Financial loss can be significant. Some notable examples include:

- *Société Générale*: Among the many issues faced by Société Générale in the aftermath of its 2008 trading scandal was the $7.18 billion loss when it closed unauthorized positions attributed to futures trader Jérôme Kerviel.
- *Parmalat*: In 2003, accounting fraud amounting to 14 billion euro was uncovered at the Italian dairy and food producer Parmalat. Among other things, its founder Carlo Tanzi was charged with embezzelling over 800 million euro from Parmalat.
- *Adelphia*: In 2002 Adelphia Cable (once the fifth largest cable company in the United States) declared bankruptcy. Among other things, it was found to have lost $100 million when members of the founding family used a complex cash management system to move funds through various entities and into their own accounts.

Loss of funds through fraud isn't the only financial cost of corporate wrongdoing. Any organization that has faced allegations regarding product quality issues, such as Sony BMG (CDs embedded with spyware), and Mattel (unsafe toys) will have felt the financial impact of loss of revenue combined with the additional expenditure required to identify and remediate the problem, recall the product and rebuild customer confidence and loyalty.

b) Restatements

Corporate wrongdoing can have significant financial reporting implications. When financial statement disclosure needs radical correction, investor confidence in the corporation may be shaken, impacting negatively on stock prices, sometimes for a prolonged period. It also often leads to regulatory action and penalties.

- *Kidder Peabody*: In 1995, Kidder Peabody discovered that one of its traders had booked $300 million in fictitious trading profits, and subsequently restated its financial statements to correct previous disclosure.
- *Nortel*: Accounting decisions made by management at Nortel led to a series of restatements that kept the company, its management team and its board on the front pages for several years.
- *Xerox*: In 2002, the SEC filed a complaint against Xerox for misleading financial statements. Without admitting or denying wrongdoing, Xerox agreed to pay a penalty of $10 million and restate its financial results for the years 1997 through 2000. Six of its executives agreed to pay an aggregate of $22 million in penalties, disgorgement and interest. Class action and other litigation initiated by investors was settled in 2008 with payment by Xerox of $670 million.

c) Legal Penalties

Legal penalties for corporate wrongdoing range from regulatory fines and penalties to damage awards in civil lawsuits. Payments can run in the tens or even hundreds of millions of dollars. In more than a few cases of particularly egregious self-dealing, successful and previously highly regarded corporate executives have been sentenced to significant prison time.

d) Corporate Failure

Some of the most dramatic instances of corporate wrongdoing have resulted in the ultimate demise of the company.

- *Barings Bank*: Nick Leeson's unauthorized speculative trading at Barings Bank ultimately resulted in losses of US$1.14 billion (twice the bank's available trading capital). Barings Bank was declared insolvent not long after the loss was discovered and attempts to negotiate a bailout failed.

- *Enron*: Enron's failure in 2001 was the result of a number of issues, including off-balance sheet transactions which disguised the corporation's vulnerabilities but enriched the corporate executives involved in structuring the transactions.
- *Adelphia and others*: Adelphia declared bankruptcy in 2002 after it disclosed $2.3 billion in off-balance sheet debt. Worldcom followed suit the same year. In Canada, both Bre-X and YBM were shown to have misrepresented their business and assets and ultimately failed.

e) Erosion of Customer Trust and Reputational Damage

The erosion of customer trust or confidence is also a serious result, as Sony BMG discovered in 2005 when it embedded certain copy prevention software on its compact discs. This "spyware" interfered with the normal way in which the Microsoft Windows operating system plays CDs, which allowed viruses to break into the system. Following a number of lawsuits and regulatory actions, Sony BMG recalled the affected CDs.

Although not shown on the balance sheet, corporate reputation is one of an organization's most important assets — and the most easily compromised asset in the wake of corporate wrongdoing. The corporation's reputation with employees, suppliers, customers, regulators, media and the investment community must be taken into consideration in determining the appropriate course of action. For example, corporate misconduct can lead to challenges in attracting and retaining top talent. Organizations known for a culture of discrimination and harassment find it difficult to attract employees at almost any level in the organization. Scandal-ridden organizations may find it difficult to recruit top talent to the boardroom or the executive suite.

Whether or not wrongdoing has actually occurred, damage may result simply from the allegations having being made. On the theory that "where there is smoke, there's fire", rumours of fraud, product contamination or integrity issues with senior management can shake the confidence of stakeholders even if the allegation is never proven.

3. How do allegations of corporate wrongdoing come to light?

Evidence of wrongdoing may surface as a result of the company's regular review procedures. The internal audit function tests compliance with corporate policies and procedures and may detect patterns of minor non-compliance or major deviations from established policy. The external auditors are also a source of fact finding and analysis in connection with their audit that may lead to the uncovering of wrongdoing.

Wrongdoing may come to light when it is reported by someone from inside the organization — often referred to as whistleblowing. Sharron Watkins of Enron is known for her attempts to "blow the whistle" on manipulative accounting practices. Although her concerns were largely ignored, whistleblowing practices established after Enron's demise have used her experience as a template, with a view to ensuring that issues raised by employees are taken seriously by the appropriate people in the organization.

On the other hand, wrongdoing may first be noticed by parties outside of the organization. The media is an important player. Investigative reporting has been responsible for either uncovering or pursuing corporate wrongdoing in a number of cases. Suppliers or customers may bring inappropriate conduct to the attention of senior management. Securities regulators may notice a pattern of trading activity immediately prior to a major corporate announcement. Parties to a prospective business deal may notice in the course of their due diligence review that everything is not as it should be. Notable examples include:

- *Hollinger International*: A lawyer reviewing the corporate records for Hollinger International in connection with a bond offering found the now famous noncompetition payments and questioned why those payments were not in Hollinger International's public disclosure. Hollinger International subsequently disclosed those payments, which attracted the attention of investor Tweedy Browne, ultimately leading to the establishment of a special committee, the departure of Conrad Black and his incarceration for fraud.

- *Enron*: Financial analyst Dan Scotto is credited with exposing Enron's impending demise. In August 2001, he was the first analyst to recommend the sale of all Enron securities. He pointed to Enron's financial leverage and questioned the reliability of Enron's reported earnings.

A paper published in 2007 by the National Bureau of Economic Research, entitled *Who Blows the Whistle on Corporate Fraud?*[1] analyzed 230 cases of corporate fraud in the US and found that fraud was revealed by the following parties:

• Employees	19.2%
• Media	16.0%
• Industry regulators	16.0%
• Analysts	14.7%
• Auditors	14.1%
• SEC	5.8%
• Others (shareholders, short-sellers, competitors, plaintiffs' counsel)	14.2%

FOR MORE INFORMATION ON EARLY WARNING SIGNALS OF POTENTIAL CRISES, SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT CRISIS MANAGEMENT.*

1 *Who Blows the Whistle on Corporate Fraud?* © Alexander Dyck, Adair Morse and Luigi Zingales, 2007.

4. What are the board's responsibilities regarding whistleblowing?

Finally, whistleblowing is an important part of the process of detecting corporate wrongdoing. While whistleblowing has existed as an informal mechanism for many years, it has become quite formalized in the post-Enron period, at least as it relates to financial reporting. Securities laws require issuers to establish a whistleblowing program — overseen by the audit committee — relating to financial reporting and accounting matters.[2] In many public companies, all whistleblowing (financial and otherwise) is folded into one program that satisfies the regulatory requirements relating to accounting and financial reporting-related issues.

There are two basic components to any whistleblowing procedure: receiving complaints and dealing with the complaints received.

a) Receiving Complaints

Many whistleblowing programs provide a mechanism for employees (and others) to register complaints or concerns confidentially and anonymously. Securities laws in both Canada and the United States require these safeguards for employees who wish to report matters relating to accounting and financial reporting, but again, many corporations extend this approach to cover complaints on any issue. Of course, it may not be possible to deal with certain complaints without knowing the identity of the complainant (for example, an employee who alleges that he or she was sexually harassed), but both confidentiality and anonymity are the starting points for many whistleblowing programs.

There are a number of ways to effect confidential and anonymous reporting. Telephone hotlines, often run by outside suppliers, are widely used. Online reporting is another option — the employee (or other person) fills out and submits a questionnaire on a website or simply e-mails a complaint. A third option is anonymous letters (mailed or deposited in an on-site drop box or to an outside provider). For these processes to be effective, there must be some way for the company to contact the complainant (for additional information, for example), while preserving both the complainant's confidentiality and his or her anonymity, until such point as the complainant has agreed to step forward in a more transparent way.

2 Multilateral Instrument 52-110

b) Handling Complaints

The second component involves reviewing, investigating and responding to the complaint. In developing this aspect of the procedure, decisions must be made about:

- who will receive the complaints
- how complaints will be prioritized for investigation (e.g. based on likely dollar value or on patterns or trends)
- how complaints will be investigated
- who will have access to the complaints
- how and when complaints will be reported
- how the results of the investigation of any complaint will be handled
- how employees and others will be educated about the procedures

In some cases the appropriate procedure to follow will be based on the nature of the complaint, but much of the process can be anticipated and documented in a corporate policy.

5. What should the board do when corporate wrongdoing is discovered or alleged?

The role of the board in the investigation and resolution of any allegation of corporate wrongdoing will depend on the specific incident. Where an incident is not material to the company from a financial or reputational perspective and where the conduct of senior management is not at issue, then it will typically be appropriate for management to deal with the issues. In some cases, it will be appropriate for management to retain outside counsel, as well as other consultants, either to secure specialized expertise or to support the independence of the process. The board should be satisfied that management is handling the situation appropriately and should expect to receive regular reports.

There are, however, situations in which a higher level of board involvement is desirable — even required. Where the situation is franchise-threatening, the board must be closely involved (although it need not necessarily lead the investigation). Certainly where senior management is implicated, the investigation should be led by the board. Where regulators may be interested in the events at issue, it may also be important that the investigation bear the imprimatur of the board.

External advisors such as legal counsel or forensic accountants may also advise as to whether a board-led investigation is necessary.

Factors to consider when determining if a board-led investigation is necessary:

— seriousness of allegation
— magnitude / pervasiveness of alleged conduct
— involvement of management
— interest of regulator
— whether remedial action / follow-up requires board approval

In determining the appropriate course of action, the board should consider not only the nature of the allegations, but any special circumstances that expose the corporation to extraordinary risk or criticism.

For example, at Boeing the CEO was put in place to rebuild confidence in the corporation's ethics in the aftermath of a procurement scandal that had sent certain Boeing executives to prison. The CEO was then himself involved in a scandal that led the board to fire him only 15 months after he assumed that position. The fact of his own behaviour being so contrary to the tone he was setting in the organization could have been very damaging to Boeing had the board not reacted as it did.

Many corporate crises arise from the circumvention of internal controls. Most breaches occur and are dealt with below the radar. However, when Nick Leeson succeeded in operating outside established risk management procedures at Barings Bank in the mid-1990s — or more recently when a rogue trader allegedly did the same thing at Société Générale — the financial and reputational implications for the institutions that employed these individuals were enormous. The boards of both organizations were closely involved in the investigation.

6. What are the objectives of an investigation?

The obvious purpose of an investigation into corporate wrongdoing is to get at the truth. But in isolation, the truth will do the corporation very little good. As management or the board moves forward to determine what has happened, they should keep a number of other objectives in mind.

First, if there is a possibility of ongoing damage to the corporation or others, then putting a halt to that conduct is an important priority. If the issue is product contamination, for example, the process of recalling the product and fixing it is critical — the corporation must be able to provide comfort to its customers as quickly as possible. Other objectives may include:

- protecting assets
- maintaining the trust of stakeholders
- preventing recurrence of the offending conduct
- identifying the cause / incentive for wrongdoing
- minimizing regulatory sanctions
- reputation management

Those responsible for the investigation should be mindful of the need to protect the organization against regulatory action, if at all possible. The internal investigation should put the organization in a position to solve a problem (obviating the need for the regulator to do so) and create a persuasive defence to any action that is ultimately taken.

The conduct of the investigation itself should also be carefully considered. The confidence of various stakeholders (investors, analysts, regulators) in the organization must be maintained. It should be conducted in such a way so as to minimize collateral damage to the organizations and the individuals affected by the investigation. Not every allegation of impropriety is supportable. In some cases a whistleblower may simply be mistaken, or the person may be seeking to settle a past score. If the investigation is not handled discretely, wholly-innocent corporate executives may suffer reputational damage from which they and their families may not soon recover.

7. What is to be done in the meantime with the person under investigation / whistleblower / practice in question?

Once commenced, an investigation may take some time to complete. A determination will need to be made about how to deal with the allegations in the meantime. Those involved in the investigation must be mindful of the fact that allegations are just allegations. On the other hand, issues of stakeholder confidence in the organization are also important.

a) Person Under Investigation

If it would be damaging to the corporation to leave the person under investigation in place, then it may be necessary to remove that person for at least a period of time. This often occurs, for example, where securities regulators are investigating issues relating to the issuer's financial statements. The fact of an informal investigation being commenced will not typically prompt a board to move the CFO aside, but it is not unusual for this to be done when the investigation reaches a more formal stage. There is no formulaic approach to these issues. The board or special committee must carefully consider the impact, for example, on the stock price, or in terms of potential liability, if the CFO remains in place in the face of the allegations. In some cases it may also be important to consider the reaction of the regulators and other stakeholders to the fact of the board having taken no action.

Where the board determines to take no action, it will often be important for a message of confidence to be delivered to the corporation's stakeholders. This may take the form of a press release in which the board expresses its continued confidence in management. Communication is equally important in situations in which the board elects to remove or replace members of senior management, in order to ensure continued confidence in the marketplace.

Employee Rights

The rights and legal protections available to employees involved in investigation (whether as whistleblowers, witnesses or subjects of the investigation) must also be considered carefully before action is taken that could compromise the rights and reputations of those involved.

b) Whistleblower

The sensitivities of the individuals involved in the matter should be taken into account. An individual who has accused his or her supervisor of harassment may find it very uncomfortable to remain in that reporting relationship while the investigation is underway. There will of course be considerations relating to the size of the organization and the opportunity to move individuals into different positions, but the issue should be considered carefully.

The person who brought the issue to the attention of management and the board may expect some accounting with respect to the way in which the corporation has dealt with the issues. Whether, and the extent to which this accounting takes place depends very much on the identity of the whistleblower. If, for example, it was the regulator and the investigation has therefore been commenced to determine whether any illegal activity has taken place, providing updates to the regulators will not only be unavoidable but highly desirable. If the person providing the information was a customer or supplier, sustaining the relationship will likely require the corporation to provide some comfort that the matter has been appropriately addressed.

These considerations need to be balanced against privacy and confidentiality concerns and the desire to avoid escalating the matter. Perhaps the most difficult situation is when the investigation is inconclusive. This may occur, for example, when there is no evidence sufficiently conclusive on which management or the board can act, but the circumstances investigated raise at least some level of concern. The result may be no announcement on the part of the corporation, leaving the person who raised the issue unsatisfied and potentially looking for an opportunity to prove his or her point in another forum.

c) Impugned Practice

Where it is a corporate practice that is in question, whether it be an accounting policy, the corporate relationship with a particular subsidiary, or an environmentally sensitive waste disposal arrangement, the board must decide whether to allow the practice to continue during the investigation or suspend it immediately. This decision will depend, in part, on the availability of alternative options.

8. What should be the involvement of the external auditor?

The external auditor plays an important role in the governance process. A preliminary question that the board must address is the extent to which the external auditor should to be apprised of the allegation and involved in its resolution. The auditor may have important views on the level of investigation required, as well as how the implications of the alleged wrongdoing should be addressed.

Some circumstances will require the involvement of the auditor. For example, an instance of corporate wrongdoing may indicate that there has been a breakdown in the design or operation of internal controls. The involvement of the auditor will be important in determining if such a breakdown has occurred, and if so, how it may be remediated and what disclosure obligations arise as a result.

In addition, any allegation of corporate wrongdoing which impacts on information previously reported by the company (whether in the form of financial statements, management's discussion and analysis, or CEO and CFO certifications) will raise the issue as to whether a restatement is required. It will be necessary to determine whether the restatement is required and which periods are affected. The board will then also need to consider what impact such restatement may have on the compensation arrangements for affected executives.

9. What role does the board play in the prevention and detection of corporate wrongdoing?

a) Oversight

The board's core function is oversight. That oversight function includes ensuring management has thought through the risks facing the organization — including its exposure to corporate wrongdoing — and has an appropriate risk management strategy in place. The responsibility for developing a risk management strategy rests with management, and should be overseen by the board.

FOR MORE INFORMATION, SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT RISK*

b) Tone at the Top

Another major role for boards is to influence the quality of the judgments made throughout the organization by ensuring that the corporation is led by individuals of high integrity and sound judgment — and that they in turn set the right tone for the organization. "Tone at the top" is an important component in the prevention of corporate wrongdoing. The Canadian Securities Administrators recommend that the board assume specific responsibility for satisfying itself (to the extent feasible) as to the integrity of the corporation's executive officers and as to their creation of a culture of integrity throughout the organization.[3] This of course requires that the board be well acquainted with the executive management team and their backgrounds and listen for presentations or responses to questions that are evasive or inconsistent. The audit committee should also ask the internal and external auditors whether they have any concerns in this area. Finally, the board should turn its mind specifically to this issue at *in camera* meetings of the board on a periodic basis. Small issues bothering one or two directors can either be resolved through discussion — or may uncover a more widely-held concern that should be pursued.

3 National Policy 58-201

c) Code of Conduct

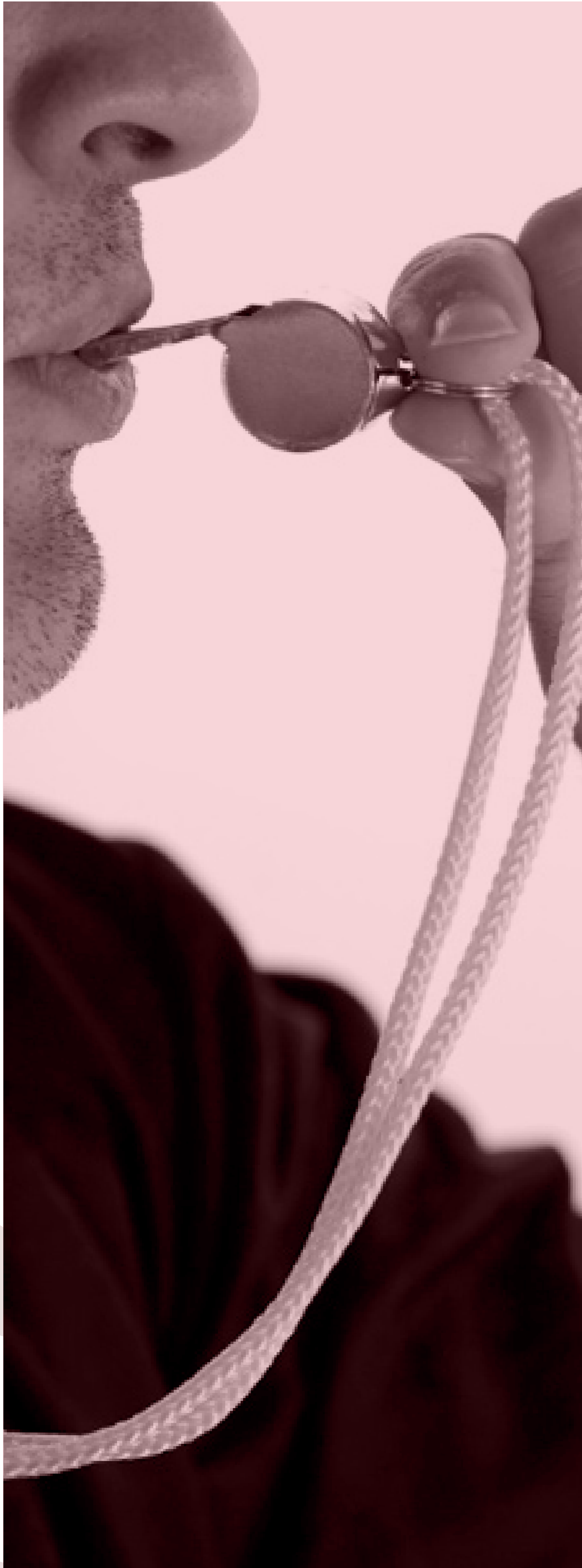
The board also plays a role in shaping the standards of conduct in the organization more broadly — through the approval of a Code of Conduct.

It is critical that the Code of Conduct is reviewed regularly and is communicated to those required to comply with it. Employees, and sometimes suppliers, are asked to acknowledge that they are familiar with the Code of Conduct and undertake to comply with it.

The Code of Conduct can be a liability to the corporation if the corporation fails to follow through on the principles it sets out. It may be used as evidence that the company understands what the appropriate standards are. If it makes little or no effort to properly train its employees to meet those standards, if it does not monitor compliance with the Code or if it does not consistently punish violations of the Code, these deficiencies may be used as evidence of a lack of commitment to these standards.

On the other hand, the company's Code will stand it in good stead if an employee's conduct falls short of the standards it articulates and leads to criminal or regulatory investigations or charges. The existence of a properly drafted, promoted and enforced Code of Business Conduct may be persuasive in negotiating an alternative case resolution (short of formal charges). If charges are laid, it may either constitute an element of a due diligence defence or argue in favour of a reduced penalty for the company. This is true of violations of the *Criminal Code,* of the criminal provisions of the *Competition Act* and of a variety of other regulatory offences. For companies that do business in the United States, the U.S. federal sentencing guidelines provide a particular incentive to adopt a Code. Under the provisions of these Guidelines, a substantially reduced fine will be mandated than might otherwise be imposed if certain mitigating factors are present, among them an effective compliance program.

FOR MORE INFORMATION, SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT CODES OF CONDUCT*



Part II — Board-Led Investigations

Investigations may be led by either management or the board, however it is important to note that when management leads the investigation the board is still responsible for overseeing it.

When the determination has been made that an investigation of corporate wrongdoing should be led by the board of directors, there will be a number of issues for the board to consider in establishing an appropriate process and charting the right course for the investigation. This part discusses the most important among those considerations.

10. What are the first steps that the board must take?

a) Striking a Special Committee

If the board has concluded that it will lead the investigation, rather than leaving it in the hands of management, it must then decide how to handle this task as a board. Typically, the investigation is not handled by the board as a whole. Instead, an *ad hoc* committee of the board, referred to as a "special committee" or an "investigative committee", is established. There are several reasons for this.

- First, the frequency of meetings makes it difficult for the full board to be fully engaged in the investigation. It is much more efficient for a smaller group of directors to oversee the investigation and to then report to the board.
- Second, and more importantly, the integrity of the process depends on the investigation being overseen by directors who are fully independent of the matter being investigated.

In a 2003 decision in *Oracle*[4] (a US decision) the court disregarded the work of a special committee on the basis that it was not independent.

A special committee struck by the Oracle board had concluded, following investigation, that there had been no insider trading by four officers and/or directors of Oracle.

4 In *Re Oracle Corp. Derivative Litigation* 824 A.2d 917 (Del. Ch. 2003)

The relationships that compromised the independence of the special committee were based on the fact that both members of the special committee were professors at Stanford University and three of the officers/directors accused of trading with inside information had ties to Stanford University.

Failure to ensure that members of the investigative committee are independent may result in the board's inability to rely on the findings of the committee. The decision of the Ontario Securities Commission in *YBM*[5] in 2003 provides an example. The board of YBM became aware prior to the public offering that the company was under investigation by the CIA, the FBI and US Immigration. The nature of the investigations was not disclosed to the corporation and so the board struck a special committee to conduct its own investigation. The chair of the YBM Special Committee was a principal of the investment banking firm that acted for YBM. That firm earned fees both on the transaction that gave rise to YBM's need for financing as well as on the public financing itself. The OSC concluded that the board could not rely on the work of the YBM Special Committee.

b) Which Independent Directors Should Serve on the Special Committee?

How does a board determine which of its directors, who are independent for the purposes of the investigation, should sit on a special committee? A determination must be made about which of the independent directors has the time and aptitude for the assignment. Directors who are employed on a full-time basis may find it difficult to extricate themselves from their daily responsibilities to devote themselves to the work of the special committee. Directors who are retired may have other commitments that restrict their flexibility. Each director who agrees to serve on the special committee must understand the time demands involved in the assignment.

Finally, the characteristics that make an individual an attractive candidate for the board do not necessarily make that person suitable to serve on a special committee. Directors vary in terms of experience and quality of judgment. Directors who have had some experience with internal investigations can be very helpful.

5 *Re YBM Magnex International Inc.*, (2003), 26 O.S.C.B. 5285 [YBM]

11. What should be the mandate and powers of the special committee?

The board should approve a mandate for the special committee that sets out the scope of its authority and provides the special committee with the resources necessary for it to discharge its responsibilities. This is sometimes done at the time the committee is first formed. It may also be done at a subsequent meeting, once the committee has had time to consider and to get advice on the appropriate scope of its mandate. The committee then returns to the board for approval of a mandate that it has developed with the assistance of its outside counsel.

Where the investigation is overseen by a standing committee of the board, it may already have the authority to investigate the matters in question. This may be the case, for example, where the audit committee is reviewing an issue relating to the financial statements. However, where the matter is significant, the committee should nevertheless keep the board closely informed.

The mandate of the special committee should describe the issue that the special committee is being asked to consider. Without clear definition, the special committee will find it difficult to determine when it has discharged its mandate. On the other hand, without knowing in advance what the investigation will reveal, a mandate that is too specific may have the effect of unnecessarily restricting the scope of the special committee's work.

FOR MORE INFORMATION,
SEE THE CICA PUBLICATION
20 QUESTIONS DIRECTORS SHOULD ASK ABOUT SPECIAL COMMITTEES

The independent investigation into the Nortel financial statement issues was overseen by Nortel's audit committee. The summary of findings of the independent review described the objective of the audit committee in connection with this matter as follows:

> The Audit Committee wanted to gain a full understanding of the events that caused significant excess liabilities to be maintained on the balance sheet that needed to be restated, and to recommend that the board of Directors adopt, and direct management to implement, necessary remedial measures to address personnel, controls, compliance, and discipline.[6]

The investigative committee must be unrestricted in its access to information and resources from within the organization. The committee must in turn ensure that its advisors have unrestricted access to those resources. This would typically come through a direction from the committee to senior management to provide documentation promptly to and cooperate fully with the investigators. The Nortel Report discloses the following process:

> The Audit Committee expressly directed that requested documents be promptly provided and that employees cooperate with requests for interviews; the Audit Committee instructed senior management to implement these directions throughout the Company. Over the course of the inquiry, more than 50 current and former Nortel employees were interviewed, some more than once. While the independent inquiry did not examine the work of Nortel's external auditor, Deloitte & Touche LLP, several current and former engagement partners were interviewed. Hundreds of thousands of hard copy and electronic documents and emails were collected and reviewed from corporate headquarters in Brampton, from company servers, and from key employees in the business units and in the regions.[7]

In YBM, the OSC was critical of the Special Committee for relying on management to provide Fairfax (its forensic investigators) with information about customers and end users. Management had restricted Fairfax to electronic searches and required the searches to be completed in ten days.

Fact finding will be an important part of the special committee's function. It will need to determine whether there has been any conduct that has led to an improper depletion of corporate assets (such as theft, fraud) or that violates laws, corporate policies, or social norms (such as harassment). If such conduct has occurred, it must determine who was responsible and whether it is still going on. From a process perspective, the mandate should set out how the committee will be run administratively. It may not be workable for the special committee to be subject to the same provisions as other committees of the board, for example, with respect to the notice required to hold meetings of the committee.

It should be clear whether the special committee is required to make recommendations to the board of directors or whether it has the authority to make decisions and take action. While the board has the authority to delegate to the special committee the power to make decisions, that power is seldom delegated for two reasons. Firstly, the members of the board who are not on the special committee are often not prepared to relinquish to the special committee unrestricted authority to make decisions about how to deal with the findings of the investigation. At the same time, the members of the special committee are often not prepared to assume the sole responsibility for those decisions but prefer to offer recommendations to the board, with the final decisions being made by the full board.

6 Summary of Findings and of Recommended Remedial Measures of the Independent Review Submitted to the Audit Committee of the boards of Directors of Nortel Networks Corporation and Nortel Networks Limited [unpublished] at 2 [*Nortel Report*]

7 *Ibid.* at 2

12. What are the duties of directors on the investigative committee?

The duties of directors who sit on a special committee are no different from their duties in any other aspect of their responsibilities as directors. They must act in accordance with their fiduciary duty and duty of care.

The fiduciary duty requires each director to "act honestly and in good faith with a view to the best interests of the corporation".[8] Conflicts of interest present the greatest challenge to the ability of directors to discharge their fiduciary duty when they serve on a special committee. A director's fiduciary duty prohibits the director from preferring the interests of another person (including his or her own interests) to the interests of the corporation. It is therefore not open to the members of the special committee (or the board) to protect wrongdoers at the expense of the corporation. While it is not impossible for directors who have a conflicting interest to nevertheless act in the best interests of the corporation, the courts do not extend the benefit of the business judgment rule to decisions made by directors who have any interest in the decision. Thus the members of the committee must be free of any interest in the outcome of the investigation, other than the best interests of the corporation.

The duty of care requires each director to exercise the "care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".[9] This generally requires that directors obtain sufficient information and advice to be able to form a reasoned judgment and take the time to independently examine that information and advice thoroughly. Retaining appropriately qualified and independent counsel (who may in turn retain qualified forensic experts) is critical to discharging the duty of care. The members of the Special Committee must critically review the advice received and ask questions as necessary to satisfy themselves about the advice on which they are relying.

The courts in Canada will not generally substitute their own business judgment for that of the directors of a corporation if the directors acted in a manner consistent with their fiduciary duty and duty of care in reaching their decision. The "business judgment rule" shields the decisions of directors from judicial second-guessing if those business decisions were made honestly, prudently, in good faith and on reasonable grounds. As one court said, "...in such cases, the board's decisions will not be subject to microscopic examination and the court will be reluctant to interfere or usurp the board of directors' function in managing the corporation".[10] However, the business judgement rules does not inhibit regulators from taking issue with decisions made by a board. They will not defer to the work of the committee if they disagree with the judgments made.

13. What are the duties of directors who are not on the investigative committee?

Directors who are not on the investigative committee may be board members who are not independent of the issues under investigation, but may also be directors who have no conflict—they simply don't happen to be on the special committee. They will necessarily have less information about the progress and likely conclusions of the investigation than will the members of the committee.

Their normal duties as board members continue to be applicable, with the addition of duties relating to the investigation. Directors may have a duty to support the special committee as requested. In addition, it will be the board's responsibility to make any final determinations. Accordingly, the board should ensure that it receives regular reports from the committee and that it probes the reports and tests the conclusions reached by the special committee, just as it would the reports and conclusions of any other board committee.

At a minimum, the board should require briefings from the special committee each time the board meets until the special committee is dissolved. Certain concerns may necessitate more frequent reporting to the full board. For example, if the special committee becomes aware of information that may be material (its mandate does not allow it to disclose that information publicly), it may need to call a board meeting in order to reach a decision about how to deal with the information. If the special committee is able to conclude—or is sufficiently concerned—that individuals responsible for the wrongdoing continue to be in a position to perpetuate (or cover up) the wrongdoing, then the special committee should present its conclusions (and recommendations) to the full board as soon as possible in order to protect the corporation from further harm.

8 *Canada Business Corporations Act s.* 122(1)(a)
9 *Canada Business Corporations Act s.* 122(1)(b)

10 *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, 39 O.R. (3rd) 755 at 774; 160 D.L.R. (4th) 131.

14. How can directors minimize their liability relating to the investigation?

Directors often wonder if their exposure to liability increases when they agree to sit on a committee. All directors are subject to the same duty of care. However, as discussed above, that duty takes into account the circumstances within which the director was operating. The circumstances in which members of the special committee operate are necessarily different from those of directors not on the special committee. For example, members of the special committee will have access to more information than will other directors, since only what the special committee considers material or relevant will be reported to the board. Members of the special committee will also have closer contact with the advisors retained to advise the committee and will have a different time frame within which to consider the information presented to them. Accordingly, although members of the special committee will be subject to the same duty of care as all other directors, they may attract more criticism, and even liability, because of their proximity to the investigation.

In the *YBM* decision, the OSC held some, but not all, of the directors responsible for the deficiencies in the public disclosure. Not all directors stood in the same position. The OSC noted that more may be expected of persons with superior qualifications, such as experienced businesspersons. When dealing with legal matters, more may also be expected of a director who is a lawyer, because that person may be in a better position to assess the materiality of certain facts.

The decision also noted that more may be expected of inside directors than outside directors. A CFO who is on the board may be held to a higher standard than one who is not, particularly if the CFO is involved in the matter at issue (in the *YBM* decision, the public offering). Due to improved access to information, more may also be expected of directors serving on a special committee or on the audit committee. An outside director who takes on committee duties may be treated like an insider director with respect to matters that are covered by the committee's work.

It is always wise for directors to revisit their indemnities and insurance when an unusual event arises—particularly when they will play a leading role in dealing with the matter. Directors (and officers) should have contractual indemnities with the corporation and should consult counsel to ensure that those indemnities provide the broadest possible protection and specify the mechanics for payments under the indemnity. Directors should also review their directors' and officers' insurance to confirm that there are no gaps that would prevent the insurance from responding if the directors are sued in connection with the investigation.

FOR MORE INFORMATION, SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT DIRECTORS' AND OFFICERS' LIABILITY INDEMNIFICATION AND INSURANCE*

15. How should the investigation be conducted?

a) Role of the Special Committee

Once the special committee is appointed, the role of the committee is to retain the appropriate experts to conduct the investigation and to oversee the work of those experts. In other words, the special committee does not conduct the investigation itself.

There are several reasons for this. First, the members of the special committee are unlikely to have the skills or experience necessary to investigate directly. They are even less likely to have the time necessary to devote to the task. Most importantly, however, if the special committee becomes directly involved in the investigation, it loses its oversight role. The special committee must protect its ability to direct, scrutinize and judge the work of the investigators — and to avoid being so invested in the process that it drives the result.

As discussed above, the board must preserve its ability to provide effective oversight of the investigation process and to consider the results of the process critically. For the most part, the day-to-day management of the investigation will fall to the special committee's counsel and any forensic investigators retained by counsel. The chair of the special committee should receive regular briefings from counsel, with the full committee being briefed regularly, and in particular as significant results emerge or as decisions must be made.

However, the special committee must be conscious of not allowing the scope of its work to expand beyond the mandate of the committee. When the advisors uncover an issue unrelated to the special committee's mandate, the committee should consider whether the issue should be referred to management. If it is apparent that the matter must be investigated under the supervision of the board, the special committee should raise the issue with the full board. Unless the corporation would suffer some damage or loss from a delay in addressing the matter, the special committee should avoid operating outside of its own mandate without the authority of the board.

b) Selecting Counsel

A special committee will need expert legal advice because of the variety of legal issues that may arise in the course of an investigation. However, the most fundamental reason for the special committee to retain its own counsel is to advise the committee on the appropriate discharge of its responsibilities.

It is important to the process that counsel be independent with respect to the issues being investigated. Where senior management is the subject of the investigation, for example, it will seldom be appropriate for the board to rely on the corporation's regular outside counsel. Counsel's established relationship with management may make it defensive of management's conduct — it may even have provided advice with respect to that conduct. On the other hand, once counsel is engaged in the investigation, it may find that the dynamic with certain members of management becomes adversarial. This may lead inevitably to a breakdown in the relationship between counsel and management. It may be difficult for counsel to be entirely objective when its own interests are at stake. The special committee can avoid these potential issues by retaining counsel with no previous material relationship with the corporation.

The YBM Committee relied on the advice of its regular outside counsel. The OSC was very critical of the YBM board for not retaining independent counsel for the Special Committee, finding that the decision not to retain independent counsel was inconsistent with good process.

In order for a special committee to rely on legal advice as a part of its due diligence defence, that legal advice must be fully informed, ostensibly credible and within the lawyer's area of expertise.[11] Although a 1990 decision in *Westfair*[12] did not deal with a special committee, it does provide an example of a court not allowing a board to rely on legal advice as part of its due diligence defence. In that case, the board of directors had obtained legal advice from two major law firms in connection with its decision to pay a dividend of 100% of the previous year's retained earnings. Both firms provided opinions, however the Court found that there were additional facts that the two law firms did not have so the Court held that the board could not rely on those opinions as part of its due diligence defence.

11 *Blair v. Consolidated Enfield Corp.* (1993), 15 O.R. (3d) 783, aff'd [1995] 4 S.C.R. 5

12 *Westfair Foods Ltd. v. Watt*, [1990] 4 W.W.R. 685 (Alta. Q.B.), affirmed [1991] 4 W.W.R. 695 (Alta. C.A.), leave to appeal refused (1991), [1993] 2 W.W.R. LXI (S.C.C.)

Second, it must have been reasonable for the special committee to rely on counsel's advice. In *YBM*, the Chair of the Special Committee argued that he had relied on the advice of counsel in respect of YBM's obligation to disclose that the auditor would not be providing an audit opinion. The Commission found that disclosure in this instance could not be resolved by simply relying on legal advice. In view of the Chair's experience, he ought to have known at a certain point that YBM would not get its audit opinion and at that point he could not rely on legal advice as a due diligence defence.[13]

c) Forensic Support[14]

The right forensic support can make all of the difference in getting at the facts in a timely way. In Canada, each of the big four accounting firms offers expert forensic expertise, as do a number of other firms. Every firm has particular experience and expertise that may make it most suitable for a particular assignment. Experience in a particular sector, for example, may be of great assistance in assembling and analyzing the facts. Board investigations of corporate conduct will typically require some type of investigative expertise, whether in the area of computer forensics, forensic accounting or interview skills. The sophistication of the systems and programs which the forensic investigators have available to them can also be crucial, as it may be necessary to review and analyze large volumes of complicated data in a very limited time frame.

Independence will be an issue in selecting forensic experts, just as it is in selecting counsel. The independence of a particular firm may be an issue if it has provided services (such as audit or tax work) to the organization in the past. Other relationships (such as familial relationships and past employment with the organization) may also compromise the independence of the forensic consultants in particular circumstances.

d) Procedural Issues

Special committees should concern themselves with the way in which those running the investigation are dealing with the individuals involved. It is important that the investigative process be carried out by knowledgeable professionals with appropriate expertise. The special committee should be clear with its advisors that only appropriate investigative techniques may be used.

13 *YBM*, supra at paras. 545-546

14 The authors acknowledge with thanks the insightful comments provided by Alan Stewart of Navigant Consulting on an earlier draft of this section.

The special committee should require assurances that the methodology used by its investigative team will not itself compromise the reputation of the organization. This happened to Hewlett Packard in 2004. It became apparent that confidential boardroom discussions about the future of then CEO Carly Fiori were being leaked. A private investigator hired by board chair Patricia Dunn concluded that one of the members of the board was the source of the leak. Scandal resulted not from the leak but from the methods used by the private investigator, which included "pre-texting" on the part of the investigator to obtain personal phone records of certain members of the board. The resulting civil and regulatory actions kept HP on the front pages for some time—leading ultimately to the resignation of the board chair.

Although the investigation is intended to gather information to allow counsel to advise the special committee, the results of the investigation may be shared with other parties with other agendas and therefore the protocol under which the investigation is conducted is very important. A standard introduction should be developed by the forensic investigators and counsel when interviewing employees. The introduction would include an explanation of the investigator's role, the fact that the investigator has been retained by counsel to the special committee, the interviewee's option to retain counsel and whether notes of the interview will be shared with regulators or other authorities.

The results of the investigation (and often the simple fact of the investigation being conducted) can be devastating to the individuals involved—whether or not they were guilty of misconduct. In order to protect the individuals, the investigation should be run as discretely as possible. Interviews should be held in a location where it is not obvious to others in the organization who is coming in and out of the interview room. Hard drives should be copied and documents collected at times and in a manner that attracts the least attention.

Some individuals will wish to consult with counsel. It is not appropriate for the corporation's in-house counsel to provide advice to individuals involved in the process and so, if they wish counsel, they will need to retain someone independent of the corporation. No negative inferences should be drawn from an individual's desire for counsel—it is important that those running the process respect the individual's right to legal advice.

Part III — Outcomes of the Investigation

16. How and when should the company cooperate with the regulators?

Where corporate conduct involves a breach of law — such as the corporation's public disclosure obligations under securities law — dealing with the regulator becomes an important focus for the board. The ideal result is for the regulator to be prepared to rely on the corporation's own internal investigation and to be satisfied that the remedial action taken by the board obviates the need for any sanctions.

It is important for the board to have a thorough understanding of the facts surrounding the alleged wrongdoing before the regulator begins to form its view. This will assist the corporation in presenting complete facts to the regulator, which in turn will make the regulator's process in understanding the facts both more efficient and more accurate. Even if the regulator ultimately decides to conduct some level of investigation of its own, the corporation will be in a much better position to present the appropriate information to the regulator if its own investigation has been completed.

The reliance that the regulator will be prepared to place on the internal investigation will depend very much on how the investigation is handled. The elements of an effective investigation, as outlined in this publication, will contribute significantly to the confidence that the regulators have in the result.

In 2002, the OSC announced Credit Cooperation Guidelines (the "OSC Guidelines"). These guidelines set out the factors that the OSC will consider in determining whether the way in which the corporation has handled a breach of securities laws justifies something less than a full regulatory response to that breach. The rewards for cooperation described in the OSC Guidelines are intended to encourage issuers to self-police their compliance with securities laws, to self-report breaches that come to light and to self-correct the behaviours that led to the failure to comply.

The Guidelines are based on market participants reporting to the appropriate authorities serious problems in respect of their systems of internal control, the reporting of financial results, misleading disclosure, illegal trading or any other inappropriate activity that has impacted investors or cast doubt on the integrity of Ontario's capital markets. In addition to cooperating with the regulators, the Guidelines contemplate the market participant taking corrective action, dealing with employees, officers and directors who have acted in a manner contrary to Ontario securities laws and providing full restitution to any investors who may have been harmed.

The Guidelines provide that no credit for cooperation will be given where, in the course of the investigation, the market participant puts the interest of the firm, or its officers, directors or employees ahead of its obligations to clients, shareholders, or the integrity of Ontario's capital markets.

The benefits of cooperating with the OSC are often compelling. If "potential respondents" act in a responsible manner during the course of an investigation and have self-policed, self-reported and self-corrected the matters under investigation, staff may recommend that the matter not be prosecuted or that no action at all needs to be taken. They may recommend sanctions such as a settlement, undertakings or a warning letter. Where staff proceeds to prosecute notwithstanding cooperation in accordance with the Guidelines, staff may narrow the scope of the allegations and recommend reduced sanctions.[15]

Some examples of successful cooperation include:

- *CP Ships* — CP Ships failed to disclose in a timely manner in 2004 that its financial statements would have to be restated. This was compounded by OSC allegations that company insiders had traded while in possession of other undisclosed information. A special committee of the board ultimately settled with the OSC.
- *Nortel* — In 2003, Nortel announced a $948 million financial statement restatement — which proved to be only the first of a series of restatements. In 2007, Nortel settled with both the OSC and the SEC. The settlement agreements with both regulators referred in very positive terms to the quality of the process run by the Nortel board after the issues came to light — and credited the board processes for the willingness of the regulators to settle on terms that minimized the penalties to Nortel.

15 It should be noted that the US Department of Justice has also issued guidelines regarding cooperation (the McNulty Memorandum). At the time of writing, these guidelines were under revision.

17. How does the board know when the investigation should end?

Some investigations run to a natural conclusion. The wrongdoer has been identified and the evidence is irrefutable, for example. In other cases, however, the results of the investigation may continue to raise concerns, with the evidence remaining inconclusive.

There are a number of factors for a board to consider in deciding whether further investigation is required. First among them is whether the board believes that it has adequate information.

Where the results of the investigation remain inconclusive, the board should also consider whether further investigation is likely to produce information that is any more definitive. Finally, directors should consider the cost and strain on the organization and on the individuals involved of prolonging the investigation. There are risks both to carrying the investigation too far, as well as to not investigating deeply enough.

The YBM situation provides an excellent example of a case in which further investigation would have been beneficial. Deciding not to pursue some of the lines of inquiry recommended to it by the forensic investigators, the special committee and the board concluded that the US authorities would not find any problems and went forward with a public offering. Shortly after that offering, the FBI moved to shut down the corporation, on the suspicion that it was simply a money laundering operation. The shareholders lost their investment when the company declared bankruptcy a short time later.

18. What actions arise from the investigation?

At the conclusion of an investigative process, action will generally need to be taken. In some circumstances, management may take action and report to the board. In others, the board itself may take action, after considering recommendations from the special committee, if any. Such actions may include termination of employees or executives, changes to company policies or business practices, or taking action against wrongdoers. Examples include:

- *Nortel*—On the recommendation of the Nortel Audit Committee, the board of directors terminated for cause the Chief Executive Officer, Chief Financial Officer and Controller as well as seven other senior finance employees. The board determined that each of these individuals had significant responsibilities for Nortel's financial reporting as a whole, or for their respective business units and geographic regions and that each was aware, or ought to have been aware that Nortel's provisioning activity did not comply with US GAAP.[16] Also, on the recommendation of the Nortel Audit Committee, the board of directors adopted the recommendations of its advisors which dealt generally with people, processes and technology.
- *Hollinger*: The Hollinger Committee recommended that action be taken against Lord Black and a number of other executives. Following its investigation, it also settled with Lord Black restructuring arrangements that restricted his ability to continue to deal with the assets of Hollinger International as he had in the past.

16 *Nortel Report*, supra at 7

19. How should the board protect information regarding the investigation?

Before a board even contemplates a report, it should consider how best to protect the privacy of the corporation and the material contained therein. For example, the evidence collected and conclusions drawn in the report could be used against the company by plaintiffs in a class action law suit or by regulatory authorities.

Plaintiffs in a law suit or regulators may be able to compel the company to produce certain documents. The exception is typically legal advice, which is protected by solicitor-client privilege. Essentially this means that the company can refuse to disclose the advice received. Solicitor-client privilege exists to protect the direct communications (written and oral) prepared by the lawyer or client and flowing between them in connection with the provision of legal advice. The communication must be intended to be made in confidence, in the course of seeking or providing legal advice and must be based upon the professional's expertise in law.

But what about the work produced by forensic investigators? That depends on the nature of the function that the investigator is retained to perform. If that work is produced by the investigator for the company, it will not be protected by privilege — because it is not produced for the purpose of providing legal advice. However, if the work is produced by the investigator for counsel to the company (or to an investigative committee), then it may be. Where the work of the investigator is performed solely for the purpose of counsel providing legal advice, it may be possible to protect the document by solicitor-client privilege. A forensic investigator is often required to assemble the relevant company information and explain that information to the lawyer. The lawyer then uses that information as the basis for the legal advice. If the forensic investigator's function is to serve as a "translator", assembling the necessary information from the client and putting the client's affairs in terms that could be understood by the lawyer, then solicitor-client privilege is likely to apply.

The safer practice is for the forensic experts to be retained by counsel, rather than by the corporation or committee itself. This is more likely to result in protection of solicitor-client privilege because, properly managed, it will be clearer that the sole purpose for the investigator's work is to provide information to counsel for the purpose of providing legal advice. In contrast, if the investigator is retained by the company, it could be argued by parties seeking to obtain the report that the investigator's work was not prepared solely for the purpose of legal advice and, therefore, that solicitor-client privilege does not attach.

In order to maintain the integrity of the solicitor-client privilege, the retainer letter should be between the forensic expert and counsel. Communications should flow from the forensic expert to counsel and the advice (which incorporates and relies on the work of the forensic consultant) should come from counsel. The report, any drafts and any working documents should be marked both "Privileged and Confidential" and "The report is prepared at the request of [name], [position], for the purpose of providing legal advice."

It is important to note that this approach may be tested in court. However, because the principles underlying solicitor-client privilege have been applied consistently by the courts, aligning the relationship of the forensic investigators as clearly as possible with the provision of legal advice provides the greatest possible opportunity for protecting the work.

20. When and how should the investigation be disclosed?

Whether and when the wrongdoing that prompted the investigation needs to be disclosed depends on the facts and whether they are material. That decision will be the subject of careful analysis by the board with the assistance of its counsel.

Often the more difficult issue is whether the fact of an investigation having been commenced (and a special committee having been formed) should be disclosed. When the events or allegations that gave rise to the investigation are public, the commencement of an investigation or formation of a committee is an important part of the corporation's response to the event or allegation and so it will want to disclose this information in order to provide some comfort to the investing public that the corporation is taking the matter seriously.

There are other situations in which disclosure of the existence of an investigative committee may not be advisable. For example, an investigation may be commenced in response to an issue raised through the whistleblowing process. Without knowing whether there is an merit in the allegations made, disclosure of the investigation may lend greater attention and credibility to the allegations than they deserve. It may even destroy the reputations of those who have been accused and are later shown to be blameless.

FOR MORE INFORMATION,
SEE THE CICA PUBLICATION
20 QUESTIONS DIRECTORS SHOULD ASK ABOUT SPECIAL COMMITTEES

However, in still other cases, failure to disclose that a committee has been established can be a serious disclosure deficiency. In *YBM*, the OSC was very critical of the YBM board and management for failing to disclose the establishment of the YBM Committee and its mandate. The YBM Committee was advised by its external legal counsel to make such disclosure. The OSC noted that the board knew that the purpose of the Special Committee was to independently investigate concerns arising out of the company's business specifically as a consequence of the investigation of YBM by the U.S. Attorney. Notwithstanding, the OSC found that the disclosure that ultimately appeared in the AIF (as set out below) was obscure.

> Over the last two years the Company became aware of concerns that had been expressed in the media and by government authorities generally concerning companies doing business in Eastern Europe and, particularly, in Russia. To this end, the Company has taken a number of steps to address these concerns, including:
>
> 2. the establishment of an independent committee of the Board of Directors who retained experts knowledgeable with political, social and economic issues in Eastern Europe to review the Company's operations to ensure that they are consistent with the standards applicable to Canadian public companies. Recommendations resulting from such review are being implemented by the Company. The Board of Directors, through the Audit Committee, will monitor ongoing compliance by the Company with such recommendations.[17]

Well managed communication, in addition to satisfying regulators, can also reap benefits in terms of stakeholder confidence and preservation of the company's reputation. The board's responsibilities include oversight of the company's communication policy, and directors should ensure that there is a well-thought out strategy in place, particularly with respect to communication of the fact and / or results of the investigation. A communication plan should take into account the following elements:

- Internal communication — the first disclosure of the results of the investigation will likely be to management. Employees will also be anxious to know the results of the investigation and how it will impact them and the company as a whole.
- External auditor — the results of the investigation and substantial detail as to its process will likely need to be disclosed to the external auditor in order for them to render their opinion.
- Shareholders, analysts and the market — there is a delicate balance to be reached between disclosure which is clear enough to inspire confidence in the corporation's ability to detect and deal with wrongdoing, but not so detailed as to infringe on privacy rights or expose the company to litigation. Some disclosure is mandated by law — for example, financial wrongdoing likely indicates a material weakness in internal controls, triggering a disclosure obligation.

17 YBM Magnex International Inc., Annual Information Form 2003

Where to find more information

Canadian Institute of Chartered Accountants publications

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20 Questions Directors and Audit Committees Should Ask about IFRS Conversions

20 Questions Directors Should Ask about Building a Board

20 Questions Directors Should Ask about CEO Succession

20 Questions Directors Should Ask about Codes of Conduct

20 Questions Directors Should Ask about Crisis Management

20 Questions Directors Should Ask about Crown Corporation Governance

20 Questions Directors Should Ask about Director Compensation

20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance

20 Questions Directors Should Ask about Executive Compensation

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Management's Discussion & Analysis: Guidance on Preparation and Disclosure

Standardized Distributable Cash in Income Trusts and Other Flow-Through Entities: Management's Discussion and Analysis — Guidance on Preparation and Disclosure

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About the authors

Carol Hansell, MBA, LL.B.

Carol Hansell is a senior partner at Davies, practising corporate, commercial and securities law and is an internationally recognized expert in corporate governance. She advises public and private companies on a variety of transactional and other business issues. She is recognized by the Canadian Legal LEXPERT Directory in the areas of mergers and acquisitions, and corporate and commercial law, by Best Lawyers in the areas of corporate governance and corporate law and as a leading practitioner by Law Business Research's International Who's Who of Corporate Governance Lawyers, She is the author of What Directors Need to Know: Corporate Governance and Directors and Officers in Canada: Law and Practice.

Ms. Hansell is an experienced director. She currently serves on the board of directors of the Bank of Canada (Canada's central bank) and of Toronto East General Hospital. She is a past director of Royal Group Technologies (having joined that board as one of the new directors recruited to help the company through its regulatory, litigation and reputational issues), the Public Sector Pension Plan (a Crown corporation) and is a past director and Vice Chair of the Institute of Corporate Directors. She is the immediate past Chair of the Securities Advisory Committee, which provides advice and assistance to the Ontario Securities Commission. She is also a member of several advisory boards. She holds a number of positions in the American Bar Association, including Chair of the Corporate Governance Committee and Canadian Advisor to the Committee on Corporate Laws. Ms. Hansell received a B.A. in History from the University of Western Ontario in 1981, an M.A. in International Relations from the University of Toronto in 1982 as well as an LL.B. from Osgoode Hall Law School and an M.B.A. from the Schulich School of Business at York University. She is a member of the bar in Ontario and New York.

Beth Deazeley, LL.B.

Beth Deazeley, LL.B. is a Principal, Risk Management and Governance at the Canadian Institute of Chartered Accountants, where her responsibilities include the development of guidance material for boards of directors and CFOs on issues relating to governance and risk.

She is a lawyer called to the Ontario bar and has practiced as a litigator, as well as developed curriculum for continuing legal education programs.

20 Questions
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277 WELLINGTON STREET WEST
TORONTO, ON CANADA
M5V 3H2
416.204.3400
WWW.CICA.CA