Canada Steps Up

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Research Study

Some Obstacles to Good Corporate Governance In Canada and How to Overcome Them

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1. Executive Summary

Good corporate governance is not a checklist of “dos” and “don’ts”; rather, it is the efficient allocation and management of corporate sector capital. This is not fixation on current earnings, but economically efficient trade-offs between hard and soft considerations, and between the present and the future. Measures to promote good corporate governance are good public policy because they promote the efficient use of the country’s resources.

Fairness of the capital market system for public shareholders often aligns with this broader goal. This is because public shareholders, whose entitlements to the firm’s cash flows are the most ephemeral, feel the pinch of poor governance first. Inept or venal management almost always erodes the share price first. Employees, creditors, and other stakeholders are harmed only if the problems persist. This use of the share price as an admittedly imprecise barometer of governance quality is the economic basis for grounding good corporate governance in legal rights for public shareholders. Directors, officers and controlling shareholders ought to owe fiduciary duties to shareholders not because shareholders are more important than others, but because shareholders are hurt first when the quality of governance flags. However, shareholder rights are a tool, not an end.

Canadian regulators, lawmakers, and good governance advocates alike look towards the United States and United Kingdom for ideas. This is sensible in many realms of law because those countries, like Canada, have Common Law legal systems and rely heavily on stock markets to assemble and allocate capital. Unfortunately, the structure of governance in much of corporate Canada is radically different from that in either the United States or the United Kingdom, and more closely resembles that in Latin America, parts of Europe, and East Asia.

These differences reflect the preservation of an older model of corporate governance in Canada - a model rejected by the United States in the 1930s and by the United Kingdom after World War II. Debates about grafting current American and British corporate governance solutions onto Canadian corporate reality are embarrassingly like debates about the best global positioning system to install in a horse-drawn buggy.

There are three fundamental elements that this older model of corporate governance preserves.

1. Governance disputes in Canada are at least as likely to pit controlling shareholders against public shareholders as to pit professional managers against shareholders in general.

When corporate governance activists in the United States or United Kingdom demand stronger shareholder rights against top corporate managers, they seek to empower middle-class investors and the institutions that represent them. Demands for more shareholder rights justifiably puzzle some Canadians. Would granting Hollinger's shareholders, notably Conrad Black, more rights *vis à vis* hired managers have checked that scandal? Doubts can be forgiven.

In Canada, corporate governance problems are as likely to pit public shareholders against controlling shareholders, as in Hollinger, as to pit shareholders against managers, as in Enron.

2. In Canada, the relevant unit for corporate governance discussion is as likely to be the "business group" as the "corporation".

In Canada, as in Latin America, East Asia, and parts of Europe, business groups are typically pyramid-shaped. A controlling shareholder - usually a wealthy family - owns a family firm, which holds voting control blocks in a first tier of listed firms. Each of these holds voting control blocks in a second tier of listed firms, and each of these holds voting control blocks in a third tier. Pyramidal groups of this sort in Canada contain up to sixteen tiers of inter-corporate ownership, and the largest encompass hundreds of corporations, both listed and unlisted.

Pyramiding lets a wealthy individual or family magnify control over one large firm into control over a huge constellation of firms. This exacerbates a range of corporate governance problems and also gives rise to a new genre - *self-dealing* or *tunnelling* - in which the controlling owner directs one controlled firm to take a loss so that another might benefit or so that he might benefit personally. These problems are worsened by dual-class shares.

Pyramiding, by giving individuals or families with substantial wealth control over clusters of corporations worth vastly more, also greatly magnifies their political influence. Pyramiding is the mechanism that, for example, lets tiny cliques of wealthy oligarchs control the greater parts of the corporate sectors of most Latin American countries. This corporate governance difference is at the root of much misunderstanding. Americans see capitalism as vigorous competition between hundreds of firms, while Latin Americans see capitalism as a handful of wealthy families controlling the country. Each side sees the other as, at best, touchingly naïve. Yet both are right. Differences in corporate governance lead to fundamental differences in the nature of capitalism. Canadian capitalism at present resembles Latin American capitalism more than American or British capitalism.

Pyramiding disappeared from the United States in the 1930s with a series of New Deal reforms aimed at cleaning up corporate governance after numerous abuses of the 1920s bull market came to light in the 1930s bear market. Tax law, not securities law, was the primary tool of the Roosevelt administration.

But pyramiding was eliminated from the United Kingdom by 1960s securities regulation reforms that forced controlling shareholders to acquire 100% stakes if they acquired more than 30%. The American approach is perhaps preferable, but the British tack is achievable in Canada through securities law and regulation reforms.

3. In deriving private benefits, controlling shareholders impair corporate governance.

Although coat tail provisions protect inferior voting shareholders from exclusion during control block transfers, and although rules opening control block sales to public investors eliminate some abuses, it seems likely that controlling shareholders derive benefits from exercising control. This might reflect their gains from self dealing or tunnelling. Or it might reflect the political influence attendant to running great corporate empires.

Regardless, these private benefits of control induce controlling shareholders to run their corporations in ways that need not align with the wishes of public shareholders. This negates many other advantages that large shareholders can bring to a firm. The negative net balance is linked to depressed valuations of Canadian companies, smaller and less active stock markets than a Common Law country Canada's size should have, and flagging total factor productivity.

These failings fade in and out of importance from year to year, but seem to be, on the whole, a recurring long-term feature of the Canadian economy. We present evidence that they reflect corporate governance deficits intrinsic to the outmoded model still in use here.

2. Summary of Recommendations

To rectify this situation, we recommend a series of policy reforms. The economic basis of each is set forth below, along with possible objections and our reasons for concluding that the recommendation is worthwhile.

These recommendations are:

Recommendation #1: Securities law should create for officers and directors a fiduciary duty to public shareholders.

Recommendation #2: Securities law should define oppression as a controlling shareholder failing to put public shareholders' interests ahead of his own.

Recommendation #3: Securities law should protect officers, directors and controlling shareholders from lawsuits for good faith business judgments.

Recommendation #4: Rules requiring certain numbers or proportions of independent directors on boards or key committees should use definition 2.

Recommendation #5: Securities law should require institutional investors be managed so that their stocks lie within the public float.

Recommendation #6: Securities law should create a fiduciary duty of institutional investor top managers to beneficiaries.

Recommendation #7: Securities law should require all institutional investors to disclose their voting policies and records.

Recommendation #8: Securities law should let public shareholders nominate and elect a fraction of directors proportional to the public float.

Recommendation #9: Securities law should permit a voting cap (a limit on the voting power of blockholders) to be enacted or removed in any listed company only if approved by a majority of the public float.

Recommendation #10: **Dual-class share structures should require periodic renewal by a majority of inferior voting shareholders.**

Recommendation #11: **Any shareholder who acquires 30% or more of a listed company should have to acquire 100%.**

Recommendation #12: **The Toronto Stock exchange should drop pyramid member firms and firms with dual class shares from its major indexes. This would let Canada present a more modern face to global investors.**

In these recommendations, the "public float" refers to outside shareholders also not affiliated in any way with the controlling shareholder. We advocate greatly empowering Canadian public shareholders because, albeit with errors, the long-term public share price, relative to its potential maximum, is a barometer of governance quality. We empower public shareholders because we would use them as a governance alarm system, not because we feel they are especially meritorious individuals, (although they may be). We also refer to "independence", which we define analogously as having no business or other relationship with the firm, its officers or directors, its controlling shareholder; or with any other firm controlled by its controlling shareholder, the officers or directors of such a firm.

We have two agendas in advocating all these reforms. One is to discourage pyramidal groups and dual-class shares, and in doing this to create a large corporate sector in Canada more like those of the United States and United Kingdom. The second is to promote as the highest possible standards of governance while this transition takes place.

We recognize that the principals of large business groups and controlling shareholders of large Canadian listed companies may dislike many, or all, of these recommendations. We also recognize that Canadian shareholders knew what they were buying when they bought shares in Canadian firms with these characteristics.

It is important to recognize that the point of corporate governance reform is not, and never has been, to deliver perfect fairness. Good corporate governance is sound public policy for the same reason as sensible tax or monetary policies are based on econometric studies of Canadian and foreign stock markets, not reflections of market participants. The studies vary in scope – some look only at very large firms, others at broader cross-sections of listed firms. Some look only at a single year's data, others study long time periods. We include ponly studies whose results probably generalize to broader cross-sections of Canadian listings. For example, some comparative studies of pyramiding and controlling shareholders look only at very large firms. Before including these, we checked Statistics Canada's Directory of Intercorporate Ownership to confirm that the issues raised pertain to smaller Canadian firms as well. We also avoid studies that other researchers consistently fail to replicate; and that use statistical techniques shown elsewhere to be problematic. Overall, we believe our recommendations reflect current academic research.

We have two agendas in advocating all these reforms. One is to discourage pyramidal groups and dual class shares, and in doing this to create a large corporate sector in Canada more like those of the United States and United Kingdom. The second is to promote as high as possible standards of governance while this transition takes place.

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It is important to recognize that the point of corporate governance reform is not, and never has been, to deliver perfect fairness. Good corporate governance is sound public policy for the same reason as sensible tax or monetary policies,: to ensure that the Canadian economy delivers the highest possible performance for Canadians.

These reforms would trigger a long-delayed modernization of Canadian corporate governance that is necessary before other reforms, like Sarbanes Oxley analogs, even merit discussion. They would at long last put Canadian corporate governance on the same page as the United States and United Kingdom, solving problems long forgotten in those countries and so making their recent legal and regulatory innovations of practical value to Canada.

3. Introduction

Good corporate governance is not a checklist of board and management characteristics. Good governance means running a company well, but honest people can disagree about what "well" means. Good corporate governance, to economists, means economically efficient management. Economic efficiency is not a narrow-minded focus on current profits, as sacrificing profits today can lead to greater gains in the future. Nor does economic efficiency neglect "softer" aspects of governance, like employee morale, supplier and customer confidence, community values, and the like. Attention to such factors can be economically efficient, as can thoughtful inattention, and competent top executives know this. Efficient management requires trade-offs, and good governance is about getting these trade-offs right so as to contribute the greatest possible net value to the economy.

This aligns well with the interests of most shareholders most of the time, so attention to shareholder concerns is sensible public policy. But shareholders do not always agree amongst themselves, and even the majority may sometimes see their best interests in directions other than adding value to the overall economy.

While good governance is most essentially about putting the right people in charge and giving them the right incentives, this can be helped or hindered by laws, regulations, and rules. Canadian regulators, lawmakers, and good governance advocates alike look towards the United States and United Kingdom for ideas. This is sensible in many realms of law because those countries, like Canada, have Common Law legal systems and rely heavily on stock markets to assemble and allocate capital.

Unfortunately, governance in much of corporate Canada differs radically from that in the United States and United Kingdom. These differences preserve an older model of corporate governance in Canada - one rejected by the United States in the 1930s and by the United Kingdom in the decades after World War II. Debates about grafting current American and British corporate governance solutions onto Canadian corporate reality are thus embarrassingly like debates about the best global positioning system to install in a horse-drawn buggy.

4. Pre-Modern Corporate Governance

Two "great divides" distance the large corporate sectors of the United States and United Kingdom from that of Canada, and from those of many other countries. These differences are not minor: they are economic chasms that make the Canadian economy sufficiently different from its erstwhile role-models as to call for either radically different regulation or radical reformation of the large corporate sector in Canada.

i. The First Great Governance Divide: Controlling Shareholders

Figure 1 encapsulates one key difference between the United States and United Kingdom on the one hand, and many other countries, including Canada, on the other. Most large, listed American and British firms are widely held (white in Figure 1), with no controlling shareholder - even if "control" means a voting block of as little as ten percent.[1]

This means that governance problems in large high-profile American and British firms entail hired top executives stealing from public shareholders - so-called "widows and orphans". Enron, WorldCom, and other recent U.S. scandals fit this pattern. Sarbanes Oxley, the Cadbury Code, the Higgs Report, and other Anglo-American reforms would empower public shareholders *vis à vis* top managers in one way or another. But shareholder rights in the United States and United Kingdom always implicitly means rights for middle-class investors whose savings are invested in publicly traded shares.[2]

Figure 1 shows that the lay of the land in Canada and elsewhere differs markedly from American and British terrain. Half of the top firms in Canada, and most large firms elsewhere in the world, have controlling shareholders - wealthy families, other firms, or large financial institutions. These controlling shareholders usually dominate the board and so are entrusted by their countries with the governance of those firms.

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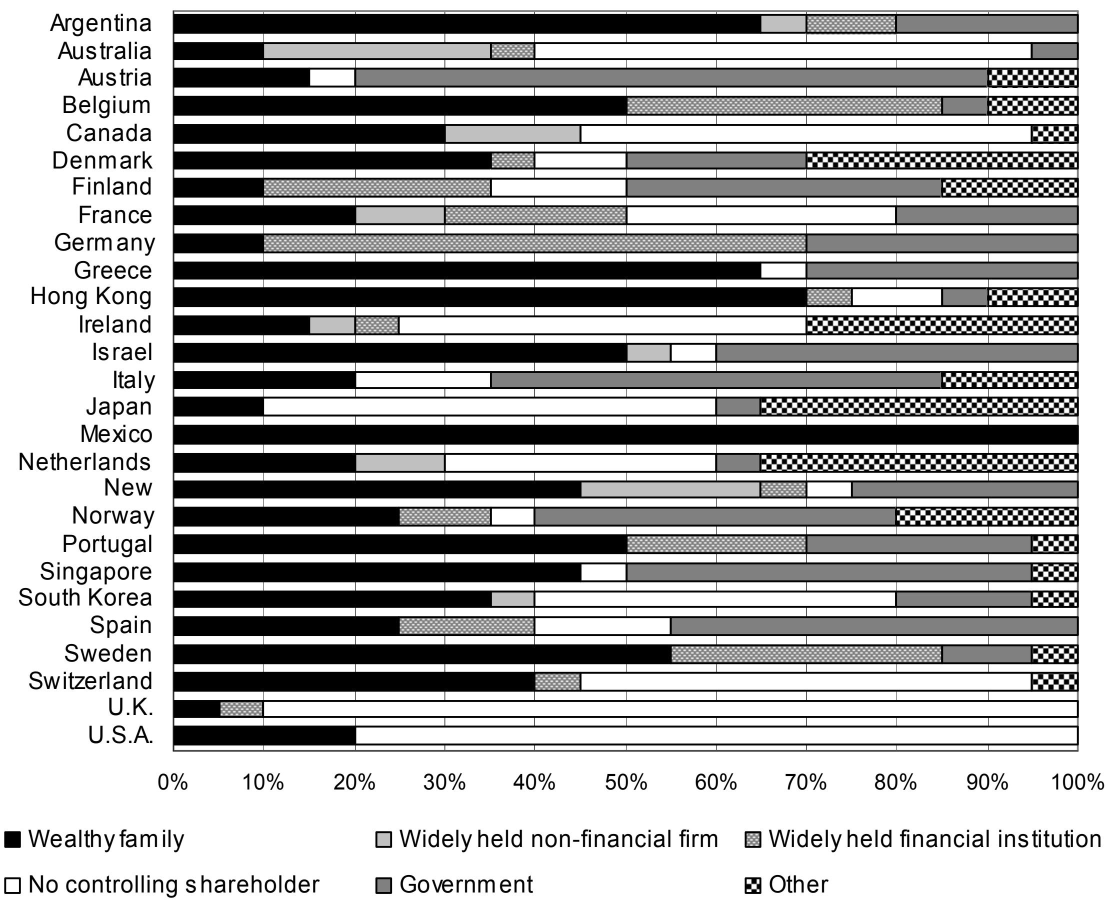
[1] Recent work by Holderness (2006), Anderson and Reeb (2004) and others argues that controlling shareholders, and family control in particular, are more common in the United States than is generally appreciated. But the lengths to which especially Anderson and Reeb go to sniff out faint residues of founding families underscore the difference between the United States and Canada. A generous definition of what constitutes a controlling shareholder makes sense, for La Porta et al. (1998) argue that a ten percent block is often sufficient to control the annual shareholder meeting if no larger or similar sized blockholders exist. But even using that standard, La Porta et al. (1998) go on to show that controlling shareholders are remarkably rare in both the United States and United Kingdom compared to other countries.

[2] See Shleifer and Vishny (1997) and La Porta et al. (1997, 1998).

Figure 1: Controlling Shareholders Around the World

The type of ultimate controlling shareholder, if one is present, in the twenty largest listed corporations in each country as of 1996. Control is inferred from a ten percent voting block. Ultimate controlling shareholder means the person at the end of any chain of corporate controlling shareholders.



Source: La Porta et al. (1998), Baums (1996). The prevalence of controlling shareholder in Japan is probably understated because the stakes of equity holders who act together are not aggregated. Figures for Germany include proxy voting rights held by universal banks.

The figure uses data for the largest companies in each country in 1996, but La Porta *et al.* (1998) repeat the comparison using middle sized firms and find a broadly similar pattern. Morck et al. (2005) show that the figures for Canada fluctuate through the 20th century, but that high levels of family control characterize most years since the 1960s

Canadians can be confused by American or British corporate governance advocates, who demand "stronger shareholder rights". Not comprehending this difference, they may be forgiven for wondering why powerful controlling shareholders need more "rights".

Controlling shareholders can be very good for a firm. If the controlling shareholder is a brilliant and highly ethical entrepreneur, freedom to act without concern for short-term share price-effects can be a boon. A sophisticated controlling shareholder can monitor and, if necessary, discipline errant managers. The very presence of a sophisticated controlling shareholder can reassure smaller investors, who rely on the blockholder to correct governance problems. Consistent with this, insider purchases raise share prices and insider sales depress them.[3]

Perhaps most importantly, controlling shareholders whose own wealth is tied up in their firms have a clear economic interest in efficient economic management: the better run their firms, the richer they are. This economic logic is sound, and empirical evidence links very high insider ownership to superior performance.[4]

Governance problems arise where controlling shareholders are either unsophisticated or wield control without owning very many shares. The former problem typically arises in family firms governed by either senile patriarchs or unqualified heirs who fail to appreciate their own competence. The second problem typically occurs where controlling shareholders actually own few shares, and wield control using super-voting shares, pyramiding, or other control magnifying devices.[5] Much empirical research links these problems to weak performance.[6]

This work gives clear guidance to Canada, and is reviewed in more detail below. The scandal surrounding the Hollinger companies features a wealthy heir, Conrad Black - whose self-confidence may or may not have been exaggerated - controlling a group of listed firms *via* super-voting shares and pyramiding. Lord Black allegedly withdrew money from firms he controlled, leaving other shareholders poorer.[7]

Professional managers subject to controlling shareholders truly are "hired help", and seldom defy their

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[3] See Seyhun (1986), but also Seyhun (1992).
[4] Jensen and Meckling (1976) formalize this argument as an economic model. Morck, Shleifer and Vishny (1988) present evidence consistent with a modified version of this model, where the effect at issue dominates only at very low and very high levels of insider ownership. Shleifer and Vishny (1986) develop and alternative model stressing large shareholdings by disinterested third parties, such as pension funds, rather than by insiders who actually wield control.
[5] For empirical evidence on the economic importance of super-voting shares, see Nenova (2003). For specifically Canadian evidence, see Amoako-Adu and Smith (2001). On pyramiding, see Berle and Means (1932), Bebchuk et al. (2000), and others.
[6] For empirical evidence, see Morck, Shleifer and Vishny (1988); Amoaku-Ado and Smith (2001), Pérez-González (2001), Bennedsen et al. (2005), and many others.
[7] Lord Black emphatically denies all wrongdoing, and the cases remain before the courts at writing.

masters. Empowering "shareholders" against professional managers misses the point here. Might scandal have been averted by giving Lord Black more power over the Hollinger firms' hired MBAs? Regardless of Lord Black's guilt or innocence, the Hollinger charges typify how corporate governance disputes in Canada (and in most other countries) pit controlling shareholders against public shareholders. To summarize: governance disputes in Canada are at least as likely to pit controlling shareholders against public shareholders, as to pit professional managers against shareholders in general.

Canadian corporate governance laws, regulations, and best practices must attend to controlling- versus public-shareholder disputes in firms with controlling shareholders, and to shareholder-manager disputes in firms without them. This requires a fundamentally broader focus than in the United States and United Kingdom, where controlling shareholders are relatively rare and good governance is mainly about preventing or solving shareholder-manager disputes.

ii. The Second Great Governance Divide: Business Groups and Pyramiding

As important as this first point is, an even greater chasm separates the United Sates and United Kingdom from most other countries, including Canada. Most listed firms in the United States and United Kingdom are "freestanding": they neither control other listed firms nor are they controlled by other listed firms.[8] In contrast, many large firms in Canada and elsewhere belong to business groups - clusters of listed and unlisted firms that hold control blocks of stock in each other.[9]

A business group in the United States or United Kingdom, if the term is used at all, typically means one listed firm with various fully-owned subsidiaries. A business group in Canada, and most other countries, refers to a cluster of separately listed firms controlled - occasionally directly, but usually indirectly - by a single controlling shareholder. This single shareholder is typically a wealthy old-money family, like India's Tata dynasty; but is also occasionally a powerful tycoon, like Italy's Silvio Berlusconi. Canadian examples include the Bronfman groups; the Power group (the Desmarais family); the Reichmann group; the Thomson group; and Lord Black's Hollinger group.[10]

Corporate governance problems in business groups have a different flavour from those in freestanding firms with controlling shareholders. This is because conflicts arise between controlling shareholders and public shareholders, and also between the public shareholders of different firms in a group. The United

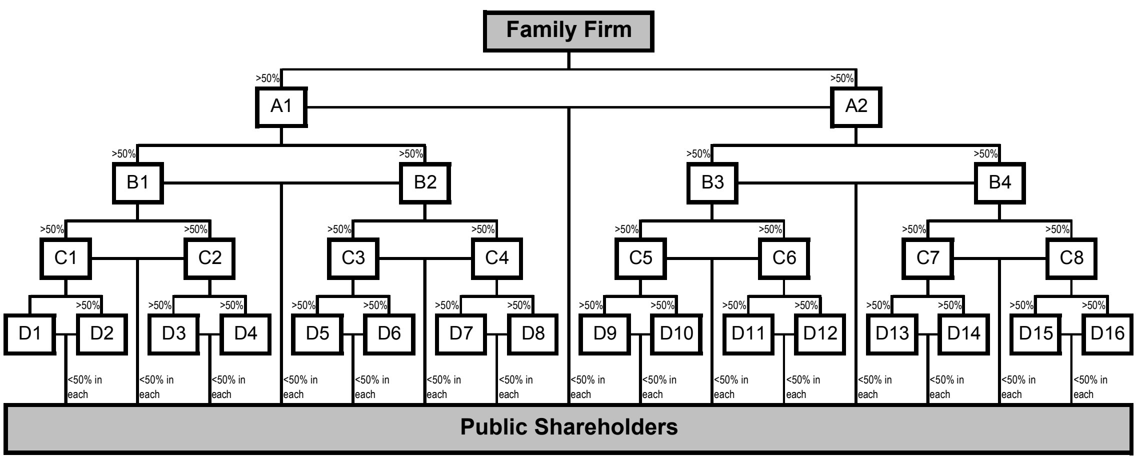
[8] For details on the ownership structures of large U.S. firms, see Morck, Shleifer, and Vishny (1988) and others. On the U.S., see Franks et al. (2005) and others.
[9] See La Porta et al. (1998) for a detailed tally.
[10] For complete lists, see the *Directory of Intercorporate Ownership*, published biannually by Statistics Canada.

States and United Kingdom both concluded decades ago that business groups no longer justified the problems they created, and deliberately eradicated these structures from their markets.[11]

Appreciating the governance problems associated with business groups requires an appreciation of typical group structures. Canadian business groups, as in most countries, are typically organized as pyramids.[12] The controlling shareholder owns an apex firm, the *Family Firm* in Figure 2, which holds control blocks in a first tier of listed firms: firms A1 and A2. Each of these holds control blocks in one or more B-tier firms; and each of these holds control blocks in one or more C-tier firms. The pyramid can continue with as many additional tiers of firms as are needed. The Bronfman pyramidal group, for example, contained sixteen tiers in the mid 1990s.[13]

Figure 2: Pyramiding Basics

A family firm controls listed firms, each of which controls more listed firms, each of which control yet more listed firms. Remaining shares in each firms are held by public investors.



Source: Morck and Steier (2005).

Pyramiding, precisely like super-voting shares, entrusts sweeping control rights to people who actually own few shares. In Figure 2, the control block in each firm is a bit more than 50%, with other shares held by "widows and orphans". The private family firm owns just over 50% of each A-tier firm, These firms in turn own just over 50% of each B-tier firm. A $100 rise in the value of a B firm raises the value

[11] For details, see Morck (2005) on the United States and Franks et al. (2005) on the United Kingdom.
[12] For general cross-country empirical evidence, see La Porta et al. (1998). For details on the structures of Canadian pyramidal groups, see Tian (2006).
[13] For details, see Morck, Percy, Tian, and Yeung (2005) and Tian (2006).

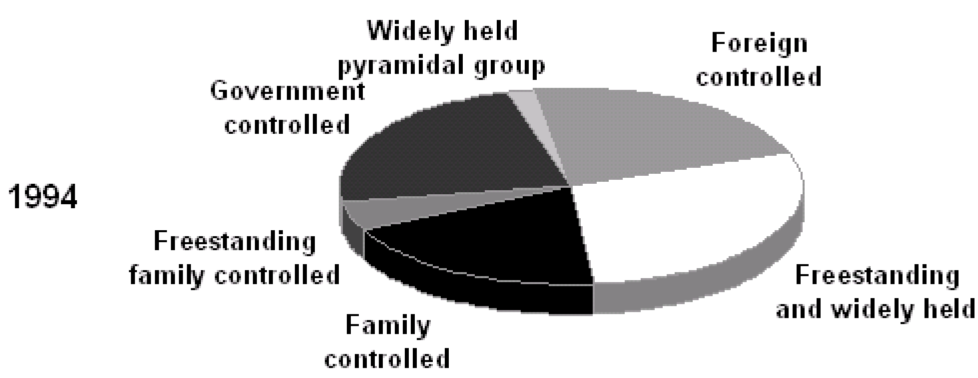
of its A-tier parent by a bit over \$50, which raises the family's wealth by a bit over \$25. In other words, the family actually owns just over 25% of each B-tier firm, although it controls over 50% of the votes in each B-tier firm. Extending this reasoning shows that the family owns just over 12.5% in each C-tier firm, 6.25% in each D-tier firm, and further diminished stakes in firms in any lower tiers not shown.

Berle and Means (1932) argue that pyramiding separates control from actual ownership more starkly than any other device. For example, sixteen tiers, which some Canadian pyramids have achieved, leave the family actually "owning" 0.0015% of firms in the bottom tier. Yet the family "controls" more than 50% of the votes in these and every other firm in the business group by dint of controlling all the firms above. The same magnification would take 65,536 vote-per-share super-voting stock in a freestanding firm whose public shareholders got one vote per share.

In practice, even smaller stakes confer *de facto* control absent another blockholder or sophisticated shareholder.[14] By using super-voting shares *and* pyramiding, some Canadian controlling shareholders rule vast pyramidal groups with very tiny actual ownership stakes.[15]

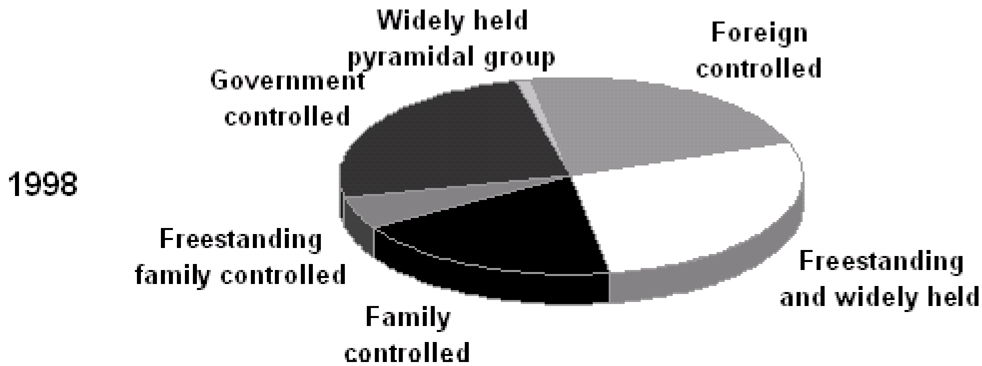
Figure 3: Great Pyramids of Canada

A family firm controls listed firms, each of which controls more listed firms, each of which control yet more listed firms. Remaining shares in each firms are held by public investors. This diagram shows the fraction of the corporate assets of the 100 largest Canadian firms (by assets) belonging to family controlled pyramids versus other corporate governance structures in 1994 and again in 1998.



[14] See Berle and Means (1932) for the U.S.; Tian (2006) for Canada; and La Porta *et al*. (1999) for cross-country data.

[15] The extensive use of dual-class shares in Canada and their governance impact are documented by Amoako-Adu and Smith (2001) and their widespread use to hold pyramidal groups together is confirmed by Tian (2006) and others. For details on specific groups and companies, see Statistics Canada's *Directory of Intercorporate Ownership*, various years.



Source: Tian (2005).

Figure 3 shows that, in the late 1990s, almost half of the assets of the top 100 listed Canadian firms belonged to firms that were members of pyramidal business groups.[16] Statistics Canada's *Directories of Intercorporate Ownership* show even relatively small Canadian firms often belonging to groups of companies that hold control blocks of stock in each other.[17]

The contrast with the United States and United Kingdom is stark, for in both countries, pyramidal (and all other) business groups are essentially unknown.[18] A diagram analogous to Figure 3 for either country would show 100% of the top 100 listed firms in each to be freestanding and most to be widely held.[19]

Consequently, an unspoken premise of the Cadbury Report, Sarbanes Oxley, and other Anglo-American governance initiatives is that listed firms are freestanding entities.[20] In both the United States and United Kingdom, corporate governance is about individual firms, for listed firms very seldom control or are controlled by other listed firms. This leads us to summarize that in Canada, the relevant unit for corporate governance discussion is as likely to be the "business group" as the "corporation".

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[16] See Morck, Percy, Tian, and Yeung. (2005) and Tian (2006) for details on how these data are gathered and how the results in Figure 3 are calculated.

[17] These volumes, published periodically, provided details about the structures of Canadian pyramidal groups. While the figures in them contain some errors, and must be double checked against data in corporate proxy statements to insure accuracy, the general picture of who controls Canada's large corporate sector firms they depict is correct.

[18] A few very small pyramidal groups do exist in the United States. One, the Cox Group, contains a few media firms. Another, Thermo-Electron, is a venture capital firm that retains equity blocks in its start-up ventures. But, business groups in the U.K. and U.S.A. are so rare that they register on the radar screens of neither regulators nor corporate governance activists. See Becht and DeLong (2005) for the U.S. and Franks et al. (2005) for the U.K. Instances of listed firms holding blocks of stock in other listed firms are usually either 100% corporate takeovers in progress or formerly 100%-owned subsidiary divestitures in progress. In rare circumstances, joint venture partners also hold equity blocks in each other, usually only for the fixed duration the joint venture.

[19] See La Porta et al. (1999), for this data.

[20] Regarding the United Kingdom, see Black and Coffee (1994), Cheffins (1999), Franks et al. (2005) and others. For the United States see Shleifer and Vishny (1997).

The bottom line is that super-voting shares and pyramiding both give blockholders control rights vastly exceeding their actual ownership. This undermines the most important governance argument for controlling shareholders: that their own money being tied up in their firms aligns their interests with good governance.

5. The Virtue of Old Ways

Pyramiding was ubiquitous in virtually every stock market in the world in the early 20th century because it mitigated corporate governance problems paramount early in a country's economic development.[21] Most developing countries now, like most Western countries a century ago, suffer rampant corruption. Business dealings and investments are fraught with peril, for no reliable judicial or other mechanisms enforce contracts, protect property rights, or guarantee performance. Such so-called institutional deficiencies are thought to be a major growth retardant throughout the developing world. For example, a Bombay firm that deals profitably with another in Bihar does not do so, for fear of being cheated. Or, a Varanasi entrepreneur obtains no capital because investors in New Delhi and Bombay, or even in Varanasi, fear he will abscond with their money. Or, temporary liquidity problems close a fundamentally sound company in Hyderabad. Businesses, jobs and goods that might have been are not, and India is the poorer.

Pyramiding is a partial end-run around these problems.[22] A firm in Bihar becomes a more reliable business partner for the Bombay firm if one wealthy family controls both. An entrepreneur who has borrowed from a family whose influence extends throughout the country is unlikely to evade his creditors. A family with a reputation for fair dealing becomes a business partner of choice, and foreigners and locals alike rationally prefer to do business to its group firms. Economic growth is perhaps still not what it might be, but at least products are produced and jobs are created.[23] Because of this logic, pyramiding was once prominent in virtually every country, the United States and United Kingdom included.[24] Pyramiding still dominates the large corporate landscapes of most developing counties,[25] and it remains more important in countries with weaker courts, worse corruption, and lower governance standards.[26] Figure 4 shows that every listed firm in Chile belongs to a business group containing at least one other firm. From Latin America, through Asia and the Middle East, and across the spectrum of post-socialist transition economies, pyramidal groups are often the only form of corporate ownership structure one finds.[27]

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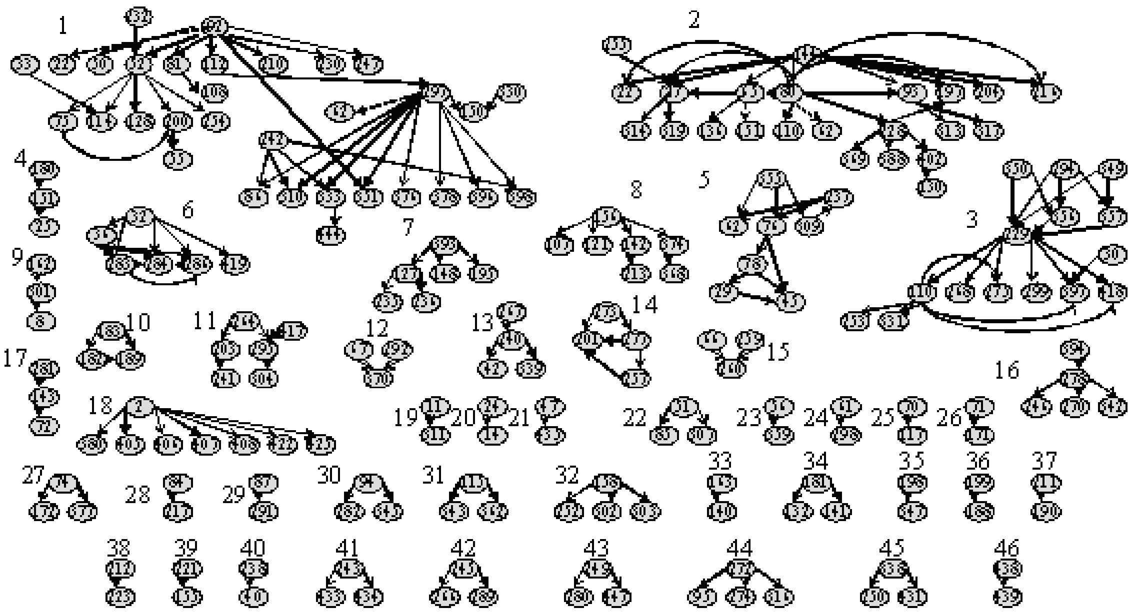
[21] For evidence, see Khanna and Rifkin (2001) and Fisman and Khanna (2001).
[22] For evidence, see Khanna (2000), Khanna and Fisman (2004), Khanna and Palepu (1997, 2000, 2001), and Khanna and Rivkin (2001).
[23] For details, see Khanna and Fisman (2004), Khanna and Palepu (1997), and Khanna and Rivkin (2001).
[24] For details, see Becht and De Long (2005) and Morck (2005).
[25] For evidence, see Khanna and Rifkin (2001).
[26] For empirical evidence, see La Porta et al. (1999) and many others.
[27] For detailed data, see Khanna and Rifkin (2001); Khanna and Palepu (2000); and Morck, Wolfenzon, and Yeung (2005).

Figure 4: A Corporate Governance Map of Chile

Each oval represents a Chilean corporation. Arrows represent equity control block holdings. Essentially all listed firms in Chile belong to pyramidal groups, **each controlled by a different wealthy family and** ranging in size from large structures encompassing many listed firms to small groups with only two listed member firms.



Source: Tarun Hanna

"Capitalism" truly means very different things in different countries, and corporate governance (in the presence or absence of pyramidal groups) plays a surprisingly important role in those differences. Pyramidal groups are the mechanisms that let a handful of extremely wealthy families totally dominate the large corporate sectors of many developing countries.[28] Ignorance of these structures is at the root of the incomprehension many American economists and political scientists display at the visceral objections to "capitalism" that their Third World colleagues see as self-evident.

Canadian "capitalism" thus preserves the form of an early stage of economic development.[29] It is more like the Chilean variety and less like the Anglo-American variety than Canadians are comfortable admitting. Embarrassing as this may be, the fact needs to be acknowledged in our corporate governance debates.

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[28] For details, see Morck, Wolfenzon, and Yeung (2005).

[29] For details on the evolution of pyramids in Canada, the United States, the United Kingdom and other countries, see Morck (2005b).

Dual-class shares, like pyramiding, were commonplace in the United States in the early 20th century, and may have served an economic purpose similar to pyramiding, though no evidence supports this. Perhaps families with reputations for fair dealing might reassure public shareholders of their continued stewardship by holding super-voting shares even as their firms raised ever more capital through equity issues.

But once a country develops passably good government - an efficient legal system, a financial system that rewards honesty, etc. - such *raisons d'être* evaporate. Once courts reliably enforce contracts between strangers, banks and financial markets provide capital to deserving entrepreneurs, and firms routinely extend trade credit to temporarily illiquid suppliers and customers, business groups start to lose their shine. Of course, courts, financial systems, and liquidity provision are imperfect even in the most developed economies. These advantages may never disappear entirely, but they attenuate markedly as the level of development rises.[30]

And even if they did disappear, whether or not we permit pyramiding or dual-class shares would be unimportant were there no downside. Business groups and dual-class shares would be economic appendixes: no longer really needed but usually causing no problems either. Unfortunately, much empirical work confirms a steep downside.[31]

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[30] Khanna and Yafeh (2005) argue that business groups' ability to 'spread risk' remains important the longest as economies develop. Hoshi et al. (1990, 1991) specifically draw attention to risk sharing in bank-centered Japanese groups in the 1970s and 1980s. However, Morck and Nakamura (1999) and Morck, Nakamura, and Shivdasani (2000) present empirical evidence that this risk shifting is highly economically inefficient. Regardless, Djankov et al. (2006) argue persuasively that a well-developed financial system should ultimately provide better risk management alternatives than membership in a business group.
[31] For specific case studies, see Johnson et al. (2000). For more general empirical evidence on the economic importance of these issues, see Morck et al. (2000), Djankov et al. (2006), and many others including, most recently, Djankov et al. (2006). For a formal economic model, see Bebchuk et al (2000).

6. The Lay of the Land Today

Since the governance problems most commonplace in Canada differ from those typical in the United States and United Kingdom, it is not surprising that the solutions might differ, too. Based on the economic issues underlying them, we can divide Canadian governance problems into four general categories. This division also turns out to be useful in thinking about solutions.

i. Other People's Money

The corporate governance problem common to Canada, the United States, and the United Kingdom is that corporate insiders spend public shareholder's money. The insiders may be professional managers, as in the big Canadian banks and in typical large American or British firms. Or, the insiders may be controlling shareholders, like Lord Black, who wield control out of proportion to their actual ownership stakes by dint of dual-class shares, pyramiding, or both.

This problem is now usually associated with widely held firms, but empirical studies show it also afflicts low-tier pyramidal group firms and firms controlled with dual-class shares.[32]

ii. Entrenchment

In the United States and United Kingdom, excessively self-serving or inept professional managers can usually be dislodged via hostile takeovers or proxy fights.[33] This is expensive, and can be thwarted by various anti-takeover defences in the United States.[34] But in Great Britain especially, an unspoken premise of corporate governance discussions is always that takeovers and proxy fights are possible as a last resort.[35]

In Canada, inefficient management is at least as likely to stem from inept or self-serving controlling shareholders as from inept or self-serving professional managers.[36] And controlling shareholders are, by

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[32] For evidence regarding this problem in widely held firms, see Morck et al. (1988). For pyramiding and dual-class shares, see Berle and Means (1932), Bebchuk et al. (2000), Morck, Stangeland and Yeung (2000), and Morck Wolfenzon and Yeung (2005).
[33] See Shleifer and Vishny (1997) for a survey of the evidence on this point.
[34] See Bebchuk and Cohen (2005), Cheng (2005), and Moeller (2005) for empirical evidence.
[35] For details, see Black and Coffee (1994).
[36] For empirical evidence, see Smith and Amoako-Adu (1995, 1999), Morck, Stangeland and Yeung (2000), Amoako-Adu and Smith (2001), and others.

definition, *in control*. Their command over large voting blocks leaves them essentially immune to hostile takeovers and proxy challenges.

One especially common governance problem arises in family firms, when family values undermine shareholder value. A controlling shareholder who is a dynamic and imaginative entrepreneur can be a boon to public shareholders. But much work, detailed below, shows that entrepreneurial genius, like other firms of intelligence, is at most, only partially inherited. All too often, the heir to a brilliant and highly ethical entrepreneur can be an ethically challenged bungler. The American Billionaire, Andrew Carnegie (1891), thought the problem even worse, arguing that "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would."

A host of empirical studies back these concerns. U.S. income tax data show heirs' work efforts to be markedly depressed relative to self-made individuals.[37] Firms whose controlling shareholders are their founders' heirs under-perform.[38] Firms' share prices typically rise on the death of the controlling shareholder if control passes to professionally trained managers, but fall if control passes to the son.[39]

Poor corporate governance, if sufficiently widespread, can have macroeconomic consequences. Thus, countries whose large corporate sectors are more dominated by old family money grow more slowly and provide worse public services to their citizens.[40]

Canadian corporate governance activists and regulators must deal with blundering by entrenched controlling shareholders, as well as by more readily disposable professional managers.

iii. Self-Dealing

In the United States and United Kingdom, corporate governance scandals usually involve professional managers diverting resources out of listed companies and into their own pockets.[41] This is the gist of the allegations against insiders at Enron, WorldCom, and other scandal-ridden corporations. In each case, the

[37] Holtz-Eakin, Joulfaian and Rosen (1993).
[38] See Morck, Shleifer, and Vishny (1988), Morck, Stangeland, and Yeung (2000), Amit and Villalonga (2004), Bennedsen et al. (2005), and others.
[39] See Perez-Gonzales (2004).
[40] For empirical evidence and economic context, see Morck, Stangeland, and Yeung (2000), Morck and Yeung (2003, 2004), and Fogel (2006).
[41] Shleifer and Vishny (1997).

wrongdoing involved managers allegedly stealing from shareholders.

Scandals in pyramidal group member firms can take this simple form too. But another class of scandal is possible, for the controlling shareholder can command one firm in the group to surrender assets or income to another at artificially depressed or inflated prices.[42] This benefits the shareholders of one controlled firm at the expense of the shareholders of the other, who, understandably, perceive a governance problem. In part, the alleged wrongdoings in the Hollinger Group take this form. Lord Black vigorously denies all charges of wrongdoing, and declares himself the victim of "corporate governance terrorists". [43]

Corporate lawyers long used the term self-dealing to describe this. Financial economists refer to this governance problem as tunnelling - perhaps unfortunately evoking rodents scuttling behind corporate wainscotings with stolen fruits.[44]

Canadian corporate governance law, in Ontario's Rule 9.1 (now 61-501), recognizes tunnelling as a problem by mandating the disclosure of large inter-corporate transactions between firms controlled by the same ultimate controlling shareholder.[45]

iv. Political Influence

Recall that the original purpose of pyramidal groups is to magnify fortunes.[46] Suppose the wealthy family in Figure 2 has wealth totalling $1 billion. If they invested this in a single freestanding firm, they might control corporate assets with a bit under $2 billion - assuming a stake a bit over 50% to retain control. If a lesser stake is needed, or if they use superior voting shares, they might control a greater pool of real assets.

But pyramidal groups leverage modestly large family fortunes into control over corporate assets worth far more. Assuming each firm in the pyramid has a book value of $1 billion, Figure 2 gives the family control over B-tier firms with $2 billion, C-tier firms with $4B, D tier firms worth $8 billion, and so on.

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[42] For case study examples, see Johnson et al. (2000). For evidence on the detrimental effects on firm performance, see Bertrand et al. (2002). For a recent survey of empirical evidence supporting this general argument, see Djankov et al. (2006).
[43] *Fortune*. September 29, 2003
[44] The term *tunnelling* originates with Johnson et al. (2000).
[45] For a careful exposition of precisely how Canadian regulations differ from those of other countries on this point, see Djankov et al. (2006).
[46] See e.g. Fisman and Khanna (2001).

And if stakes less than 50% can provide control, or if superior voting shares are used at each tier, the magnification factor can be much larger. A larger multi-tier pyramid of the form shown in Figure 2 can theoretically magnify $1 billion in real family wealth into control over firms worth a substantial fraction of a large industrial economy's corporate sector. In fact, structures of this form are commonplace in many developing economies, and are the mechanisms that permit handfuls of wealthy families to exercise control over virtually the whole of their national economies.[47]

This is the virtue of pyramiding in corrupt economies. Many firms under one hand permit business transactions that inefficient courts, weak financial systems, and general corruption would otherwise deter.[48] But a side-effect is that those hands wield vast political influence too, for pyramiding in particular is the mechanism that entrusts the greater parts of the large corporate sectors of many developing economies to handfuls of so-called oligarch families.[49]

Do pyramidal groups provide similarly disproportionate political influence to the Canadian families that control them? Canadian governments are extremely secretive about their subsidies to industry, and Statistics Canada has repeatedly rebuffed my inquiries along these lines.

A few news stories do, however, suggest that a problem exists. One such story involves the Charles Bronfman family, which controls one of Canada's larger pyramidal groups. The family secured a temporary 1991 change in federal tax policy effective around the dates when tax would have become due on a $2.2 billion capital gain in their family trust. A subsequent federal tax deferral of over $2.1 billion for the family also raised eyebrows among tax economists. There is no allegation that the Bronfman family broke any law, only a concern that their influence affected public policy in a way few others could match.[50]

Fears of disproportionate political influence were one of the key drivers of reforms in the United States in the 1930s that essentially eliminated pyramiding in that country. Although concerns about price-fixing, tax evasion, and governance problems also loomed large, New Deal reforms viewed the control permitted

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[47] See Morck, Wolfenzon, and Yeung (2005) for details.
[48] Fismand and Khanna (2001).
[49] See Morck, Stangeland and Yeung (2000); Rajan and Zinglaes (2003), Morck, Wolfenzon, and Yeung (2005); and others for empirical evidence supporting this argument.
[50] For details about the tax ruling and a contemporaneous Bronfman donation to the University of Toronto, see http://www.varsity.utoronto.ca/archives/118/dec01/news/bronfman.html.

by pyramidal groups as fundamentally un-American.[51] The Roosevelt administration therefore undertook a series of reforms that effectively eliminated pyramidal groups from the United States by the late 1930s.[52] These were:

- the double taxation of dividends paid by one corporation to another;
- capital gains tax breaks for firms that either absorbed or spun off partially owned listed subsidiaries;
- explicit restrictions on pyramidal groups in regulated public utilities industries;.
- the elimination of consolidated income tax filings for most pyramidal groups; and
- rules preventing mutual funds and other investment companies from being used to control pyramids.

Subsequent analysis of the dismantling of pyramidal groups shows that the most important factors were probably the first and second: inter-corporate dividend taxes and capital gains exemptions. Canada currently levies no taxes on inter-corporate dividend income if the parent's stake in the subsidiary is 20% or more. U.S. tax law requires an 80% stake to eliminate inter-corporate dividend taxes.

Perhaps because the severance of voting power from ownership is more obvious with dual-class shares than pyramiding, the former came under sustained attack earlier. Harvard Professor Ripley, especially, blasted dual-class shares in a 1925 address to the American Academy of Political Science, and reiterated his concerns in the *Atlantic Monthly* and the *New York Times*.[53] The New York Stock Exchange responded in 1926 by banning, with few exceptions, the listing of firms with dual-class shares.[54] The ban was lifted in 1986, but relatively few U.S. firms took advantage of the change.[55] Loud objections by institutional investors, whose stakes (though small by Canadian standards) are becoming appreciable, may be to blame.

[51] For a detailed account of how pyramidal groups were eliminated in the United States in the 1930s, see Morck (2005). A quicker summary is in Morck and Yeung (2005).
[52] The following is from historical and archival evidence gathered by Morck (2005).
[53] See Ripley (1925); Becht and Delong (2005), p. 656.
[54] Gompers, Ishi, and Metrick (2004).
[55] Becht and DeLong (2005).

7. Do We Need to Change?

All the above is unimportant if controlling shareholders provide economically efficient governance. But controlling shareholders sometimes glean benefits - pecuniary and non-pecuniary - that other shareholders do not share and that distort corporate strategies to the determinate of the economy. Understanding these private benefits of control is critical to understanding corporate governance problems in countries like Canada

Private benefits of control can be large.[56] For example, a media baron might derive more joy from the political influence he wields than from the dividends he collects.[57] But his public shareholders get only the dividends and the general citizenry may or may not benefit from his editorials. Or, a controlling shareholder whose pyramid commands several listed companies might direct one company to lose money so another might gain more.[58] For example, one firm might support a politician who advocates legislation that benefits a second firm. If the second firm is wholly owned by the controlling shareholder, public shareholders have no part at all in the controlling shareholder's private benefit.

i. Why Some Standard Gauges Are Problematic in Canada

Two standard approaches to valuing private benefits of control, and thus gauging the corporate governance deficit prevalent in a country, are to measure block premiums and superior voting premiums. Unfortunately, both methods are ill-suited to Canada.

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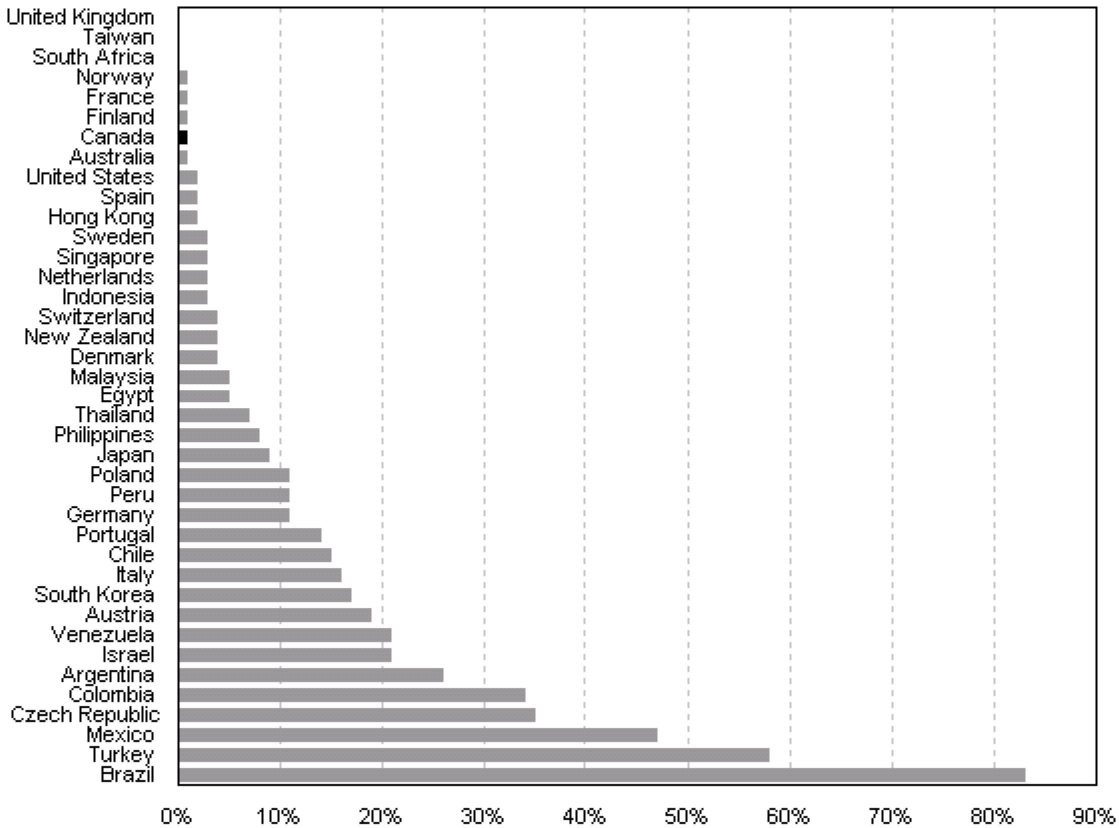
[56] Private benefits of control in different countries are estimated by Nenova (2003) and by Dyck and Zingales (2004) using different estimation techniques. The two approaches generate broadly comparable figures, and confirm the very large magnitudes of private benefits of control in many countries.
[57] For empirical estimates of the value of such private benefits of control in media companies worldwide, see Djankov et al. (2001).
[58] The ideas suggested in the remainder of this paragraph reflect the arguments set forth, and backed up with detailed case studies, by Johnson et al. (2000). For a detailed discussion of broader empirical evidence of political influence as a private benefit of control, see Morck, Stangeland and Yeung (2000) for Canada; Högfeldt (2005) for Sweden; and Morck and Yeung (2004) as well as Morck, Wolfenzon and Yeung (2005) for cross country comparisons.

Figure 5: Control Block Premiums in Different Countries

The premium at which control blocks trade relative to the price of shares in ordinary trading on the same day as the transfer of control.



Source: Dyck and Zingales (200?)

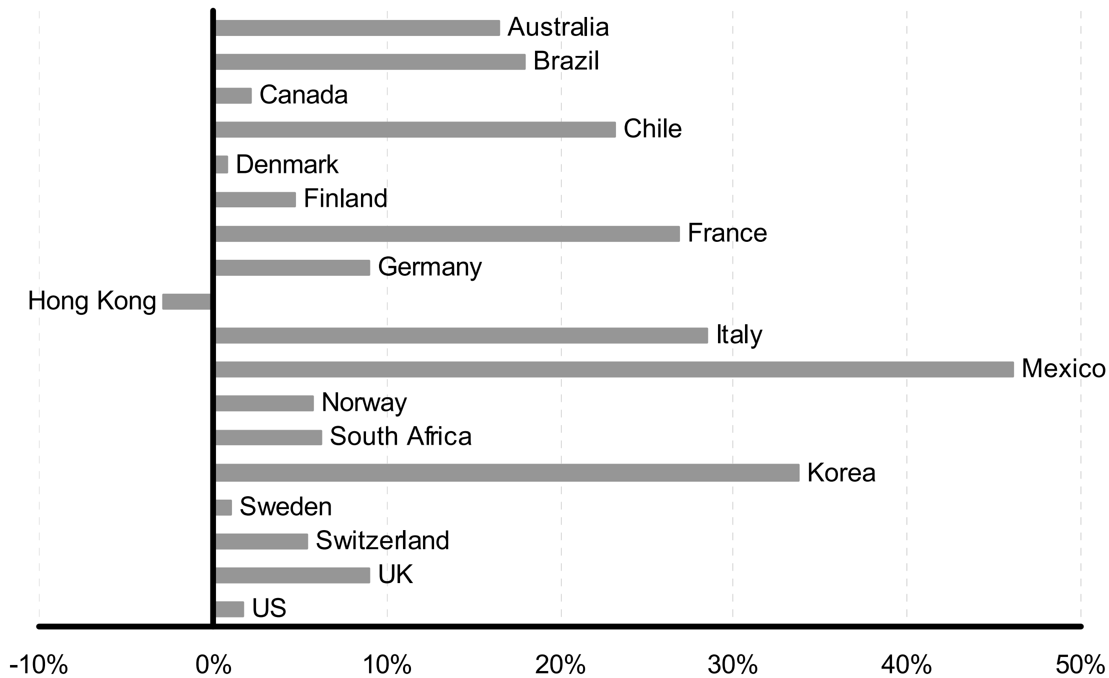
The first approach compares the prices at which control blocks trade to the prices of shares in normal trading.[59] Figure 5 shows that control blocks in Canada trade at a very slight premium relative to control blocks in many other countries. Dyck and Zingales (2004) show that control premiums are greater in countries that score worse on international comparisons of corruption. It seems a key private benefit of control is political influence, and that this is worth more in more politically corrupt countries.[60] Note how good Canada looks.

[59] This method is most recently used by Dyck and Zingales (2004) to estimate private benefits of control for a broad range of countries. See Figure 5 for their results. In essence, they argue that, when one controlling family sells a firm to another, the price is the value of the firm's normal return to shareholders plus private benefits of control. The higher the price of control block sales relative to the market price of the company's shares, the greater the imputed private benefits of control. Their estimates average such calculations for all available control block sales in all countries with reliable stock market and control block price data.

[60] This argument is developed by Zingales (1994), Morck, Stangeland, and Yeung (2000), Dyck and Zingales (2004), Morck and Yeung (2004), Rajan and Zingales (2003), and others.

Figure 6: Standardized Voting Premiums

The value premium for voting versus non-voting shares in each country is estimated using all classes of shares with different voting rights issued by listed companies in each country. The premium is standardized to adjust for different dividend rights and different disparities in voting rights across different companies.



Source: Nenova (2003).

A second approach looks at the difference in price between shares with superior versus inferior voting rights.[61] The technique adjusts for differential dividend rights (inferior voting shares often pay higher dividends) and for differences in the divergence in voting rights (some firms have one versus zero votes per share stock, others have ten versus one votes per share stock) to estimate a standardized voting premium across all firms with dual or multiple classes of shares in a given country. Figure 6 summarizes these estimates for the mid 1990s.

Canada looks great in Figure 6 too, for superior voting shares don't command a large premium here.

[61] This technique is most recently used by Nenova (2003) to estimate private benefits of control for a number of countries. Its logic is that shareholders who own super-voting shares are likely to be asked to tender their shares in any sale of control. Consequently, the prices of those shares should equal the value of the normal returns (dividends, etc.) plus the market's estimate of the controlling shareholder's private benefits of control. Inferior voting shares, in contrast, are not needed by a new controlling shareholder purchasing control from the old one, so their price capitalizes only the value of normal returns to shareholders.

Taken at face value, Figures 5 and 6 suggest that Canada's highly concentrated corporate control is not that big a problem. But looks can be deceiving, for Figures 5 and 6 are sensible approaches to detecting governance problems in most countries, but not in Canada.

In most countries, control blocks trade separately from the normal course of share trading at separate prices. But in Canada, block purchases must often be extended to public shareholders and the take-up pro-rated across all shareholders who accept the offer. This effectively reduces the block premium to near zero while the block trade is occurring. However, this in no way implies that blockholders are conducive to good governance in Canada.

Likewise, in most countries, buying superior voting shares is sufficient to buy control. But in Canada, bidders must extend control block bids to holders of inferior voting right shares at the same price as their bid for superior voting shares. This reduces the difference in price between superior and inferior voting shares. But again, this in no way implies that dual-class shares are conducive to good governance in Canada.

Rather, in Canada, laudable efforts to provide somewhat fairer treatment to minority and inferior voting shareholders reduce block premiums and superior voting share premiums, making them less useful for measuring the governance problems they more faithfully reflect elsewhere. Though these efforts mitigate specific instances of disproportionate harm to public investors, they are unlikely to forestall most private benefits of control. They do, however, have the unfortunate side-effect of undermining the validity of Figures 5 and 6 as measures of private benefits of control in Canada.[62]

ii. But Other Approaches Do Work in Canada

So how can we gauge the real quality of corporate governance in Canada? Fortunately, there are many other ways of assessing the economic importance of private benefits of control and of corporate governance deficits in general.

[62] Jog (2006) infer the cost to the Canadian market of dual class shares from panel regressions across firms with and without dual class shares. A preliminary draft highlights a rapidly growing valuation deficit for firms with dual class common equity. Perhaps if institutional investors increasingly shun such firms, declining valuations may trigger unifying recapitalizations. Regulators may lose credibility if reforms thrust upon them in this way, however.

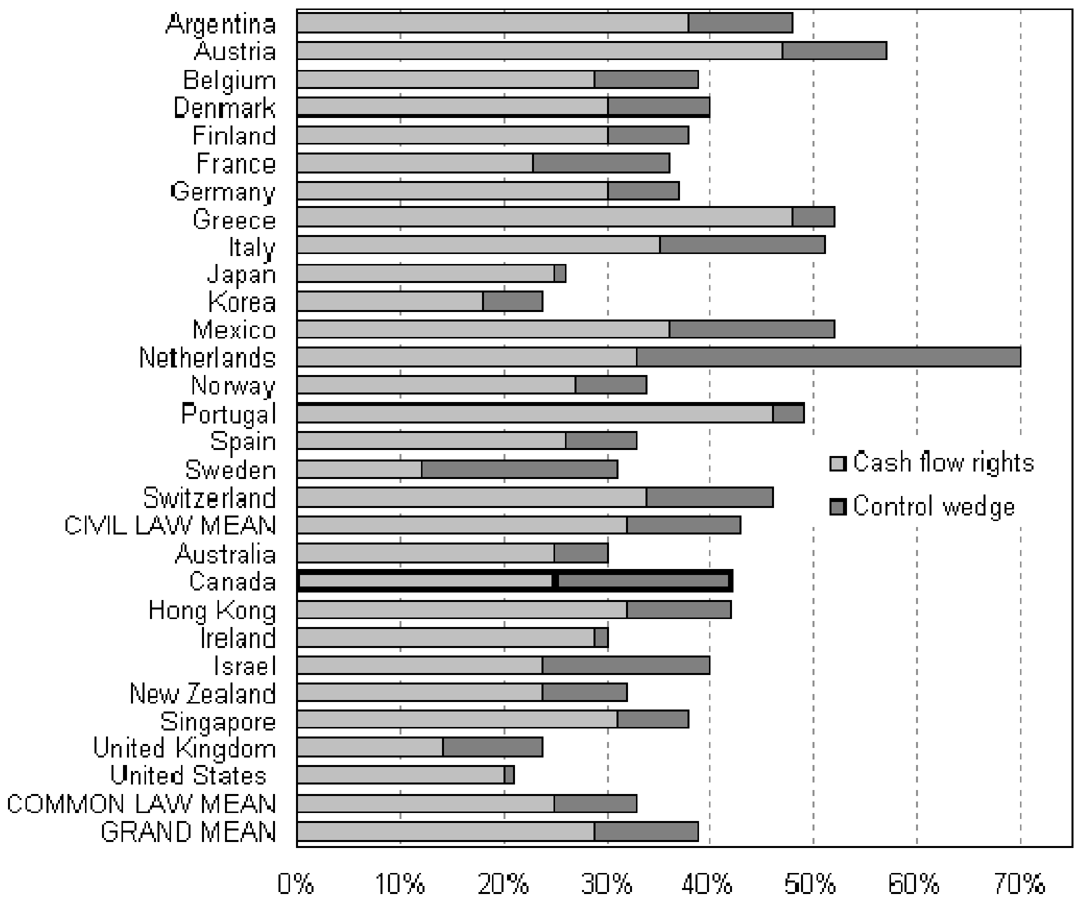
a) The Prevalence of Control Blocks

One important clue is the simple prevalence of controlling blockholders. Burkart *et al.* (2003) argue that, where private benefits of control are slight, wealthy investors diversify their holdings across many firms. This is because the benefits of diversification outweigh available private benefits of control. Their argument, which follows directly from finance first principles, implies that a prevalence of control blocks signals private benefits of control at least large enough to outweigh the benefit of diversification. In other words, they argue that countries whose large firms are more likely to have controlling shareholders are also countries whose controlling shareholders reap larger private benefits of control.

Figure 7 shows that control blocks in large Canadian firms are more substantial than in any other Common Law country. It also shows that Canadian controlling shareholders make more extensive use of pyramiding and/or super voting shares, for their control rights exceed their actual share ownership by a greater margin than in other Common Law countries.

Figure 7: Control Blocks in Canada and Other Countries

The total length of each bar is the size of the average voting control block in the top twenty listed firms, ranked by market capitalization, in each country. The light grey segment of each bar is the average actual ownership stake of the controlling shareholder. The darker grey segment is the average control wedge: the average excess of that shareholder's voting power over his ownership stake, and is due either to super-voting shares or pyramiding.



Source: La Porta et al. (1999).

Applying their logic to Canada, we see that control blocks are remarkably important here. Figure 7 shows that control blocks in large Canadian firms are more substantial than in any other Common Law country. It also shows that Canadian controlling shareholders make more extensive use of pyramiding and/or super voting shares, for their control rights exceed their actual share ownership by a greater margin than in other Common Law countries.

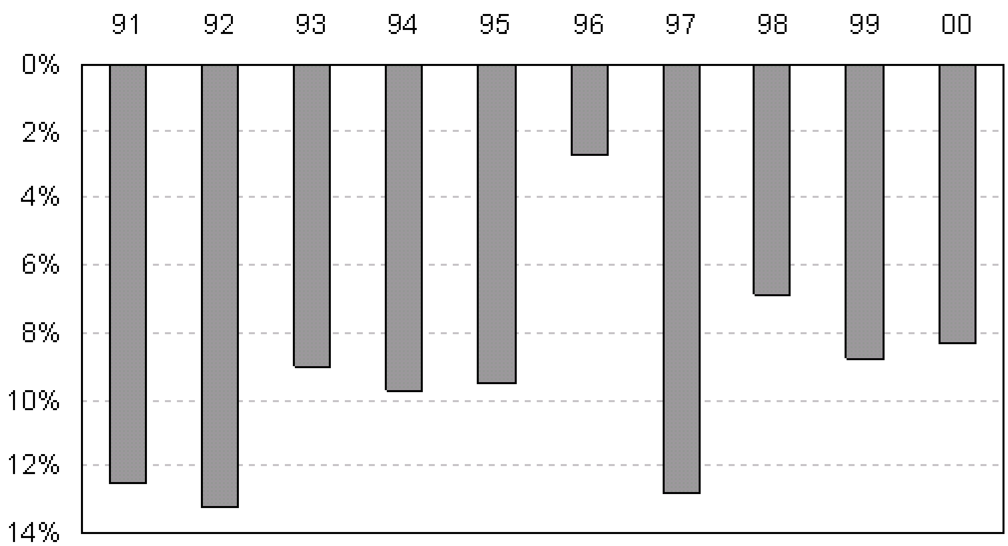
In both respects, Canada more closely resembles Civil Code countries, like Argentina or France, which provide public shareholders with near uniformly weak protection from insiders.[63] Table 7 presents indirect evidence of very large private benefits of control in Canada, at least relative to the United States and United Kingdom.

b) The Canada Discount

Another approach to gauging the private benefits of control is valuation ratios. Table 8 compares the book-to-market ratios of Canadian listed firms with those of similar-sized United States firms in the same industries. It shows that Canadian firms trade at substantial discounts relative to otherwise similar United States firms. For example, in 1991, a generic Canadian firm was worth about twelve percent less than an otherwise identical firm in the United States. Over the full decade shown, this *Canada discount* averages a hefty 9.3%.

Figure 8: The Canada Discount

Average book-to-market ratios of Canadian firms minus those of United States firms of similar size and in similar industries, 1991 to 2000.



Source: King and Segal (2003).

[63] For a detailed discussion of how Civil Code legal systems generally permit worse corporate governance problems than do Common Law legal systems, along with empirical evidence supporting their arguments, see La Porta *et al.* (1997, 1998, 2002). Common Law countries are those whose legal systems derive from British law. Civil Code countries have legal systems derived from Imperial Roman law, usually via the Napoleonic Code, a system of law developed in France in the decades immediately after the French Revolution.

The Canada Discount

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Why do public shareholders mark down the value of Canadian firms by almost ten percent? Unless Canadian investors are irrationally more pessimistic than their American cousins, they must expect lower dividends and other returns from Canadian stocks. One possible reason for these reduced expectations is that Canadian controlling shareholders siphon off private benefits. Might there be reasons other than weak corporate governance for the Canada Discount? This seems unlikely, for King and Segal (2003) eliminate an exhaustive list of alternative possible explanations.[64]

Unless some alternative explanation emerges, Figure 8 predicts that, were Canadian standards of corporate governance brought up to par with those in the United States, the typical Canadian public stock market investor would be almost ten percent richer! That includes defined benefit pension plans, workers compensation funds, and government pension plans, not just individual shareholders investing directly.

ii. Stock Market Development

La Porta *et al*. (1997, 1998) argue that the size and activity of a country's stock markets indirectly measure the quality of its corporate governance. If insiders gather large private benefits of control, less remains for public shareholders. This makes the stock market less attractive to small savers, who invest more in savings bonds and the like and less than in shares. If this logic is valid, and much work suggests it is, stock markets with unusually slight trading activity, or that are unusually small, can be interpreted as signals of a corporate governance deficit.[65]

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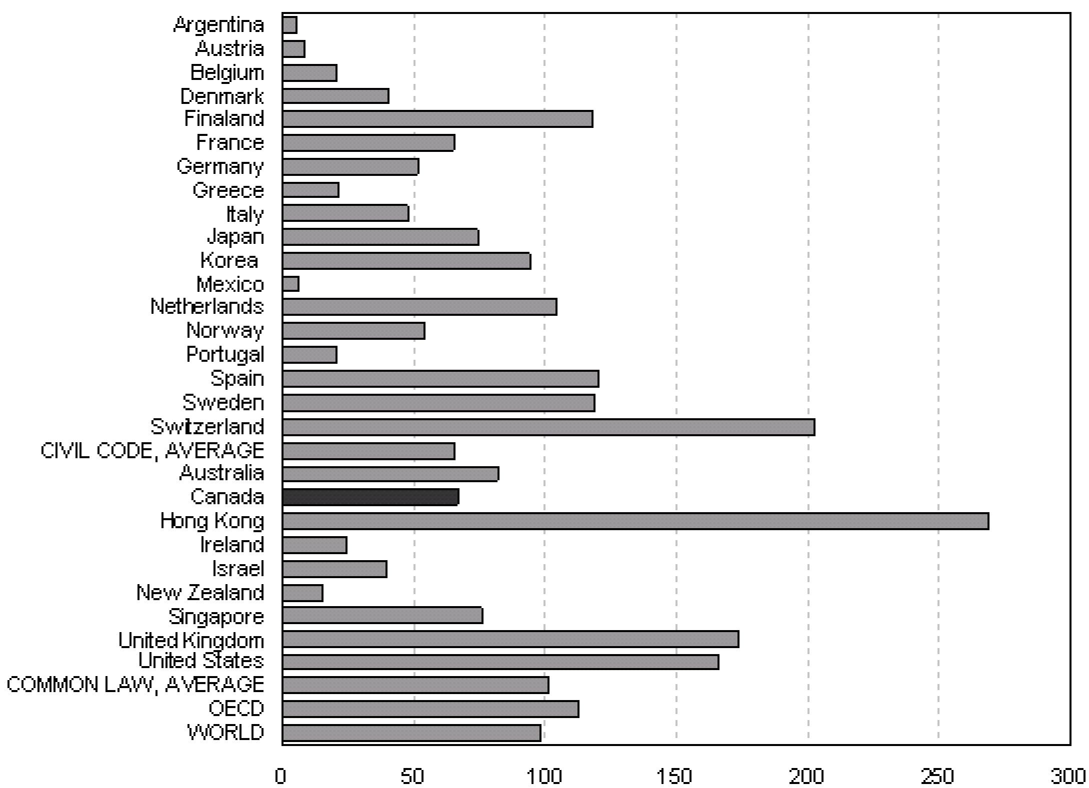
[64] Specifically, they confirm the discount across a range of valuation measures. Differences in accounting do not explain the result, as it persists in Canadian interlisted firms that report under both Canadian and U.S. generally accepted accounting principles. Moreover, the discount exists despite Canadian-listed firms having lower equity costs and higher profitability than comparable U.S-listed firms. They consider company-specific factors, including industry, firm size, cost of equity, and profitability, as well as stock market factors, such as secondary market liquidity and overall market performance, and find that a country discount persists after controlling statistically for all these company-specific and market-specific factors.

[65] Subsequent work verifying this logic includes La Porta et al. (2004), Djankov et al. (2006), and others.

Figure 9 shows that Canada's stock markets are less active, in terms of the value of shares traded as a percentage of GDP, than those of other major Common Law countries. Canada's markets only beat out those of tiny Common Law countries like Ireland, Israel, and New Zealand. Instead, Canada's stock markets post levels of activity in line with the average Civil Code country. That is, Canada's markets are less active that half the Civil Code countries in Figure 9! This is remarkable, given that stock markets are economically relatively unimportant in Civil Code countries.[66] The bottom two entries show that Canada's stock market is less active than the weighted average for all OECD countries, and for all countries in the world. Canada has remarkably sleepy stock markets for a large, rich Common Law country![67]

Figure 9: Stock Market Activity

Total shares traded as percent of gross domestic product, 2004 data.



Source: World Development Indicators database, World Bank.

[66] La Porta *et al.* (1997) show that corporations in Civil Law countries are far less likely to raise funds from stock markets than those in Common Law countries.

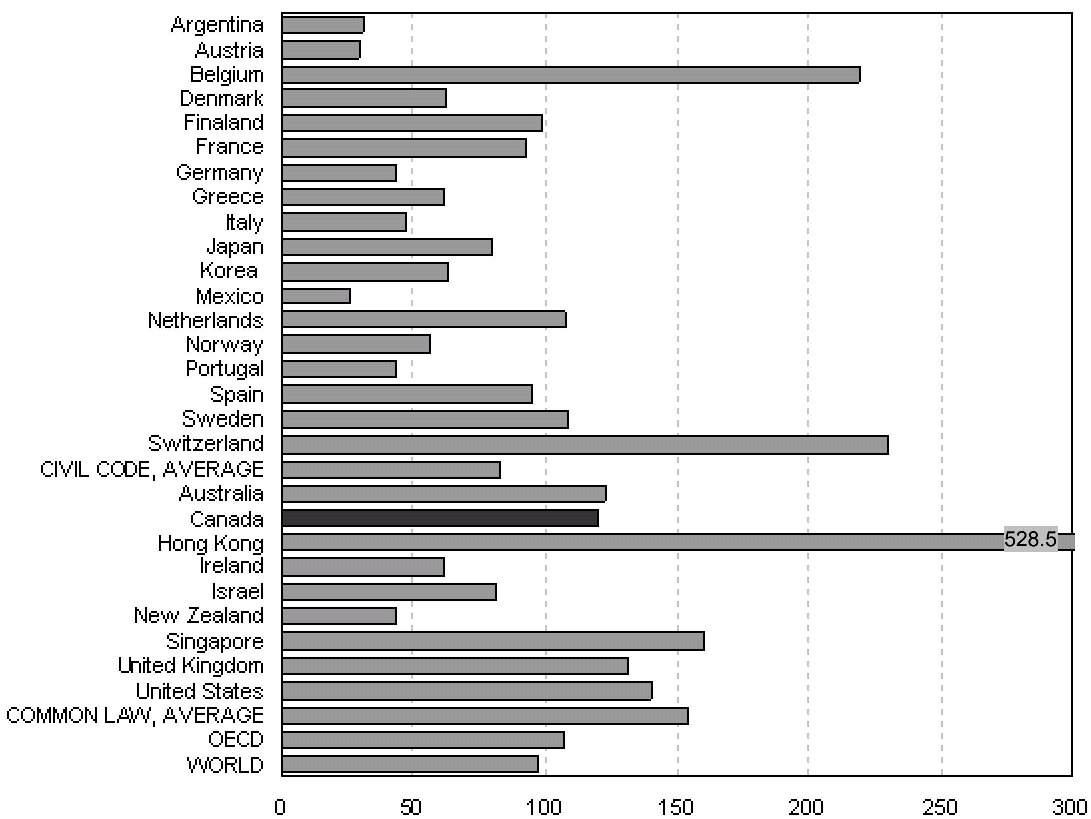
[67] The OECD, or *Organization for Economic Cooperation and Development*, includes all developed countries plus a few higher income developing countries. See www.oecd.org.

Another measure of a country's financial development is the sheer size of its stock market relative to the country's economy. Figure 10 graphs each country's total stock market capitalization as a fraction of its GDP. Again, Canada lags behind the other major Common Law countries, though in these rankings it does manage to outdo the Civil Code country average, as well as the OECD and world averages. Nonetheless, Canada has oddly small stock markets compared to the Common Law average.

Figures 9 and 10, together, show that Canada has smaller and less active stock markets than would be expected in a Common Law country of its size. Relatively small, relatively sleepy stock markets are a likely symptom of a national corporate governance deficit.

Figure 10: Stock Market Size

Total stock market capitalization as percent of gross domestic product, 2004 data.



Source: World Development Indicators database, World Bank.

This picture of small, sleepy markets seems inconsistent with the country's importance in raising funds for resource companies, and with the sheer number of Canadian listed companies per capita.[68] However, these apparent exceptions actually prove the rule. Small natural resources firms are typically capitalized on the reputations of the individuals seeking funds, not on the information contained in disclosure documents or on the strength of Canadian governance standards. The dearth of comparable small cap financing for start-ups in other industries is an ongoing brake on the national economy. Also, the sheer number of listings is a questionable indicator of market dynamism. Many Canadian stocks are so thinly traded as to be essentially illiquid. Also, Canadian markets feature so-called reverse takeovers, where unlisted firms acquire listed *shell companies*, dormant listed firms or *capital pool companies* (so-called *clean shells*), as a quick route to a listing.[69] Reverse takeovers provide a quick listing to firms needing capital, but the numerous shell companies awaiting reverse takeovers should also not count as genuine listings.

iii. Economy Performance

Poor corporate governance means that firms are run inefficiently. That is, in a country beset by weak corporate governance, firms spend more on inputs than they need to and end up producing outputs that are not as valuable as they could be. The growth in economic efficiency of a country's corporate sector is measured by its *multifactor productivity growth*, where multifactor productivity is defined as the value of output minus that value of all inputs.[70]

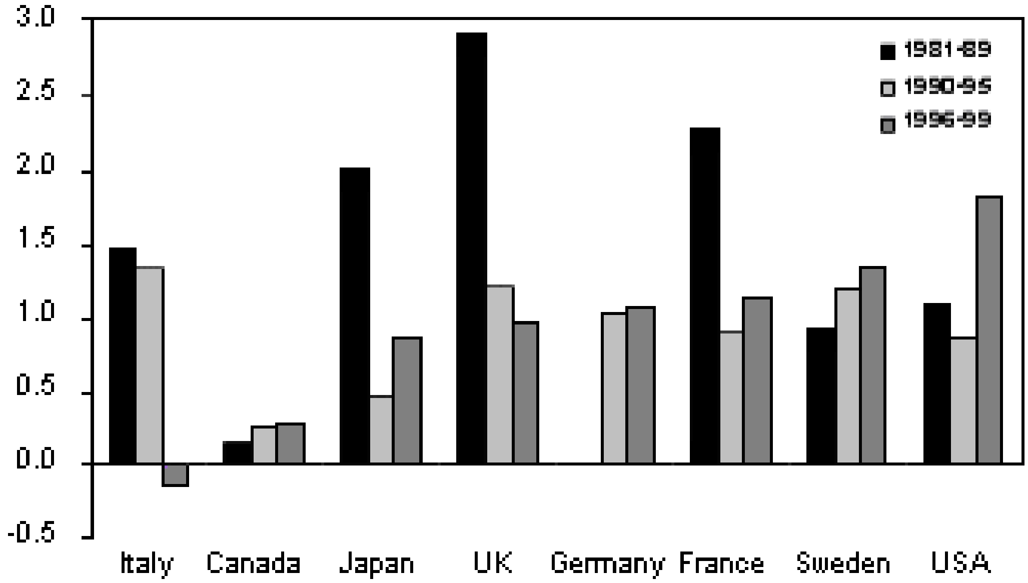
Figure 11 shows that Canada's multifactor productivity growth is abysmal compared to other developed economies. Martin and Porter (2001) blame this lacklustre performance squarely on Canada's businesses, arguing that they grew too accustomed to making money off low-technology natural resource extraction and government favours, notably covert and overt trade barriers. They argue that, if the situation is to improve, Canadian firms must innovate to find ways to make dearer products using cheaper inputs - they

[68] See the report by Nicholls in this collection.
[69] See Anand and Klein (2003) for a discussion of regulatory issues surrounding reverse takeovers. See Mandel (2001) on the importance of pre-listed shell companies to the listing process in Canada, and on so-called *clean shells*.
[70] Multi-factor productivity is now perhaps the most widely accepted measure of economic performance in academic economics research. A huge literature discusses how it should be measured and what determines variations in multi-factor productivity growth across firms, countries, and industries. For a survey, see *Corporate Governance: A Survey of OECD Countries*, Organization for Economic Cooperation and Development Press, Paris.

must compete the way firms elsewhere are forced to compete. An absence of such improvement, they argue, is macroeconomic evidence of pervasive poor corporate governance in Canada.

Figure 11. Economy Multifactor Productivity Growth

Multifactor productivity growth measures the increase in "value-added" by each country's business sector over and above the cost of its inputs. Higher multifactor productivity growth means a country's businesses are either making higher value outputs, using lower value inputs, or both. Multifactor productivity growth is a central measure of the extent to which a country's business sector is contributing to overall economic growth.



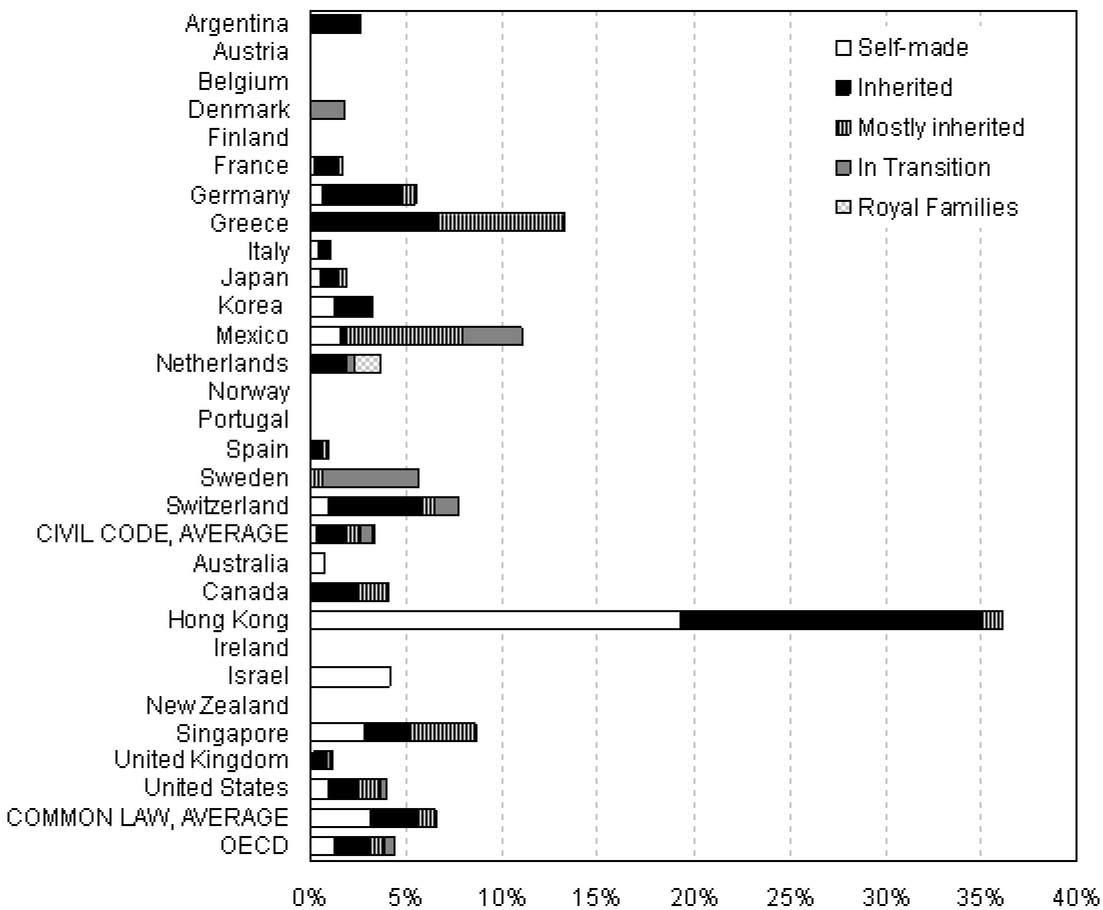
Source: Martin and Porter (2001).

Low productivity can be due to poor government policies as well as to weak corporate management.[71] However, the two are often interconnected. Less capable top corporate managers often resort to lobbying governments for trade protection, subsidies, or other favouritism.[72] This strategy can boost corporate performance in the short term, but is destructive to overall national competitiveness and productivity.[73] In practice, corrupt or inept government tends to occur in the same countries whose private sectors exhibit weak governance.[74]

[71] See Baumol (1990) and Murphy et al. (1991, 1993) for more detail.
[72] Originally controversial when first proposed by Tullock (1967) and Krueger, (1974), this line of economic reasoning is now mainstream economics.
[73] See Lenway et al. (1996, 1998) for detailed examples and empirical evidence.
[74] La Porta et al. (1997, 1998) and others provide empirical evidence.

Figure 12: Billionaire Wealth, by Source of Fortune

The total length of each bar is the wealth of all billionaires or billionaire families resident in the country as fraction of GDP, all as of 1993. The shading of each bar reflects the source of the wealth - self-made or inherited. In some cases, most of the wealth is inherited, but the heirs have added somewhat to the fortune, and in others a transition from the first to second generation is in progress. The former are classified as "mostly inherited", the latter as "partially inherited". Billionaire royal families are taken as a separate category.



Source: Morck et al. (2000).

iv. The Canadian Disease?

Morck, Stangeland, and Yeung (2000) argue this interaction is stronger in Canada than in other rich Common Law countries. Using cross-country data, they find weaker economy performance in countries that more extensively entrust corporate governance to old money families.

Figure 12 shows that old money billionaire families predominate in typical Civil Code countries, but self-made billionaires feature prominently in Common Law countries. A notable exception is Canada, where old money families are more important than in most other Common law jurisdictions, and whose billionaires better resemble those of typical Civil Code countries.

Firms whose governance is entrusted to heirs under perform on average.[75] Morck *et al.* (2000) document that Canadian heir-controlled firms under perform size- and industry-matched U.S. firms by a worse margin than other Canadian firms the same age, despite having more capital per dollar of sales. Heir-controlled Canadian firms also invest less in R&D and hold fewer patents.

Canada entrusts the corporate governance of much of its large corporate sector to entrenched, politically influential, old money families. Morck *et al.* (2000) present evidence that this saps its economic performance. They refer to this condition as "the Canadian disease", and suggest it weakens many developed and developing economies.

v. Bottom Line

Much indirect evidence suggests that private benefits of control in Canada are larger than in other high-income Common law countries. Quantifying these benefits more precisely is an important research objective because larger private benefits of control are shown elsewhere to induce economically substantial governance problems and discord between controlling and public shareholders. Large private benefits of control undermine the good that might otherwise come from the presence of large blockholders. The bottom line is that, in deriving private benefits, controlling shareholders impair corporate governance.

[75] For empirical evidence, see Morck *et al.* (1988), Smith and Amoaku-Ado (1999), Morck *et al.* (2000), Amit and Villalonga (2005), Pérez-González (2001), and Bennedsen *et al.* (2005). Bennedsen et al. (2005) are especially thorough in their statistical analysis, and dispose effectively of virtually all criticisms levelled at earlier work.

8. Moving Forward

We have shown above that Canada retains a governance framework - entrusting corporate governance to wealthy families who control firms through pyramiding and/or dual-class shares - long-abandoned in the United States and United Kingdom. In this respect, Canadian corporate governance closely resembles that in much of the Third World, parts of Asia, and certain continental European countries that similarly cling to old ways. This framework has certain advantages in a country beset by inefficient or politicized courts and corrupt government. But in a 21st century developed liberal democracy, this anachronism becomes an economic burden.

Radical reform that would align Canada with American and Britain is attractive in that this would make it possible for Canada to interact with those other Common Law jurisdictions. We suspect that such changes are inevitable, for increasingly influential institutional investors are already banding together to press for reform. In our view, the only issues are whether change will be fast or slow, and whether regulators will lead or be dragged along.

We therefore plot a course for reform considering major aspects of Canadian governance regulation and how each might be changed. Our objective is to limit the scope for abuse by controlling shareholders wielding magnified power through dual-class shares or pyramiding. We follow this course because we doubt that Canadian regulators are up to the task of simply banning pyramiding and dual-class shares. We therefore propose a gentle path out of our current morass.

i. Majority of the Public Float Votes

We now require majority of the minority votes for transactions where a controlling shareholder might extract large private benefits. For example, minority squeeze-outs typically require the approval of a majority of shareholders excluding controlling blockholders and affiliated persons.

This is a start, but not enough. First, the controlling shareholder does not always hold a majority. Blocks below 50% can bestow control if the other shares are diffusely held.[76] We therefore should speak of requiring the approval of a majority of the public float.

Below, we outline additional circumstances we believe call for majority of public shareholder votes. For

[76] See La Porta *et al.* (1999).

now, we recommend that standing to participate in such votes be clear.

Definition 1: Securities law should define "public shareholders" as persons who meet all the following:

1. they are not "insiders", for insider trading purposes, and have no business relationship with any insider;
2. they exercise no control, and have no business relationship with any person who exercises control; and
3. other firms in the same business group, their insiders and their controlling persons are not public shareholders, nor are persons who do business with them or with any of the above.

Our concept of public shareholders is basically shareholders whose investments compose the public float of the stock, and who are unrelated in any and all ways to insiders or the controlling shareholder. This usually means passive share-holdings, including diffuse holdings and outsider blocks below twenty percent.

ii. Fiduciary Duty

A Common Law tradition assigns a fiduciary duty to the officers and directors of a corporation to forsake their self-interest for the interest of the corporation. But the corporation is an artificial entity - a legal fiction feeling no pain or pleasure. What is the interest of the corporation?

American Courts generally treat the interest of the corporation as indistinguishable from that of its owners, the shareholders. The Delaware Supreme and Chancery Courts, in particular, use the terms "shareholders" and "corporation" interchangeably and assign directors an obligation to either or both. In key cases, like *Mills Acquisition Co. v. Macmillan Inc.*,[77] the Delaware Supreme Court clearly enunciates shareholder primacy. There, the court rules that a board deciding on a takeover offer may consider "the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some relationship to general shareholder interests".

All of this permits a relatively simple answer: in the United States, the interests of the corporation lie in long-term shareholder value. Officers and directors thus have a fiduciary duty to act in the shareholders'

[77] 559 A. 2d 1261, 1282, n. 29 [Del. 1989].

interests, so defined.[78] In the United Kingdom, the *Companies Act* even more clearly assigns directors a duty to shareholders alone. Although corporate governance matters are subject to the system of self-regulation embodied in the Cadbury Code and its successor guidelines, the primacy of shareholders is evident throughout.

The Delaware and British perspectives make eminent sense if shareholders invest in corporations for one and only one reason: to reap dividends and capital gains on their shares. This is a safe assumption for public shareholders, but controlling shareholders sometimes buy control blocks to extract private benefits. Ought we then to assign officers and directors a legal duty to help controlling shareholders do this? Should a firm's officers and directors be obliged to help a media baron run his newspapers into the ground with unpopular political rants? Should they have to lose money helping a politician who promises to repay the controlling shareholder with benefits to another of his firms? Most people would probably say not.

Consistent with this, the Supreme Court of Canada recently rules in *Peoples v. Wise*[79] that directors have a fiduciary duty to the corporation, and that this does not imply a duty to any particular stakeholders, including shareholders and creditors. This is sensible, in that a duty to shareholders is unwarranted. However, the ruling is unfortunate in that it does not clarify Section 122(1)(a) of the Canada Business Corporations Act, which mandates that directors "act honestly and in good faith with a view to the best interests of the corporation". How can directors fulfill a duty to a fictitious legal person? Are they to preserve the existence its fictitious life at all costs? Its health? Its happiness? How can directors to fulfill, or violate, this duty? If a corporation's liquidation value exceeds its going concern value, surely the board should wind it up.

By deliberately fogging directors' fiduciary duty, *Peoples v Wise* seems to fortify a business judgment rule - protecting directors from lawsuits arising from honest errors or unlikely events. This is desirable, in that it insulates directors from the capricious and petty shareholder lawsuits triggered by precipitous, albeit unavoidable, drops in the share prices that have plagued some U.S. officers and directors.

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[78] Several American states recently changed their regulations to permit directors to balance the interests of multiple classes of stakeholders, including shareholders, creditors, employees, etc. These reforms are widely regarded as anti-takeover laws to protect managers from shareholder oversight, and are regarded as impediments to good corporate governance by American shareholder rights groups. Most large U.S. firms are incorporated in Delaware, so the primacy of a duty to shareholders is not significantly eroded by other state's initiatives at present.

[79] 23 C.B.R. 4th 200.

However, much legal uncertainty associated with board membership in Canada reflects a thicket of unrelated legislation assigning directors personal liability for everything from environmental costs to unpaid wages. For *Peoples v Wise* to create a meaningful business judgment rule would have required protection from all such lawsuits, if they arise out of honest errors of judgment or unlikely events. *Peoples v Wise* is only the first step in a long road of legislative and regulatory reform leading to a business judgment rule that provides a truly safe harbour for honest and competent directors.

Thus Canadian corporate governance is hampered by another burden: Canadian directors have vague fiduciary duties and unsafe harbours. In our view, the Supreme Court missed a wonderful opportunity in *Peoples v. Wise* to rationalize the fiduciary duty of directors. The historical purpose of the board, as far back as the charter of the Hudson's Bay Company and the Dutch East Indies Company, is to represent shareholders who cannot be present to oversee their investments. The law should reflect that purpose. The controlling shareholder is present in person, and so needs no representative.

This "back to basics" logic leads to our first recommended public policy reform:

Recommendation #1: Securities law should create for officers and directors a fiduciary duty to public shareholders.

This first recommendation is likely to illicit several objections.

One is that the controlling shareholder has a huge investment in the firm and deserves representation on the board. This is a valid concern, but is met in practice because the controlling shareholder always has a seat at the board. What British and Delaware law recognizes, and Canadian law does not, is that whenever the controlling shareholder elects to use public investors' savings to create or expand a business, he assumes an obligation to them. The board meets to insure that the controlling shareholder honours that obligation.

Another objection is that the board advises the controlling shareholder and management. Mandating a duty to public shareholders compromises the frank exchange of information and advice. This is a valid concern, but can be solved readily if the firm seeks such advice and counsel from appropriate parties without placing them on the board.

A third objection is that a substantial number of firms in Canada actually do resemble large American and British firms, in that they are truly widely held. This objection is met because Recommendation #1, absent a controlling shareholder, implies a duty to all shareholders. It thus automatically folds into what is shown to be sensible regulation in the United States and United Kingdom for Canadian firms whose ownership structures resemble that typical in those countries.

Another objection is that case law and corporate law statutes set out a series of bright line rules about what directors should and shouldn't do under different circumstances. We believe this misses the point. Corporate governance is about promoting the economically efficient use of Canadians' savings by the corporate sector for the good of the country. Since public shareholders' returns are the least firmly guaranteed by labour law, bankruptcy law, and other parts of the legal and regulatory systems, public shareholders are the first to see their returns decline under adverse circumstances. A fiduciary duty to public shareholders ties board decision-making to this very sensitive barometer of the firm's health. Bright line rules are fine, but only if they generally fulfill this economic purpose.

No-one denies that stock prices can fluctuate due to irrational exuberance, and public shareholders should not be free to sue at the slightest drop in share price. Directors need to be protected from market irrationality through business judgment rules. But for the law to ignore the public share price as a usually useful "governance problem meter" is the worse evil.

Yet another objection is that insolvency and probable insolvency require other priorities. This too is a valid concern, so we should restrict this first recommendation to solvent firms. If a firm is solvent, its contractual obligations to its creditors, employees, suppliers, and customers are, for the most part, certain; and the board's decisions do not affect the firm's ability to fulfill those obligations. In contrast, the dividends and other returns public shareholders may or may not receive are directly rendered more or less uncertain by the board's decisions. That is why they require direct representation on the board.

If a firm is insolvent, the public shareholders typically get nothing - an unfortunate, but certain, return. The parties who need representation on the board are now those whose claims on the firm are cast into uncertainty - creditors, employees, suppliers, and customers. This means we might add
Recommendation #1.5: Securities law should create for the directors of an insolvent listed firm a clear fiduciary duty to act for stakeholders, other than the controlling shareholder, whose claims the prospective insolvency renders uncertain. Probable, but uncertain insolvency should create a duty to balance public shareholders' interests against those of such stakeholders.

The reader might wonder how securities law dare infringe on bankruptcy law. However, the Supreme

Court in *Peoples v. Wise* clearly extends fiduciary duty under securities law and the oppression remedy to such situations. *Peoples v Wise* is about fiduciary duty in bankruptcy, though the court's language implies a general application to firms in sound financial states too.

iii. Oppression

The oppression remedy in the Canada Business Corporations Act and provincial analogs creates a channel through which public or minority investors can sue controlling shareholders who oppress them. This remedy is a unique Canadian legal innovation, designed to counter governance problems in an economy of firms with controlling shareholders who derive private benefits of control.

However, the oppression remedy is an incomplete end-run around inadequate fiduciary duties. This is because it, like *Peoples v. Wise*, is vague about what constitutes a breech of acceptable governance. It lets the courts, for the most part, decide what is or is not oppression. There are no statutory bright line tests, let alone guidance in the form of broad principles, to help judges decide such cases.

This uncertainty works to the detriment of public shareholders. Oppression lawsuits by public shareholders are rare, and successful ones vanishingly rare. The Supreme Court lauds the oppression remedy in *Peoples* as a balm for all governance ills, but its track record is unimposing.

Asthenia in the oppression remedy is especially apparent in case law. One example is *Pente v. Schneider*.[80] Maple Leaf Foods made the highest bid for Schneider, but the Schneider family accepted a lower offer from rival white knight Smithfield because of tax benefits for the family. The court held that the family has no duty to public shareholders, and that directors did them no harm because the board could not have forced the family to sell to Maple Leaf Foods. In other words, a controlling shareholder has no duty under the oppression remedy to act in the interests of public shareholders; and a director who lets a controlling shareholder put his own interest ahead of public shareholders breaches no duty.

We also leave it up to the courts to decide who has standing to launch an oppression suit. Though public shareholders are clearly the economically relevant victim of oppression, the Supreme Court in *Peoples* advocates the oppression remedy as a tool for realizing stakeholder rights of all sorts. No-one denies the good in protecting employees, creditors, and other stakeholders if their claims on the firm grow tenuous. But shareholders' returns are always problematic (except in bankruptcy), for the share price rises and falls

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[80] *Pente Investments Management Ltd. v. Schneider Corp.* (1998) 43 BLR 3rd 46; 42 OR (3d) 177 (Ont.).

as a barometer of the firm's financial health (unless it settles at zero). Share prices can be buffeted by irrational exuberance, and business judgment rules should recognize this, but ignoring this barometer entirely is unwise.

In our view, the oppression remedy needs to be energized and refocused, *viz*.

<u>Recommendation #2:</u> Securities law should define oppression as a controlling shareholder failing to put public shareholders' interests ahead of his own.

This recommendation seems implicit in earlier case law on the oppression remedy. But it should be explicit so that a well-intentioned supreme court never decides the oppression remedy implies balanced obligations to multiple stakeholders. This is a real danger, for the Supreme Court in *Peoples v. Wise* seems headed in this direction.

If a firm is insolvent or near-insolvent, claims that creditors, suppliers, customers, and employees have are thrown into uncertainty, and a controlling shareholder might well oppress them with actions that worsen the uncertain value of their claims to benefit himself, and an analog here to Recommendation 1.5 is sensible. But, stakeholder oppression is markedly less plausible in a solvent firm, for it risks triggering bankruptcy. The law should clarify that a controlling shareholder cannot defend against an oppression lawsuit by public shareholders with a showing that his actions, though they harmed public shareholders, benefited some other stakeholder.

iv. Business Judgment

Canadian directors - and, reading *Peoples v. Wise* broadly, controlling shareholders, too - are open to lawsuits from many directions: from public shareholders, employees, retirees, environmental groups, and doubtless more as-yet-undefined stakeholders. Ideally, a clear safe harbour should exist. As long as those entrusted with corporate governance act honestly and competently, they should be safe from legal harassment. We therefore recommend a business judgment rule in securities law,

<u>Recommendation #3:</u> Securities law should protect officers, directors and controlling shareholders from lawsuits for good faith business judgements.

Again, some likely objections should be considered.

First, are business judgment rules the province of securities law? In Canada, the answer seems to be yes. The recent appeal ruling in the *Danier* case effectively brings the Business Judgment Rule, originally a corporate law concept, into securities laws. Moreover, the confusion sown by *Peoples* and *Pente* requires that regulators or legislatures clarify the situation.

Second, although many laws create liability for corporate insiders, they are seldom enforced. Perhaps, they can simply be ignored? Given the activist turn of the Supreme Court of Canada, this seems overly sanguine. An activist judge in New York created a new criminal offence, stock parking, from similarly neglected legal clay to convict Michael Milken.

Third, critics of corporate Canada might see such broad protection as unwarranted. But risk-taking is part of what businesses do, and Canada does not benefit from overly cautious corporate governance. Many directors and officers already purchase liability insurance, and a rash of economically unjustified lawsuits would only increase its cost. Since firms often pay for this insurance, and sometimes even pay judgments against top insiders, public shareholders end up paying for their own winnings. Ideally, we should limit lawsuits to where Recommendations 1 or 2 are clearly violated, and force those entrusted with corporate governance to pay their own insurance premiums and judgments. This would also hopefully induce insurance providers to price unqualified officers, directors, and even controlling shareholders out of the game. A clear business judgment rule is a first step in this direction.

v. Independence

In the United States and United Kingdom, independence of directors or auditors typically means independence from influence by the CEO, CFO, or other top professional managers. But this definition makes little sense in Canada.

Can a controlling shareholder be "independent"? What about the officers and directors of another firm controlled via pyramiding by the same controlling shareholder? What about a lawyer, banker, supplier, or customer who has nothing to do with the firm in question, but who has economic ties to another firm in the same pyramidal group? In Canada, independence ought to mean independence from the controlling shareholder and from other persons subject to the controlling shareholder's influence, as well as from professional managers.

Definition 2: Securities law should define "independence" as:

1. No business or other relationship with the firm or its officers, directors or controlling shareholder.
2. No business or other relationship with any firm controlled by the firm's controlling shareholder or by its officers or directors.

In an economy where many firms belong to business groups, this is necessary if independence is to be more than ornamental. Thus,

<u>Recommendation #4:</u> Rules requiring certain numbers of proportions of independent directors on boards or key committees should use definition 2.

An inevitable objection here is, "where are we to find qualified directors who meet such a stringent definition?" We admit that this becomes a problem if the unvoiced additional qualification, "and who is loyal to the current insiders", is added. But the whole idea of independent directors is to force the abandonment of the unvoiced qualification by shrinking the pool of people who fit it plus the formal requirement. Board meetings should not be comfortable get-togethers of like-minded men. They should bring independent views, invite difficult questions, and occasionally be downright uncomfortable for the officers and controlling shareholder. That is the objective of the Higgs Report in Britain and of Sarbanes Oxley in the United States.

Modernizing corporate governance in Canada requires moving down a similar path.

However, we are sceptical that independent directors in Canada can be as useful a force for good governance as they might be in the United States and United Kingdom. Rising up to remove an errant or inept professional CEO is sometimes sensible, for the CEO, once deposed, cannot strike back. But why should independent directors challenge a controlling shareholder who cannot be dislodged. As Machiavelli teaches, "If you strike the king, you must kill him."

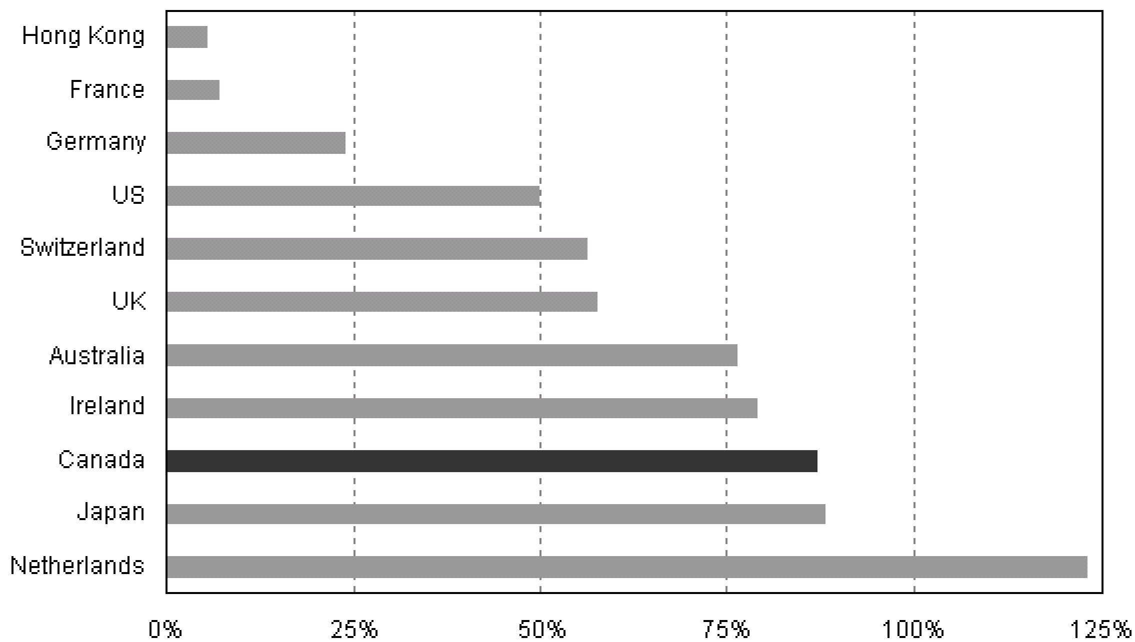
vi. Institutional Investors

If our expectations of independent directors are reduced in an economy rife with pyramiding and dual-class shares, we can perhaps tilt the playing field to empower institutional investors and then expect more from them. Canadian institutional investors, organized by the Canadian Coalition for Good Governance and led by Ontario Teachers and OMERS, seem up to the task.

Figure 5 shows institutional investors are more important in Canada than in most other developed economies. Institutional assets now total over US$1 trillion, about 87% of total capitalization (US$1.2 trillion). This compares to about 50% in the United States and 58% in the United Kingdom. Given Figure 5, it is perhaps remarkable that Canadian institutional investors are catching up with the activism of their American and British cousins, rather than out in front.

Figure 5. The Importance of Institutional Investors

Pension fund assets as fraction of total stock market capitalization for selected developed economies.



Source: Pension assets are from Watson Wyatt and various secondary sources, as reported in the FEI Canada Accounting & Finance Review, February 2006 Edition. Market capitalizations are from the World Bank's World Development Indicators database.

Of course, all the holdings of Canadian institutional investors are neither stocks nor Canadian. But the sheer numbers are striking. And as the capitalization of the Canada Pension Plan proceeds, and public sector plans move towards full funding, Canada's ratio can only rise.

Lawmakers and regulators can accommodate the growing influence of institutional investors or block it to sustain the current status quo. Since we regard the current situation as neither desirable nor sustainable, we heartily recommend the former path. To this end, we recommend a set of carrots and sticks to make institutional investors fill the breech.

First, the majority of the public float votes should include institutional investors.

<u>**Recommendation #5:**</u> **Securities law should require institutional investors be managed so that their stocks lie within the public float.**

This has some corollaries. First, institutional investors must not have conflicting ties with firms whose stocks they vote. Just as Sarbanes Oxley limits auditors' conflicts of interest, Canadian securities law should check any conflicts of interest involving institutional investors.[81] Bank head offices, pension plan sponsors, and other interested parties should be unable to influence institutional money managers' voting strategy. If institutional investors are to compensate for the limitations imposed by large blockholders, pyramiding, and dual-class shares, they must be free of internal governance problems. To this end, we recommend:

<u>**Recommendation #6:**</u> **Securities law should create a fiduciary duty of institutional investor top managers to beneficiaries.**

That is, pension funds, mutual funds, index funds, participation units, and exchange traded funds should be run so as to maximize long-run returns. Index funds and participation units are designed to minimize management fees, and forcing elaborate voting duties on them would defeat that design. However, a straightforward automatic voting policy based on best practices regarding poison pills, entrenchment charter amendments, etc. could be implemented without significant cost, and should be adequate to avoid all liability.

Pre-committing to voting policies best practice voting policies should both lessen conflicts of interest pressures and create a safe harbour to immunize fund trustees and managers who adhere to those policies from charges of breaching their fiduciary duties.

Government-sponsored pension funds, such as the Canada Pension Plan, are growing quickly. At some point, many listed Canadian companies may be *de facto* nationalized as these state-run institutional

[81] See Lakonishok *et al.* (1991, 1992) and Romano (1993, 1995) for empirical evidence on such governance problems in institutional investors.

investors become dominant shareholders. It is very importance to get governance within public sector funds sorted out now. Otherwise, we will probably have to go through scandals of political influence and patronage destroying the values of their portfolios, as with the Caisse de Dépôt et Placement du Québec not long ago.[82] State-controlled institutional investors have proved irresistible to patronage-minded politicians elsewhere, notably in Italy.[83] Lesser, but still significant problems of political influence also afflict some American public sector pension funds.[84]

Institutional investors who fail to vote in the interests of their beneficiaries should be legally accountable, and this requires transparency.

Recommendation #7: Securities law should require institutional investors to disclose their voting policies and records.

National Policy 81-106 requires mutual funds to disclose their proxy voting. We advocate similar or stronger requirements for all institutional investors - including pension funds, exchange-traded funds, and participation units backed by shares. Only funds that exclusively use derivatives to mimic indexes would not be affected.

Once institutional investors have incentives to promote good corporate governance, they need to be empowered.

Recommendation #8: Securities law should let public shareholders nominate and elect a fraction of directors proportional to the public float.

Recommendation #8 circumvents the problem of the CEO or controlling shareholder nominating "independent" directors who meet the *de jure* definition, but who are not really *de facto* independent. Golfing buddies are not independent.

Of course, the directors so nominated could not represent the institutional investor, for that would make institutional investors insiders. The idea is that institutional investors nominate from a pool of professional, independent directors, such as retired CEOs, professional directors, and financial experts.

[82] See Arbour (1993).
[83] For details, see Aganin and Volpin (2005).
[84] For evidence, see Romano (1993, 1995).

This pool of expertise would develop quite naturally as demand grows.

vii. Takeover Defences

Although takeovers can often reflect governance problems, like ego-driven empire-building, for the acquirer they are also important mechanisms for dislodging underperforming management teams from misgoverned target firms. On balance, the economic evidence indicates that we are better off with takeovers than without, but more efficient and less abuse-prone ways of correcting governance deficits are clearly desirable. A greater role for independent directors is one such hope in the U.S. and U.K., but as noted above, provides less hope in Canada.

Takeovers, especially foreign takeovers, are subject to much criticism everywhere. State anti-takeover laws proliferate in the United States, and various defensive devices like poison pills, poison puts, and staggered boards clutter corporate America. British corporations largely refrain from such measures, perhaps reflecting the less ambiguous primacy of shareholders there.

Canada lies between the United States and United Kingdom, with poison pills and staggered boards proliferating, but subject to higher standards of shareholder approval, and (so far) without explicit anti-takeover laws. But takeover barriers around some Canadian firms are formidable, with dual-class shares and pyramiding rendering many utterly invulnerable. Even many widely held firms, notably the large banks, are invulnerable to takeover bids by dint of voting caps, which cap any shareholder's voting power at, e.g. 20% of the total. And recent takeovers, such as those of the Bay, Inco, and other landmark firms may encourage checks on good governance pressure in the guise of nationalism. In particular, many studies show that anti-takeover restrictions entrench underperforming managers.

Since takeover barriers seem inevitable, and perhaps even not entirely unjustified, we recommend that securities law direct their construction to minimize adverse governance consequences. In particular, we recommend that voting caps of the sort in place at the large banks be encouraged as the takeover defence of choice.

<u>Recommendation #9:</u> Securities law should permit a voting cap to be enacted or removed in any listed company only if approved by a majority of the public float.

Voting caps are preferable to other anti-takeover defences if their imitation as well as their removal is entirely entrusted to public shareholders. This makes them a poor tool for managers or controlling shareholders seeking entrenchment. By enacting a voting cap, public shareholders can effectively disenfranchise a controlling shareholder who acts oppressively or who proves incompetent. By removing a voting cap, public shareholders can invite a controlling shareholder to take charge and remove underperforming professional managers.

Recall that large shareholders can often be beneficial in terms of providing good governance and advancing public shareholders' interests. They become problems only if they focus excessively on gleaning private benefits or reveal themselves incapable. Securities law needs to undermine the influence of controlling shareholders only under these circumstances. We see no alternative to public investor input in deciding if these circumstances apply. Other anti-takeover devices, such as poison pills, might also be enacted and revoked only by a majority of the public float, but none can discipline a controlling shareholder, even one exercising control through dual-class shares or pyramiding, as cleanly as Recommendation #9.

Also, Canada is subject to periodic episodes of nationalism, in which politicians grow concerned about foreign takeovers. Such nationalism may be irrational and economically destructive (we think so), but it cannot be dismissed in a democracy if it reflects genuine popular sentiments. Even if a widely held firm's shareholders all believe their firm should not be taken over by a foreign raider, each individual shareholder may decide all the others will tender and therefore resigns to tenders his shares. This is an example of a so-called prisoner's dilemma, a common market failure (Nash, 1950. 1953). This perceived market failure motivated the Trudeau government to establish the Foreign Investment Review Agency (FIRA) to vet foreign takeovers. The politicization of corporate governance is always undesirable. Of the alternative methods of blocking foreign takeovers we might consider, voting caps seem least disagreeable. Removable voting caps would let shareholders decide whether or not to pass over foreign takeover bids for the sake of patriotism.

Some additional caveats may be in order.

Shareholders may well be subject to periodic fits of irrational exuberance or other errors. To encourage sober reflection, Recommendation #9 might require a majority of the public float in two consecutive annual meetings.

A voting cap should never block institutional investors, or other outside blockholders, from coordinating voting plans at shareholder meetings. Institutional investors acting in concert to improve corporate governance should trigger a voting cap individually only. Their combined stakes should not trigger it.

viii. Dual-Class Shares

The NYSE long banned dual-class shares, relegating them to lesser exchanges in the United States where they mostly still reside. Dual-class shares are also rare in London.[85] However, they remain common in developing economies and certain developed countries, notably Italy and Canada.[86] In general, dual-class shares are most important where corporate governance is weakest.[87] Their continued importance in Canada is thus not exactly a compliment.

Dual-class shares are not necessarily unfair to public shareholders. Investors who buy inferior voting shares ought, after all, to understand what they are buying, and should pay less for them.[88] And controlling shareholders often justify their superior voting shares as necessary to deter raiders who are unqualified to run the firm. However, neither argument is persuasive in motivating public policy.

Poor corporate governance in general is similarly fair to shareholders, who ought to recognize cronyism, excessive CEO pay, and other common governance problems, and discount the stock appropriately when they buy it. Improved corporate governance is good public policy because it increases the likelihood that the country's great corporations are run efficiently. This is important to the general prosperity of Canada. The same logic applies for dual-class shares.

The second argument is also easily countered, for if the incumbent insider is the most qualified person, and runs the firm transparently enough, the share price reflects this and the stock is too dear for any rational raider. A removable voting cap can prevent temporary price fluctuations from inviting unneeded takeover bids.

Controversy over the corporate governance implications of superior voting shares has led to unifications in many countries including Canada, where some firms have unified all classes of common shares into

[85] Gompers, Ishi, and Metrick (2004).
[86] See Zingales (1994) re. Italy; Smith and Amoako-Adu (1995, 1999) and Amoako-Adu and Smith (2001) re Canada.
[87] For empirical evidence across countries with different governance standards, see Nenova (2003). For within-country evidence, see Carvalhal da Silva and Subrahmanyam (2006).
[88] Smart, Thirumalai, Ramabhadran and Zutter (2005) show this to be so.

one-vote-per share stock.[89] Unifications immediately raise shareholder value, especially in family-controlled firms, leading Lauterbach (2004) to argue that an Israeli moratorium on new issues of superior or inferior voting shares is sound public policy.

Canada should follow Israel in moving towards the Anglo-American model and away from the Italo-Latin American model. A total ban is probably desirable, but will certainly be met with vigorous lobbying by entrenched controlling shareholders. A smaller step in the right direction might be:

<u>Recommendation #10:</u> Dual-class share structures should require periodic renewal by a majority of inferior voting shareholders.

For example, shares with superior voting rights might automatically revert to one-vote-per-share after three years unless renewed by a majority of inferior voting shareholders. Inferior voting shareholders should also always be entitled to elect some board representation, and should have the right to nominate directors for those positions. It should not be possible for corporate charters to contract around any of these rights. The problem with dual-class shares is their undesirability as a matter of broad public policy, to which the controlling shareholder's freedom to draw up contracts as he like comes second. This same logic requires that existing dual-class shares not be grandfathered out of these requirements.

ix. Pyramiding

Pyramiding is an alternative, and often even effective, way of giving controlling shareholders sweeping voting rights with minimal actual ownership.[90] The whole point of pyramiding is leveraging family wealth by mixing in public shareholders' money at each level of the pyramid. This is what expands a substantial family fortune into control over assets worth vastly more. It is also what lets the family exercise complete control over each firm in the group, despite really "owning" very little of the lower-tier firms.

Simple arithmetic shows how pyramiding can reproduce precisely any disproportionate voting power insiders can gain with dual-class shares.[91] Restricting dual-class shares therefore means little unless pyramiding is similarly constrained.

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[89] See Smith and Amoako-Adu (20010, Hauser and Lauterbach (2004), and others.
[90] Berle and Means (1932), Graham and Dodd (1934), Morck, Wolfenzon, and Yeung (2005), and others.
[91] For details, Bebchuk *et al.* (2000).

The United States eliminated pyramiding in the 1930s with a series of reforms, especially levying taxes on intercorporate dividends and providing direct capital gains tax incentives to dismantle pyramids. Above, we advocate stretching securities law across areas formerly in corporations law. But rallying securities law to invade the borders of tax law is too imperialist (even for us). Sadly, Canadian tax economists neglect important corporate governance implications of the tax code, although one can hope for more reflective tax policies in the future.

Fortunately for Canada, the United Kingdom also largely rid itself of pyramiding - and largely with securities and corporations law to boot! In 1968, in response to rising institutional investor dissatisfaction with pyramiding, the London Stock Exchange enacted a takeover rule requiring any shareholder who acquires 30% or more of a listed company to acquire 100%.[92] This was later formalized as statute.

By forcing controlling shareholders to acquire 100% of the firms they control, this rule effectively eliminated British pyramidal groups. Although control could often be held with a stake less than 30%, the active takeover market in Britain permitted raiders to contest the initial controlling shareholder's control by acquiring a slightly larger stake. The initial controlling shareholder would then have to up his stake, and this process soon led to one or the other crossing the 30% threshold and triggering a 100% buy-out.

Other European countries adopted similar mandatory takeover rules - absent an active takeover market - to limited and possibly even negative effect.[93] However Canada has an energetic market for takeovers, and such a rule might well be as effective here as in the United Kingdom. Given that the preferred path, tax incentives to eliminate pyramiding, lies beyond the scope of securities law reform, Canada should follow the British lead.

<u>Recommendation #11:</u> Any shareholder who acquires 30% or more of a listed company should have to acquire 100%.

The current 20% threshold rules for control block sales in Canada imitates the London rule in form only. It requires no 100% bid, only that a bid be open to all shareholders and taken up *pro rata*. Also, numerous exempt-bid rules let many control block transfers sidestep even these meagre requirements. There should be no exemptions whatsoever to Recommendation #11.

[92] See Franks et al. (2005) for a detailed description of the U.K. reforms.
[93] See Hoffmann-Burchardi (2003).

Mandatory takeover rules like Recommendation #11 are a second choice to tax policy because they can reduce the incidence of control block transfers. This is undesirable if such transfers reallocate corporate assets to better-qualified controlling shareholders.

However, highly levered financing of the sort used by L.B.O. specialist firms can circumvent this problem by providing additional capital for 100% bids. We expect that adopting Recommendation #11 might depress M&A activity temporarily until the Canadian finance industry develops the capacity to finance larger control bids.

Prominence

To further discourage pyramiding and dual class shares, the Toronto Stock Exchange might drop pyramid member firms and firms with dual class shares from prominent indexes. Including such firms in indexes artificially inflates their shareholder bases, and hence their stock prices, because index funds become essentially captive shareholders.

Recommendation 12: **Firms controlled by listed firms or via super voting shares should be excluded from stock market indexes used by Index Funds.**

This proposition would have the salubrious effect of giving Canada's premier stock market a more developed appearance to foreign investors. Since membership in a prominent index is a signal of confidence in firms so honoured, this policy also signals boards that archaic governance structures might be reconsidered.

9. Conclusions

Canada has a corporate sector, and consequently governance problems, that more closely resemble those prevalent in Italy and Latin America, than those of the United States and United Kingdom. This is largely because Canada missed a first stage of corporate governance reforms that the United States implemented in the 1930s and that fell into place in the United Kingdom in the decades after World War II. This first stage of reforms created large corporate sectors of freestanding and mainly widely held firms in the U.S. and the U.K. Absent these reforms, Canada's large corporate sector remains characterized by dual-class shares and Byzantine corporate groups.

We advocate a series of reforms that recognize this reality, and that would encourage the development of a large corporate sector more like those of the United States and United Kingdom. We recognize that the principals of large business groups and owners of superior voting shares may dislike many, or all, of these recommended reforms. We also recognize that Canadian shareholders knew what they were buying when they bought shares in Canadian firms with these characteristics.

But the point of corporate governance reform is not, and never has been, fairness for individual shareholders. We desire good corporate governance for the same reason we desire sound economic policies in general: to ensure that capital is allocated and managed efficiently in order to advance general prosperity. Public share values are valid, albeit imperfect, barometers of this.[94] Recent empirical work shows that countries best improve their stock markets through policies that empower and embolden public shareholders, for in pursuing their expanded legal rights they help promote better allocation and management of their countries' collective savings.[95]

We recommend these particular reforms as a long overdue modernization of Canadian corporate governance critically necessary before other reforms, such as analogs to Sarbanes Oxley, even merit consideration. The reforms we recommend would at least put Canadian corporate governance on the same page as corporate governance in the United States and United Kingdom, ending Canadian governance problems long-solved in those countries and so rendering their more recent legal and regulatory innovations of practical value to Canada.

[94] For direct evidence, see Wurgler (2000).
[95] See esp. La Porta *et al.* (2004).

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