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Regulating Competitively:

Corporate Governance Reform for the Long Run

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Executive Summary

Corporate governance is important. Companies that subscribe to higher standards of corporate governance earn higher valuations in financial markets. Countries that impose higher standards of corporate governance have larger stock markets and higher standards of living. The unwillingness of certain countries and corporate insiders to accept the importance of good corporate governance can be likened to the unwillingness of certain narrow special interests to support free trade. Good governance restricts the freedom of action of powerful insiders in large, established corporations. The ill of this must be balanced against the good that good governance achieves by solidifying public investors' private property rights and thereby helping new issuers raise money.

Canada scores well on most metrics of corporate governance, and Canadian regulators and exchanges deserve appreciation for that. But Canada is seldom a world leader in setting forth best practices. In particular, Canada lags in certain aspects of disclosure, such as executive compensation and large ownership stakes, and in controlling insider trading. Despite these problems, Canada's markets perform well in terms of fostering value creation and distinguishing good firms from bad ones.

International best practice in corporate governance is becoming clear in some areas, but remains murky in others. The protection of a set of basic shareholder private property rights is clearly fundamental. These include: shareholders' right to mail in their proxy votes, no requirement to deposit shares prior to a General Shareholders' Meeting, the right to allow cumulative voting or proportional representation, an oppression remedy, the right for moderately large shareholders to call Extraordinary Shareholders' Meetings, and the requirement that preemptive rights be waved only at a shareholders meeting.

In addition, best practice unambiguously includes detailed financial disclosure, as well as disclosure of the details of conflicts of interest and of related party transactions. Detailed disclosure of executive compensation and of the identities of firms' major shareholders also matters, but less. Assigning regulators rule-making powers is useful, but empowering them to pursue administrative or criminal actions is not. Rather, forcing detailed disclosure and then letting aggrieved shareholders pursue legal actions is revealed to be international best practice. International best practice entails shifting the burden of proof from plaintiffs to defendants in corporate governance cases once the plaintiffs have demonstrated that poor governance likely occurred. This shift is desirable because the defendants, corporate insiders, have much easier access to critical evidence in the typical case than do the plaintiffs, public shareholders. Once this threshold is met, it makes sense to impose the burden of gathering needed evidence on the side with the lowest gathering costs. Of course, the threshold should be reasonably high to protect corporate insiders from harassment.

In other areas, such as the importance of independent directors in various committees, the separation of the roles of CEO and chair, the detailed operation of fiduciary duties, and so on, international best practice remains subject to honest disagreement. For example, experimental human psychology suggests that independent directors and non-executive chairs should improve governance, but econometric evidence is incomplete. In such areas, it makes sense for regulators to experiment, so that best practice might be revealed over time. Convergence towards any particular current practice, including that in the United States, is unwarranted at this time. The recent

Sarbanes Oxley reforms are unworthy of emulation, but in other areas United States practice may well be a model for other countries.

Instead of convergence, a system of mutual recognition is desirable. In such a system, different regulators, who all incorporate established best practices, compete for business from investors and issuers by offering innovative regulatory alternatives. Jurisdictions with poorly regulated markets should be free to lose issuers and investors to well regulated ones. Over time, these experiments will reveal more about best practices, and provide ever improving corporate governance.

Introduction

The symposium "Competing Globally, Regulating Nationally: Competitive Governance in a Global Market", jointly organized by Canadian Foundation for Investor Education and the University of Alberta Business School in September of 2003, brought together a cross section of cutting edge regulators and leading academics to try to chart a course for Canada's securities markets and their regulators. [1] High profile scandals and controversies have rocked almost every major securities market in recent years. More scandals may well lurk beneath the markets' Kondratieff waves; but cosmetic quick fixes applied by panicked politicians may pose greater dangers to prosperity than the scandals themselves.

The central problem in all discussions of corporate governance is the difficulty of instilling in corporate insiders an economically meaningful sense of responsibility to public shareholders.

The CEO typically appoints directors, even non-executive directors, to the slate of candidates presented to shareholders at the annual general meeting. Extensive experimental work in psychology demonstrates that human beings feel a deep-seated compulsion to return favors. [2] In everyday life, remembering and returning favors underlies not only business deals, but numerous mundane aspects of society too. In our more distant evolutionary past, favor trading may well have played a role in the rise of trade, and hence of civilization. But in the boardroom, directors who feel they "owe" the CEO understandably find loyalty to an abstraction like "public shareholders" elusive.

[1] This paper is my synopsis of the ideas exchanged at a symposium. As such, it probably reflects my views of these issues more than it should; however, I make every effort to attribute ideas to other participants and to express all reasonable views evenhandedly. I am deeply grateful to all the participants in the symposium for their thoughtful consideration of these issues.

CEOs are also usually strong leaders, whether by track record, family pedigree, or sheer ability to dominate a room. Other work in experimental social psychology shows that human beings have an innate tendency to fall into line behind a legitimate authority figure.[3] This seems to involve emphasizing the moral importance of "loyalty" in a way that subsumes normal individual decision-making considerations. Again, this trait was doubtless advantageous while hunting mammoths, and is still critical to the efficient functioning, especially in their lower levels, of organizations like armies, churches, and corporations. But once again, this innate fixture deep within our common human nature misfires in boardrooms. Directors quite understandably come to see their duty as one of "loyalty" to the CEO.

Yet another line of experimental work in psychology reveals that humans are remarkably adept at realigning their ethical views to accommodate actions that maximize their short-term well-being.[4] Thus, officers and directors at misgoverned companies are remarkably, and probably quite unconsciously, creative at devising reasons why their loyalty to a dysfunctional CEO accords well with their duty to public shareholders. Only when disaster strikes do they realize their errors, often with a deep sense of shock at their own blindness.

To counterbalance these innate human tendencies, corporations law in many, though certainly not all, jurisdictions explicitly assigns corporate officers and directors a legal duty to represent *the corporation* as in Canada, *public shareholders* as in the United

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[2] See Axelrod (1984).

[3] See Milgram (1973), who found that sixty-three percent of a sample of average Americans, paid to "assist" in a sham psychological experiment, willingly electrocuted its ostensible "subject" simply because the lab-coat clad psychologist in charge ordered them to.

[4] See Festinger (1956), who attributes this behavior to *cognitive dissonance*. Humans whose actions are inconsistent with their ethical norms experience a psychological distress, or *dissonance*, that induces them to search for more acceptable ethical norms.

States, or an explicit list of *stakeholders* as in Germany. Corporate governance problems arise because *loyalty* to the CEO often sublimates even explicitly defined duties to these distant abstractions.

Good corporate governance therefore requires measures that counteract basic elements of human nature to refocus officers' and directors' attention on their duty to public shareholders. Different countries attempt this in different ways, and with different degrees of seriousness.

No universal consensus is possible on issues, like corporate governance, that involve deep rooted human factors as well as an economic balance between the short and long term benefits to multiple parties. Issuers, regulators, institutional investors, and politicians would each like maximal benefits for themselves at minimal cost to themselves. Nonetheless, a surprising degree of unanimity emerged – both regarding how Canadian markets might evolve towards better governance practices and regarding what sort of philosophy ought to underlie that evolution.

Moreover, while academics have made immense progress in understanding the economics of corporate governance, we are not sure enough of our conclusions to unequivocally define *best practice*. Agreement is possible on only a core of best practices, but not beyond that. This makes directed convergence towards a *universal standard* undesirable, for we do not yet know the proper destination of such a convergence.

Where optimal regulatory standards are unclear, "competitive regulation" often makes the most economic sense. Different jurisdictions and markets should be encouraged to experiment with different systems of regulation, and investors should be free to move capital between markets. Well regulated markets attract capital, and grow over the long run. Ill regulated markets may attract capital in the short run, but outrageous scandals and debauched reputations ultimately undo them. In the longer run, ill regulated markets must imitate well regulated ones lose volume and listings.

This competition between regulators driving regulatory innovation can both reveal and improve “best practice standards”. In the case of corporate governance regulation, this requires a system of *mutual recognition*; whereby investors may entrust their savings in any stock market whose regulations meet the current general consensus as to what *clearly constitutes* best practice. But where best practice is unclear, regulators should be free to experiment, and to devise creative new ways of fostering good governance. As time passes, these experiments should reveal further detail about best practices, allowing the expansion or revision of the core list above.

Since different countries have different industrial bases, histories, cultural norms, and legal systems, corporate governance may necessarily take on different hues in different places. Moreover, different countries’ legal systems may alter the importance of specific corporate governance regulations. For example, weaker fraud laws might render stronger disclosure rules and more severe restrictions on non-arm’s-length transactions critical. A universally applicable best practice may never emerge, but deeper principles may instead come to guide us in permitting different standards.

Canadian markets and regulators should move quickly to adopt best practices where they are clear, but should resist pressures from other jurisdictions, most notably the United States, to impose standards that do not clearly constitute best practice. Regulators should continually seek lower cost ways to better protect public investors’ private property rights over their stocks to attract issuers and investors from other markets. Stronger property rights are clearly linked to larger and more vibrant markets; and these, in turn, are clearly linked to more prosperous economies.

The Importance of Corporate Governance

It is hard to overstate the importance of the issues debated under the rubric of corporate governance, for they are at the very heart of a free market economy. They are extraordinarily important for at least two critical reasons. First, shareholder value can only be fully realized in a transparent governance regime that makes corporate insiders accountable to public shareholders. Second, and equally important, an internationally competitive governance environment is essential if Canada is to narrow the productivity gap by which Canada trails the United States, shown in Figure 1, and reverse the consequent decline in our relative standard of living.[5] Good governance makes firms adaptable and innovative, and able to respond in an entrepreneurial manner to opportunities arising from changes in the global and North American economies.

In more tangible terms, Figure 2 shows that firms with higher governance standards generate greater shareholder value.[6] At the national level, countries with better standards of corporate governance have larger and more dynamic stock markets, higher share valuations, and cheaper capital.[7] And Figure 3 shows that these same countries also

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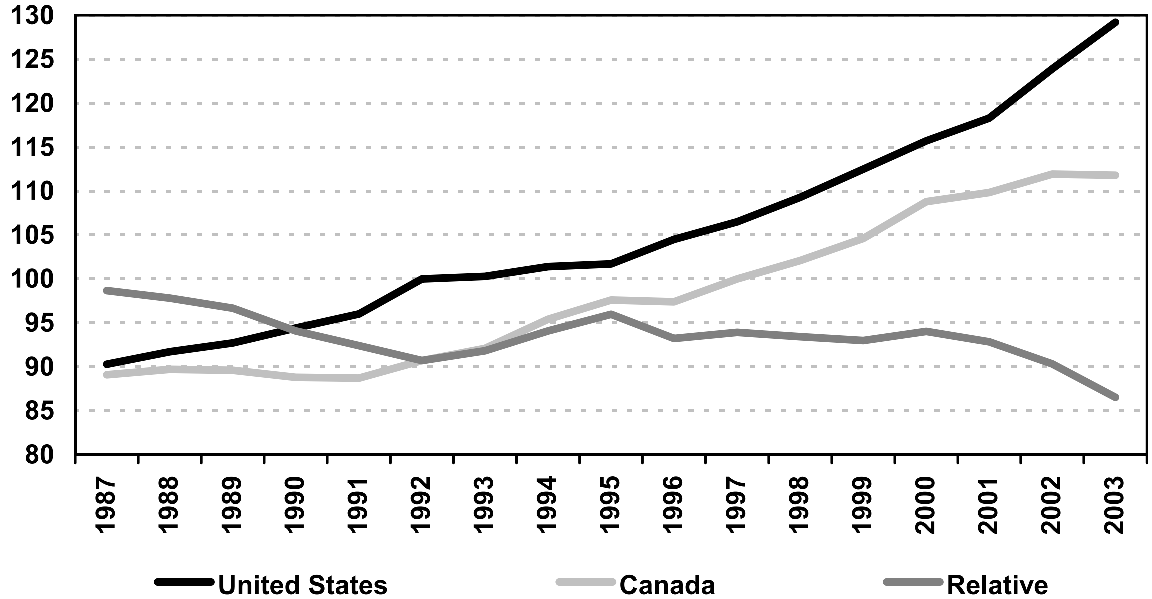
[5] Porter and Martin (2001) argue that Canada's public sector is increasingly internationally competitive, and attribute this productivity gap to lackluster management at Canadian corporations.
[6] Gompers, Ishi, and Metrick (2001) show that US companies adhering to higher standards of governance generated more value for shareholders during the1990s.
[7] La Porta *et al.* (1997, 1998) show that better shareholder protection is associated with larger and deeper markets. La Porta *et al.* (2002) find significantly higher stock valuation ratios in countries with better shareholder protection. Himmelberg, Hubbard, and Love (2002) link weaker investor protection to higher costs of capital.

have higher standards of living.[8] Better governance seems to lead to prosperity, and a prosperous middle class doubtless also demands better corporate governance regime of its politicians and regulators.

Figure 1. Labor Productivity in the United States and Canada
Canadian labor productivity growth, in light gray, substantially lags that in the United States, in black. Canadian labor productivity as a fraction of US labor productivity, the dark gray line, thus steadily declines.



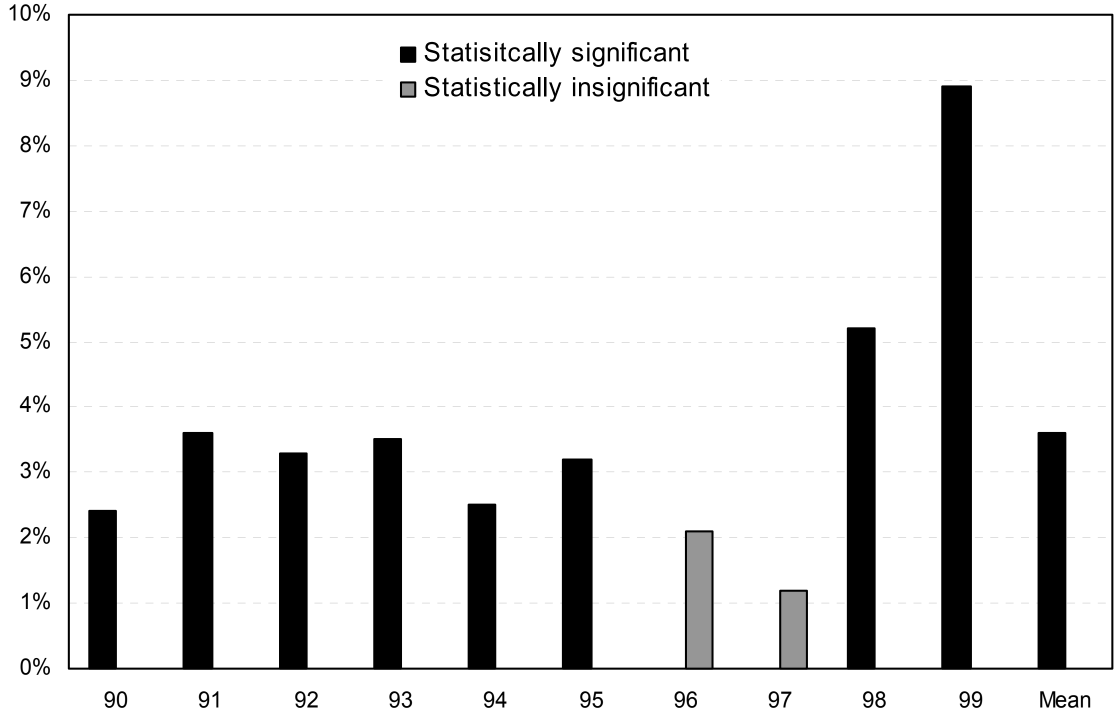
Source: National Income Accounts

Since good governance is essentially about making stock markets more attractive places for investors to put their money, these findings make intuitive sense. They also highlight how regulation, law and enforcement matter. Sensible regulations and laws, and tough enforcement combine to make stock markets attractive places to invest because they *protect public shareholders' private property rights* in the companies they own.

[8] King and Levine (1993) demonstrate a highly statistically significant link between measures of capital market development and *per capita* income growth.

Figure 2. Tobin's Q Ratio Premium Associated with Good Governance

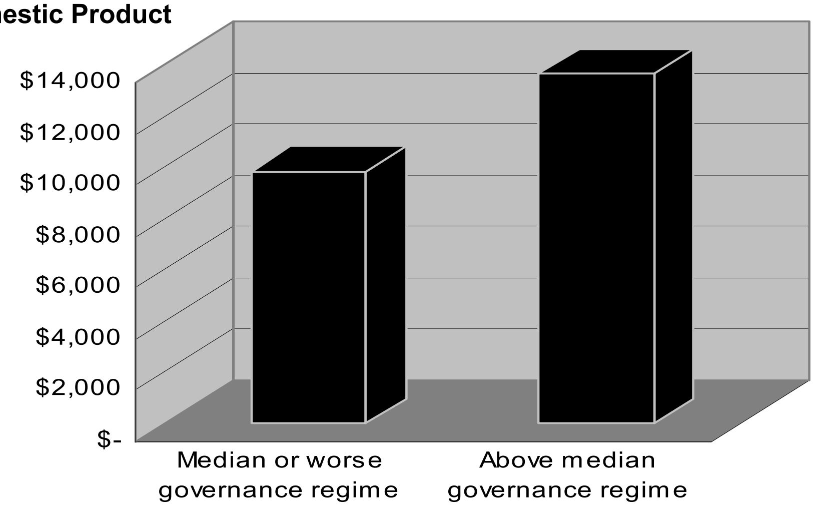
Large US firms with high scores on a checklist of good governance criteria have higher Tobin's Average *Q* ratios. Tobin's Average Q is a market to book ratio that marks historical cost accounting items to estimated current market values. A higher Tobin's Average Q is a widely recognized indicator of successful shareholder value creation.



Source: Gompers, Ishi, and Metrick (2001).

Figure 3. Standard of Living and Corporate Governance

Countries whose legal and regulatory systems score well on a checklist of shareholder property rights protection have higher standards of living, as measured by per capita Gross Domestic Product



Source: La Porta et al. (1998) and national income accounts.

While these general correlations are well known, precisely which aspects of governance matter the most sometimes remains subject to debate.

The current governance debate follows a wave of corporate scandals around the world. The Asian, Latin American, and Russian financial crises of the mid 1990s laid bare serious corporate governance problems in the great corporations of those regions. Corporate governance scandals at Enron, WorldCom, Tyco, Adelphia Communications, and other American blue chip companies led the United States Congress to pass the Sarbanes-Oxley Act. In passing this act, the U.S. clearly created pressures and regulators in other countries to follow suit. Unfolding controversy regarding Parmalat, the Berlusconi holdings, and other respected European companies keeps corporate governance on the front pages of European newspapers. And lest we forget Bre-X, the current drama in the boardroom of Hollinger reminds us that Canadian corporations too can top the lists of Google searches for corporate governance problems.

Although recent governance lapses are responsible for raising awareness of corporate governance, it would be unfortunate if corporate governance laws, regulations, and standards reflect knee-jerk reactions to unfolding scandals. A better focus should be ascertaining an appropriate long term strategy for Canadian stock markets, regulators, and governments.

The Academic Literature on Corporate Governance

The academic literature on corporate governance can be technically intricate, and interpreting the cautionary notes, statistical inference issues, and econometric jargon can be daunting. For instance, statisticians use the term “biased estimate” with a precise mathematical meaning that has little to do with the ordinary usage of the word "biased". Yet a layperson, seeing the term, might easily dismiss a perfectly valid study as "self-admittedly biased".

Moreover, the sheer volume of the literature means that at least one study can usually be found to support any side of any argument. It is easy to list sets of counterbalancing studies and conclude that we know nothing. However, not all studies are equal. Although almost all studies help advance our understanding of the issues, some are more problematic than others. Different approaches raise different warning flags to financial economists, and warrant differing degrees of acceptance in the halls of policy makers.

Finally, to add to the layman's confusion, a school of academic economists makes their raison d'être the construction of mathematical optimizing equilibrium models explaining any and all phenomena. Special accolades attend those boffins who explain especially outrageous abuses as "optimal". This line of work ultimately abides by the philosophy *what is observed must be optimal*. Such models are useful for highlighting the unrealistic assumptions one must accept to justify observed phenomena as optimal. A failure to appreciate this point is responsible for many public policy debacles.

Despite all these problems and distractions, several lessons can be distilled from all this work.[9]

1. Certain rules and regulations have emerged as "international best practice". In other areas, what constitutes best practice remains unclear.

[9] Good surveys of the literature are: Shleifer and Vishny (1997), Karpoff (2003), and Chew and Gillan (2003).

2. Corporate governance problems create pressure for corporate ownership to become more concentrated. More concentrated ownership, under many circumstances, further aggravates corporate governance problems. Widely dispersed ownership, though it also invites certain abuses, requires a high level of trust by small investors. Widely dispersed ownership should therefore be seen as a vote of confidence in country's markets and regulators.[10]

3. Controlling shareholders value their shares more highly than do public shareholders.[11] This indicates that controlling shareholders enjoy "private benefits of control" – returns to ownership in addition to the dividends and capital gains accruing to public shareholders. These private benefits can be substantial.[12] Groups of listed companies that control each other or that have a common controlling shareholder seem prone to self-dealing problems in many countries.[13] International best practice recognizes these problems, and mandates disclosing conflicts of interest, disclosing details of related party transactions, and empowering public shareholders to pursue oppression suits against controlling shareholders. It is possible that the forced breakup of such groups, as in the United States and United Kingdom, might actually constitute best practice, but this remains unclear.

4. The market for corporate control is good for corporate governance. While value-destroying takeovers can often be a symptom of poor governance in the bidder

[10] See La Porta *et al.* (1999) for details.
[11] See Holderness (2003) for a summary of the literature.
[12] See Dyck and Zingales (2003) and Nenova (2004) for recent precise estimates of the value of private benefits of control. The weaker the protection a country assigns to public shareholders' property rights, the greater the private benefits of control.

firm, this is an argument for better governance in bidders, not against takeovers. The benefits of takeovers outweigh their costs.[14] In the years immediately after takeover defenses like poison pills became commonplace, managers used them to bargain for higher takeover premiums, to the benefit of public shareholders.[15] However, target insiders now increasingly use such defenses to bargain for private side deals, like generous golden parachutes, rather than for high premiums to target shareholders.[16] The beneficial aspects of poison pills can be retained and the undesirable aspects avoided by always vesting waiver powers over takeover defenses with public shareholders, rather than the board.[17] Other defenses, particularly staggering board elections over multiple years, appear to depress share value markedly.[18]

5. Institutional investors are able to influence corporate governance by, for example, ousting CEOs of firms that are underperforming.[19] However, evidence that institutional investors induce superior stock market or operating performance is scant.[20] One interpretation of these findings is that institutional investors mainly intervene in the shadow of looming disaster, and that achieving "normal"

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[13] See Bae *et al.* (2002), Bertrand *et al.* (2002), Claessens *et al.* (2002), Johnson *et al.* (2000), and others. But see also Faccio and Lang (2003). These problems seem especially important in jurisdictions that protect public shareholders private property rights poorly.

[14] See Morck *et al.* (1990) for evidence on value destroying takeovers. See Morck *et al.* (1988, 1989) and Shleifer and Vishny (1997) for analysis of the role of takeovers in fostering good governance.

[15] Comment and Schwert (1995) show that poison pills were initially used by managers to raise takeover premiums, to the benefit of public shareholders.

[16] See Moeller (2004).

[17] See Bebchuk (2003).

[18] See Cohen and Bebchuk (2003).

[19] See Karpoff (2003).

[20] See Karpoff (2003).

performance in such a firm is indicative of success. Another is that some institutional investors have governance problems of their own.[21]

6. Outsider dominated boards appear to induce greater CEO turnover following abnormally bad performance, but do not seem to generate superior long term performance. Much of the work on psychology discussed above predicts that outsiders *ought* to have a positive effect. The presence of a second, dissenting, authority figure seems to undermine our instinctive loyalty, and encourages reasoned decisions.[22] Two conclusions are possible. Either results from experimental psychology do not generalize to situations in boardrooms or many of the directors classified as "outside", "independent", "non-executive", or "external" are actually just as beholden to the CEO as executive directors are. The second explanation seems to fit the facts better. Outsiders seem more effective if shareholders force the CEO to accept outsiders. But if a regulation requires a certain number or percentage of outsiders, the CEO appoints "outsiders" who tow the line.[23]

7. The CEO should probably not also chair the board, for this seems to make the CEO harder to dislodge following poor performance.[24] Combining the roles does not necessarily depress shareholder value indefinitely, for such firms were

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[21] Romano (1993) argues that public sector pension funds can be influenced by political pressure, and that corporate. John Pierce informed the symposium that only 50% of United Kingdom fund managers need meet corporate governance criteria from their mandates. Lakonishok *et al.*(1991, 1992) argue that many private sectors pension fund investment decisions are distorted by what essentially amounts to governance problems.

[22] Milgram (1973) reports that experimental subjects can be induced readily, out of feelings of loyalty to the experimenter, to electrocute passive laboratory subjects. Introducing a second experimenter, who explicitly disagrees with the first about the appropriateness of the experiment, undermines these feelings of loyalty and causes experimental subjects to evaluate the appropriateness of electrocuting the subjects themselves.

[23] See Hermalin and Weisbach (1998, 2003).

[24] See Morck, Shleifer and Vishny (1989).

unusually common targets of hostile takeovers in the years before takeover defenses spread. [25] However, takeovers are probably more disruptive to the employees and other stakeholders than is replacing the CEO. Nonetheless, further work is needed to clarify the importance of separating these roles.

8. The relationship between executive stock options, bonuses, and earnings-based pay-for-performance on the one hand, and corporate performance on the other is also poorly understood.[26] CEO pay rose dramatically in the 1990s and most of this increase was options and other performance-linked compensation. Linking CEO pay to share price performance or to measures of accounting performance that do not permit manipulation of accruals may well be good governance.[27] Current pay-for-performance techniques need improvement, however. In particular, restricted stock seems preferable to options in many ways. Nonetheless, further work is needed regarding optimal executive compensation.

The State of Corporate Governance in Canada

Corporate governance in Canada really is a different game from that in the U.S., at least with regards to a large swath of the economy. That means simply replicating what the Americans do often means solving non-problems while missing genuine economic and governance trouble spots.

As Michael Percy, the Dean of the University of Alberta Business School pointed out, the biggest difference between the two countries is that most large U.S. firms are very widely held. A large shareholder in the United States is often a family or

[25] See Morck, Shleifer and Vishny (1989).
[26] See Core *et al.* (2003).

institutional investor with a three to five percent stake.[28] In this environment, shareholders are weak and corporate governance is about protecting public investors' property rights from self-serving professional management who are spending *other people's money*.

A minority of large U.S. firms are vulnerable to another kind of corporate governance problem – *entrenchment*.[29] This occurs when a controlling shareholder so dominates corporate policies that public shareholders stand hostage to her self-serving behavior – or even just her ineptitude. While both widely held and narrowly held firms occur in the large corporate sectors of both countries, the balance is almost perfectly reversed here. Most large Canadian firms have controlling shareholders.[30] This means entrenchment governance problems ought to be near the top of the list of our concerns.

Entrenchment can cause big problems both for public shareholders and countries.[31] Recent research shows that timely top insider turnover is a healthy factor for shareholder value in both U.S. and Canadian companies.[32] Research also indicates that our productivity shortfall relative to the U.S. may be, in part, linked to governance problems in the Canadian corporate sector.[33] Historical studies of economic growth link corporate insider entrenchment to slow economic growth. This seems to be because

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[27] See Abowd and Kaplan (1999).
[28] See Morck, Shleifer and Vishny (1988).
[29] See Stulz (1988), Morck , Shleifer and Vishny (1988), and others.
[30] See Morck, Stangeland and Yeung (2000) and others.
[31] Morck, Shleifer and Vishny (1988), McConnell and Servaes (1990), and others find that very narrowly held US firms trade at a discount. Although Himmelberg, Hubbard, and Palia (1999) question whether ownership levels cause the discount or the discount causes insiders to retain their stock, other work clearly implies the former. Fields and Mais (1994) test the direction of causation directly. Himmelberg, Hubbard, and Love (2002) confirm that weaker investor protection leads to higher insider ownership, and that this in turn leads to higher costs of capital.
[32] Johnson, Magee, Nagarajan, Newman, and Schwert (1985) report that CEO sudden death causes significant stock price decreases about as often as significant increases. That substantial numbers of CEOs stay on long enough to become liabilities to their firms is evidence of entrenchment. Morck, Stangeland and Yeung (2000) find that Canadian firms controlled by "old money" families underperform.

entrenched insiders are often simply the wrong people to have in charge when economic conditions change and frequently react by becoming excessively risk averse.[34]

Corporate insiders often entrench themselves using either dual class shares, pyramids of inter-corporate ownership, or both. Dual class shares and pyramidal groups let insiders control the majority of votes at an annual shareholders meeting with a very small percentage of actual ownership. This exposes companies to both *other people's money problems* and *entrenchment problems* simultaneously.[35]

Canada's current corporate legislation rejects the old United Kingdom model and adopts the approach of the United States in taking a more formalistic and rule-based approach to regulating corporate governance. Nonetheless, the Canada Business Corporations Act did this in an innovative manner. Canada didn't simply mark up the US rules. Rather, it adopted them to Canadian circumstances in an intelligent way. For example, when it was enacted in 1975 the Canada Business Corporations Act was an international high standard for best practices in protecting minority shareholders from controlling shareholders.

Canada's securities regulation also parallels that of the United States, despite small differences. While convergence is evident in many dimensions, a mutual recognition philosophy prevails. The *multijurisdictional disclosure system* (MJDS) of 1991 permits Canadian issuers to use Canadian filings to pursue US securities transactions. The MJDS, however, does require reconciliation with US GAAP rather than Canadian GAAP.

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[33] See Porter and Martin (2001).

[34] Landes (1949) concludes that France fell behind Britain during the 19th century because of entrenched insiders' domination of large French companies. Chandler (1990) arrives a similar finding regarding the United Kingdom versus the United States in the 20th century.

Accounting rules in Canada are thus under market pressure to converge to United States Generally Accepted Accounting Principles (GAAP), though there is an ongoing discussion of moving to Internationally Accepted Standards (IAS).

Some Canadian innovations clearly do not constitute best practice, however. Canadian residency requirement for directors were implemented in the 1970s due to nationalist theory. These have been relaxed and are on their way out.

Canadian executive compensation disclosure rules lag international best practice. When MJDS was brought forth 1991, it prompted a debate among securities regulators about whether Canadian companies that were U.S. registrants had to comply with U.S. rules. The Ontario Securities Commission (OSC)[36] proposed a compromise falling short of the U.S. model: Aggregate disclosure is acceptable unless one officer's compensation exceeds forty percent of the compensation of the top five officers. The justification for not requiring a Canadian listed corporation to tell its owners what it pays its top managers is obscure. The Ontario government intervened and forced the OSC to adopt the American approach.

Poison pills in Canada typically require a shareholder vote, whereas in the United States, they require board approval only in many circumstances. This arguably holds Canadian boards to a higher standard. Also, Canadian firms like TransAlta, were at the forefront of designing the second generation of poison pills, which allow shareholders to nullify the takeover barrier in the event of a hostile bid.

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[35] See Bebchuk, Kraaakman, and Triantis (2000), Morck, Stangeland, and Yeung (2000), and others.

[36] Since Canada's largest securities market is in Ontario, that province tends to set standards in all aspects of corporate and securities law. It thus has a role much like that of Delaware in the United States. Alberta, British Columbia, and Québec also regulate large securities markets.

Ontario also requires the disclosure of large related party transactions, and their approval by outside directors or minority shareholders. Again, this holds Canadian firms to a higher standard than their United States peers. However, the prevalence of corporate groups of listed companies with a common controlling shareholder in Canada, and their complete absence in the United States, means that related party transactions are a much greater concern in Canada too. The United States forced the dismantling of such groups in the 1930s.[37]

The effectiveness of Canadian corporate governance laws relative to those of other countries can be gauged in several ways.

La Porta *et al.* (1997, 1998) enumerate the property rights the laws of each country provide public shareholders. They give a country one point each for having laws that:

1. Let shareholders to mail their proxy votes.
2. Do not require shareholders to deposit their shares prior to the General Shareholders' Meeting.
3. Allow cumulative voting or proportional representation of minorities on the board of directors.
4. Provide an oppression remedy.
5. Permit a shareholder with a stake of ten or more percent to call for an Extraordinary Shareholders' Meeting
6. Allow shareholders preemptive rights to be waved only at a shareholders meeting.

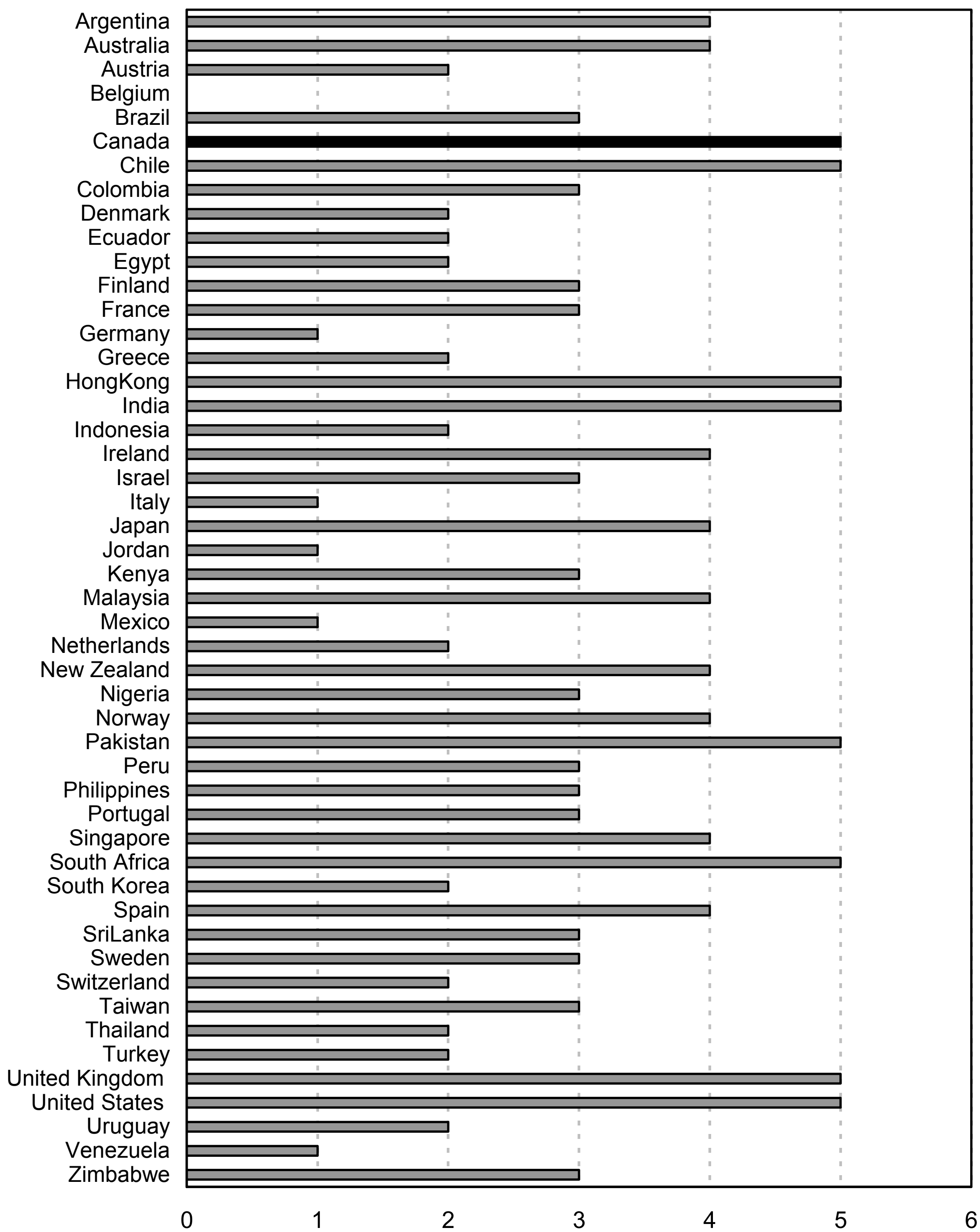
[37] Morck (2003) describes how the Roosevelt administration enacted double taxation on intercorporate dividend income to make corporate groups severely tax disadvantaged relative to freestanding firms; and how the Public Utilities Holding Companies Act mandated that public utilities be freestanding firms

Figure 4 illustrated these rankings graphically. Canada has on its books shareholder property rights protection as good as that of any country in the world. However, this shareholder rights index counts rights available in the law, but not how effectively they are enforced.

To infer the actual effectiveness of shareholder private property rights protection, Figure 5 examines the incidence of dispersed ownership among each country's leading firms. Only relatively high income countries are listed because dispersed ownership is virtually nonexistent in the ranks of large corporations in low income countries. That large firms remain widely held indicates well regulated markets for two reasons. First, dispersed ownership means wealthy individuals and families cannot extract sufficient private benefits to justify acquiring control blocks. Second, public shareholders trust corporate insiders sufficiently to value the stocks highly enough to deter takeovers by wealthy individuals and families. By this metric, the United States, United Kingdom, and Japan have the best regulated stock markets. Canada's stock market still ranks well, tied for sixth place with France and Switzerland, but is no longer the best in the world.

Figure 4. Public Shareholder Property Rights

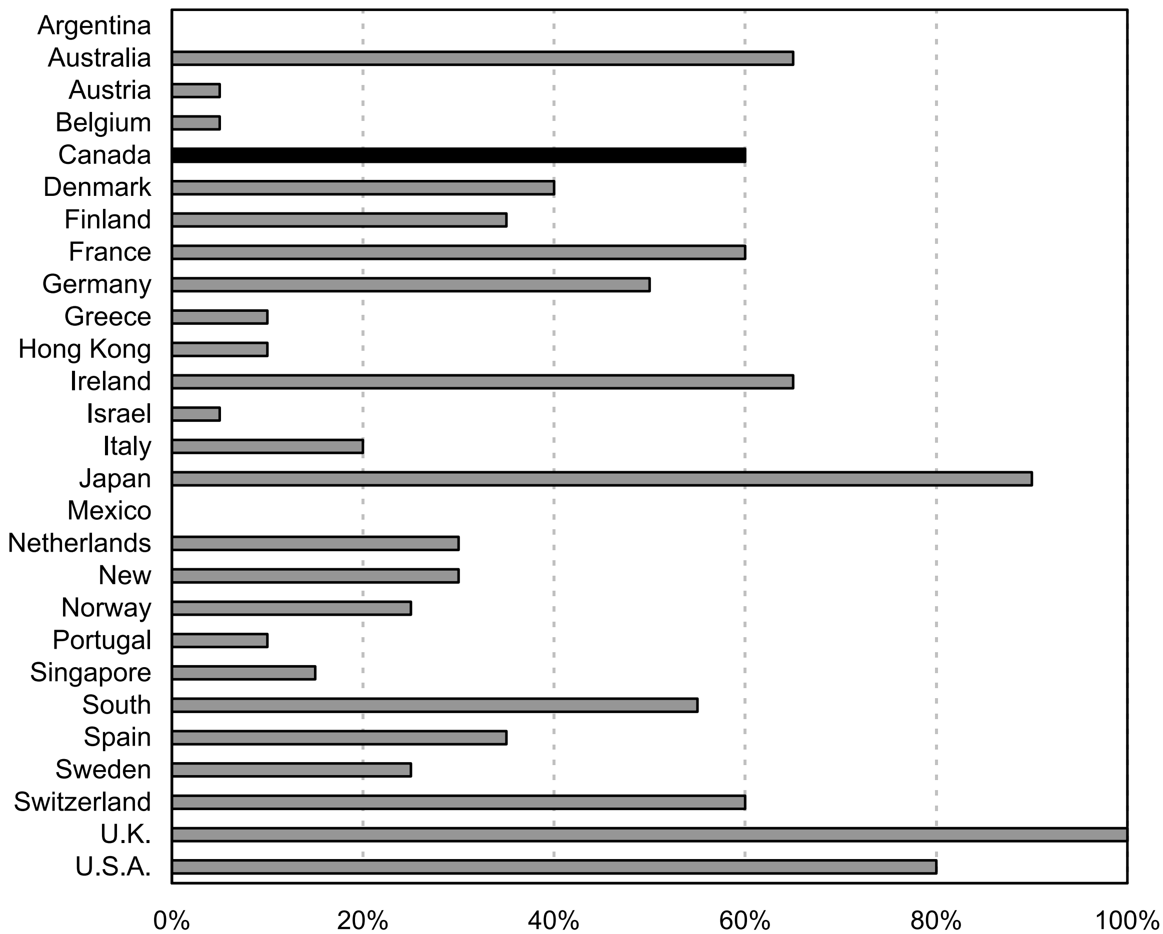
The strength of public shareholders private property rights protection over their investments in various countries. A higher index indicates stronger property rights. The index measures property rights provided in the law, not the effectiveness with which they are enforced. Data are for 1996.



Source: La Porta et al. (1998)

Figure 5. Dispersed Ownership of Large Firms

The fraction of the top twenty firms in each country that have no shareholder with a stake of twenty percent or greater. A greater incidence of dispersed ownership can be interpreted as signifying a higher level of trust by small investors in corporate insiders. Data are for 1996.



Source: La Porta et al. (1999)

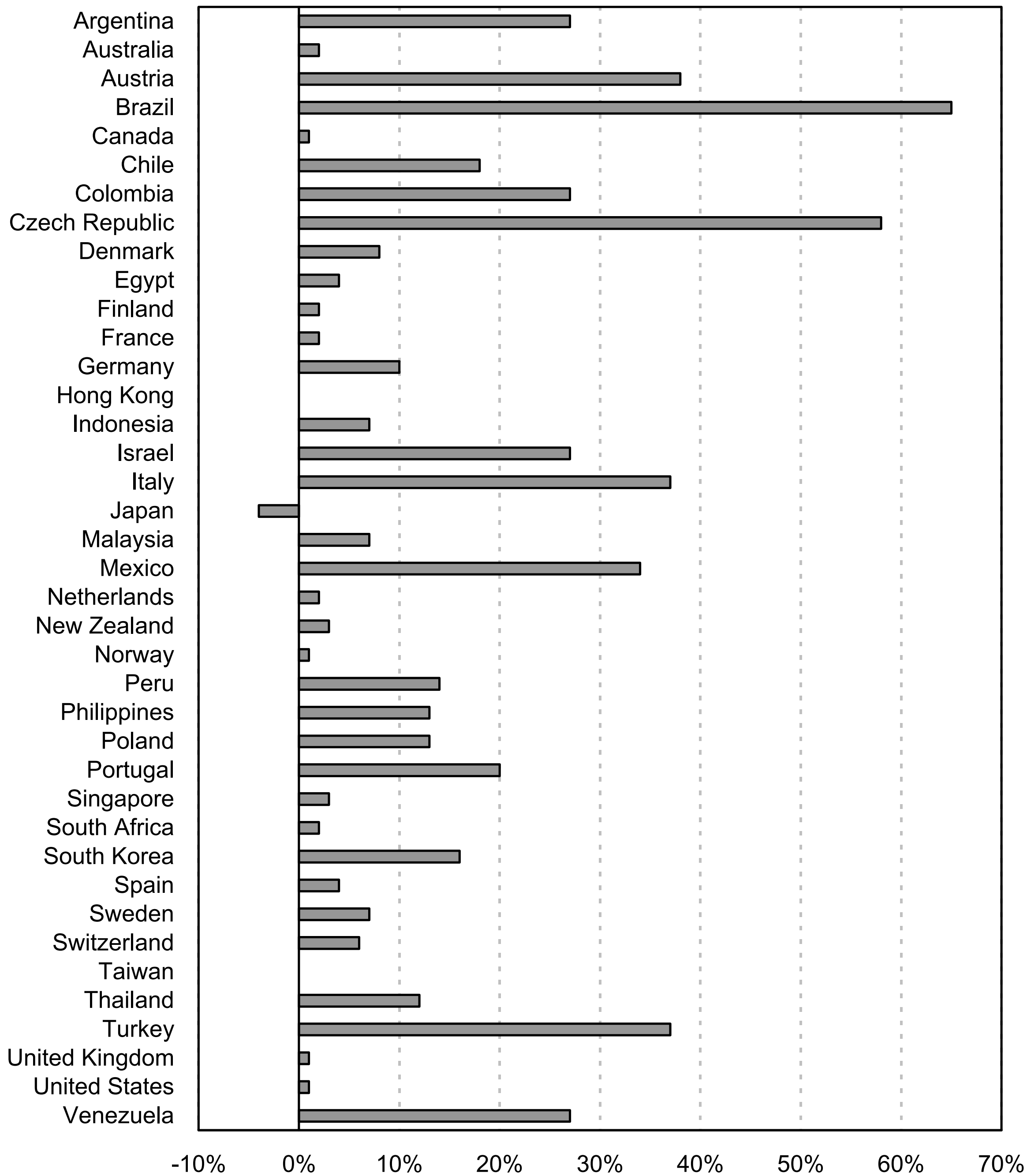
Another way of inferring the strength of public investors' property rights is by estimating how much value insiders assign to control. This follows if insiders are willing to pay a higher price for control blocks when they have more freedom to do as they wish with corporate assets, regardless of the effects on public share values. Figure 6 shows that Canadian control blocks trade at the seventh smallest premium in the world. This suggests that private benefits of control in Canada are not great, at least by international standards. However, the effect of Canadian control block rules may be to temporarily elevate public share prices to match those of control block shares.[38] Further work is needed to confirm that the value of control blocks in Canada is not significantly elevated.

Figure 7 uses another technique to gauge the strength of public investors' property rights – the premium of voting shares over similar nonvoting shares. If control allows a voting blockholder to appropriate private benefits at the expense of other shareholders, voting shares should trade at a premium. The premium at which Canadian voting shares trade is fifth lowest in the world, again indicating that Canadian markets are relatively well regulated.

[38] The rules governing sales of control blocks in Canada virtually guarantee this result, for sales of blocks of twenty percent or more must be pro rata offered to all shareholders. This means that the estimation technique of Dyck and Zingales (2003), used to generate Figure 6, may not be appropriate for Canada.

Figure 6. Block Premiums

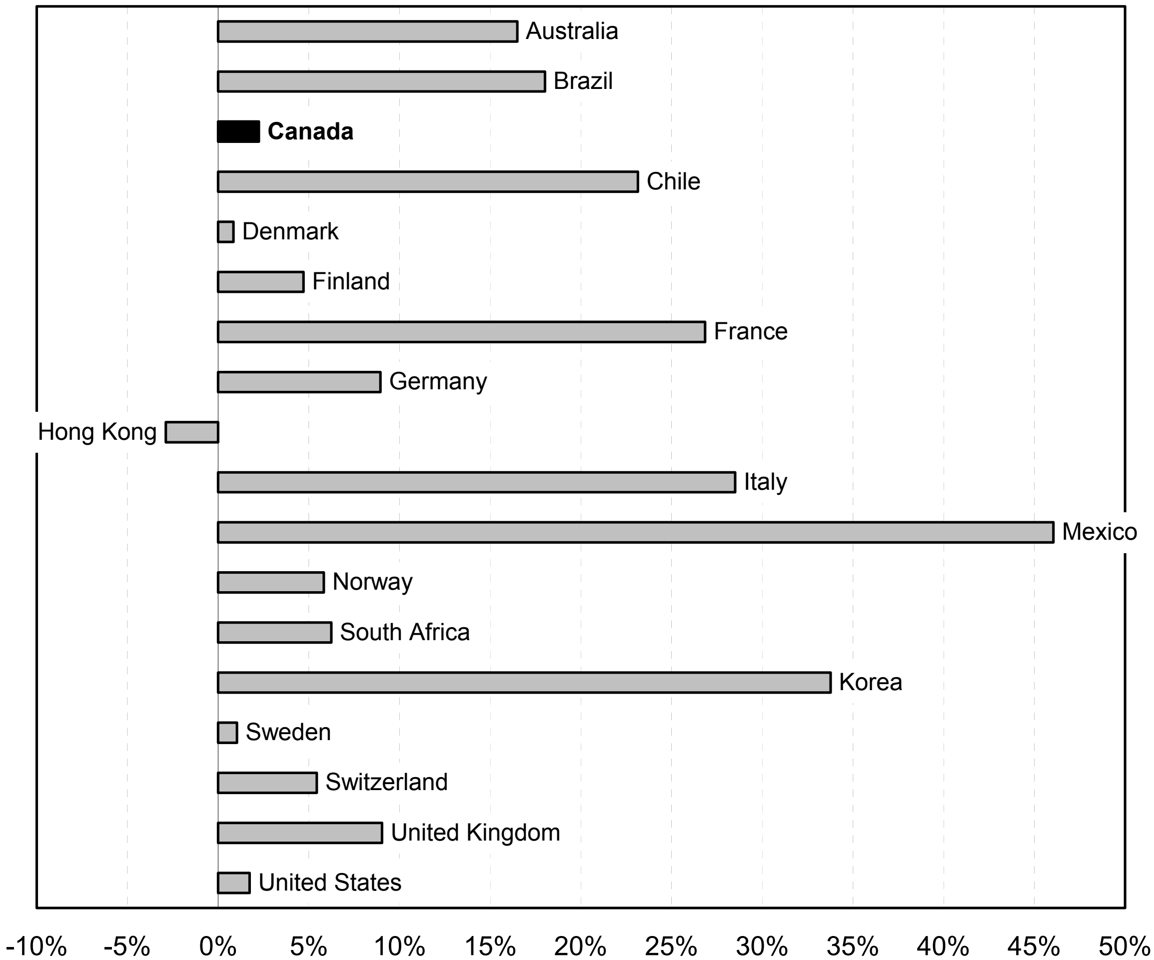
The value of shares in traded control blocks relative to publicly traded shares in the same company at the same time. Higher block premiums indicate higher private benefits of control.



Source: Dyck and Zingales (2003)

Figure 7. Voting Premiums

The value of voting shares relative to non-voting shares in the same company, after adjusting for dividend differences. Higher voting premiums indicate higher private benefits of control.



Source: Neneva (2004)

Another approach to gauging the "fairness" of a stock market to small investors is to estimate the average profits from insider trading. One of the most lucrative opportunities for insider trading occurs just before the public announcement of an action that will cause a sharp rise in the stock price. Such actions include self tenders, negotiated tender offers by other firms, and other transactions.

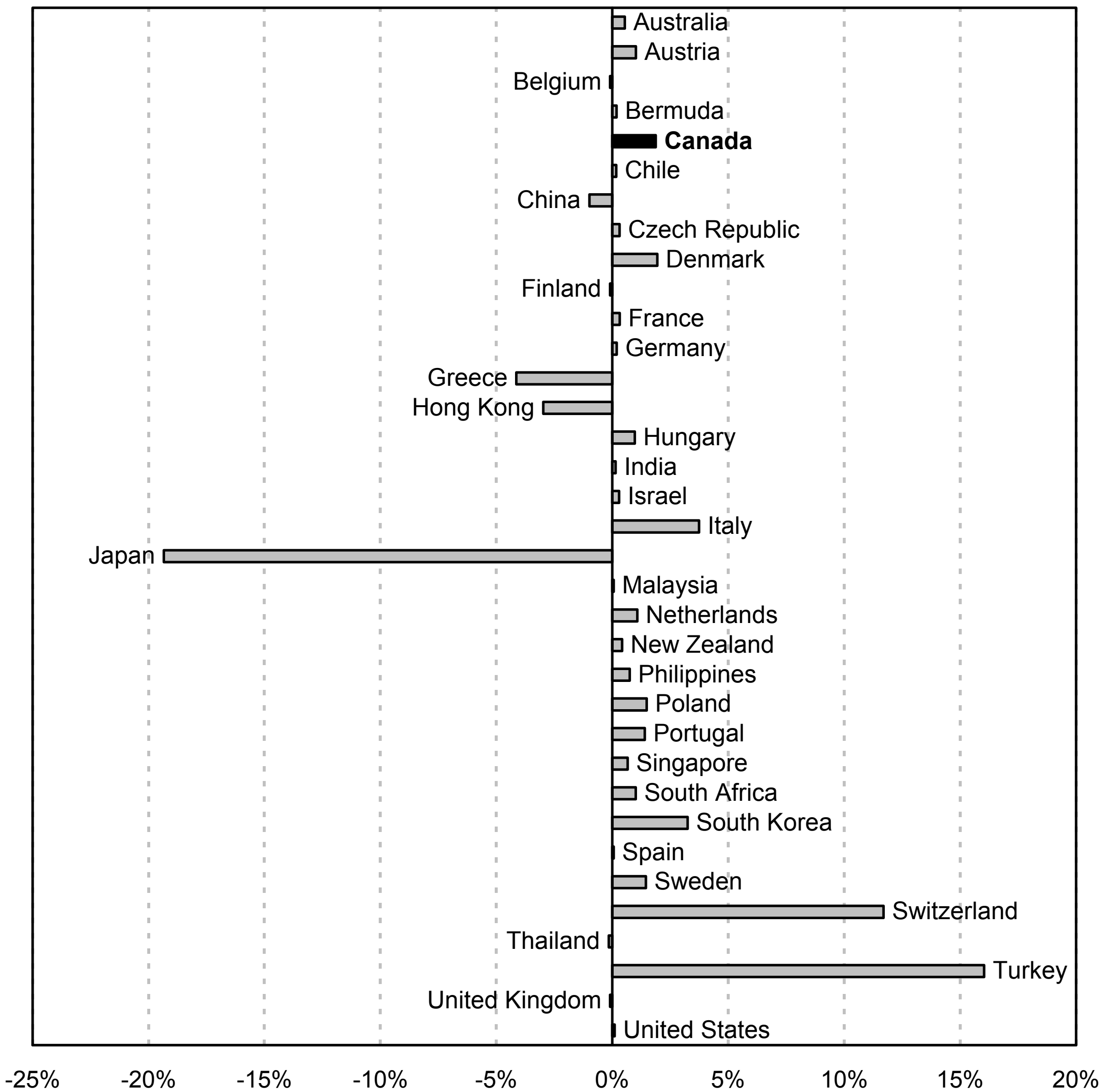
Bris (2000) measures the extent to which stock prices rise before such public announcements in different countries, and from this infers typical profits from insider trading in each country. If insiders typically buy low and sell high, earning significant insider trading profits, we can infer that a stock market fails to protect public investors' property rights adequately. Figure 8 lists the pre-announcement run-ups typical for each country. On this metric, Canada fares worse. Canadian insiders bid up prices significantly prior to the public release of information, rendering our markets the fifth worst in the world on this metric. Since Canadian insider trading laws are on the books, and the existence of insider trading is simple to infer from price movements, the problem seems one of enforcement.

Yet another measure of the quality of regulation in a given stock market is the degree of independence in the movements of stock prices. Morck *et al.* (2000) show that stock prices tend to move up and down *en masse* in markets in which investors' property rights are ill protected. They suggest that this is because such markets are especially prone to waves of sentiment-based buying and selling. In contrast, individual stocks' prices tend to move relatively independently in markets in which public investors' property rights are well protected. They argue that this is because such markets are more information-rich, with individual stock prices better representing detailed changes in firm fundamental values.

Figure 9 shows that Canada's markets are the third best in the world, after those of the United States and Ireland, and just edging out those of the United Kingdom. Stock prices in Canada's markets are among the most information rich in the world. The data shown are for 1995, however the rankings change little in subsequent years.

Figure 8. Insider Trading Estimated Profits

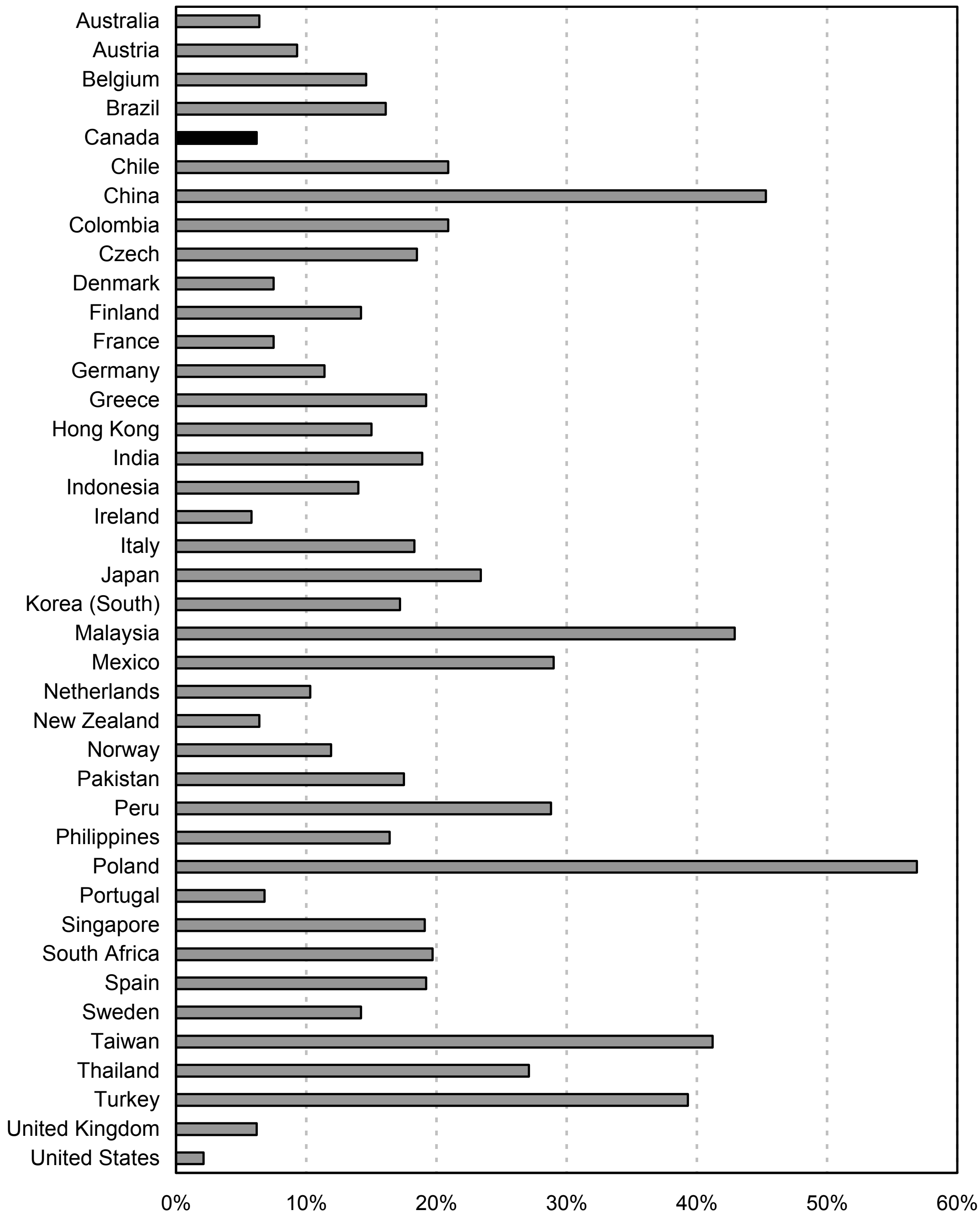
The magnitude of insider trading profits in various countries is measured as the percentage price run-up for sixty to five days prior to announcements of major events, such as corporate takeovers



Source: Bris (2000).

Figure 9. The Extent to which Stock Prices Rise and Fall Together

This graph shows the fraction of the variation in a typical stock that is common to all stocks. Markets in which prices rise and fall *en masse* are more likely to be driven by irrational exuberance than are markets in which some prices rise and others fall on a typical day.



Source: Morck et al. (2000).

Yet another measure of the success of a stock market is the average valuation of the securities that trade on it. La Porta *et al.* (2002) estimate Tobin's average q ratios for the stocks trading on the exchanges of a large number of countries. Tobin's average q ratio is essentially a "souped-up" market to book ratio, which adjusts for standard accounting practices that can distort ordinary market to book ratios.[39] These are displayed in Figure 10. Canadian stocks have the third highest valuation of any in the world, tied with those of the Netherlands, lagging those of the United Kingdom somewhat, and trailing those of the United States substantially. Canada's markets look good by this measure, but are not the best in the world.

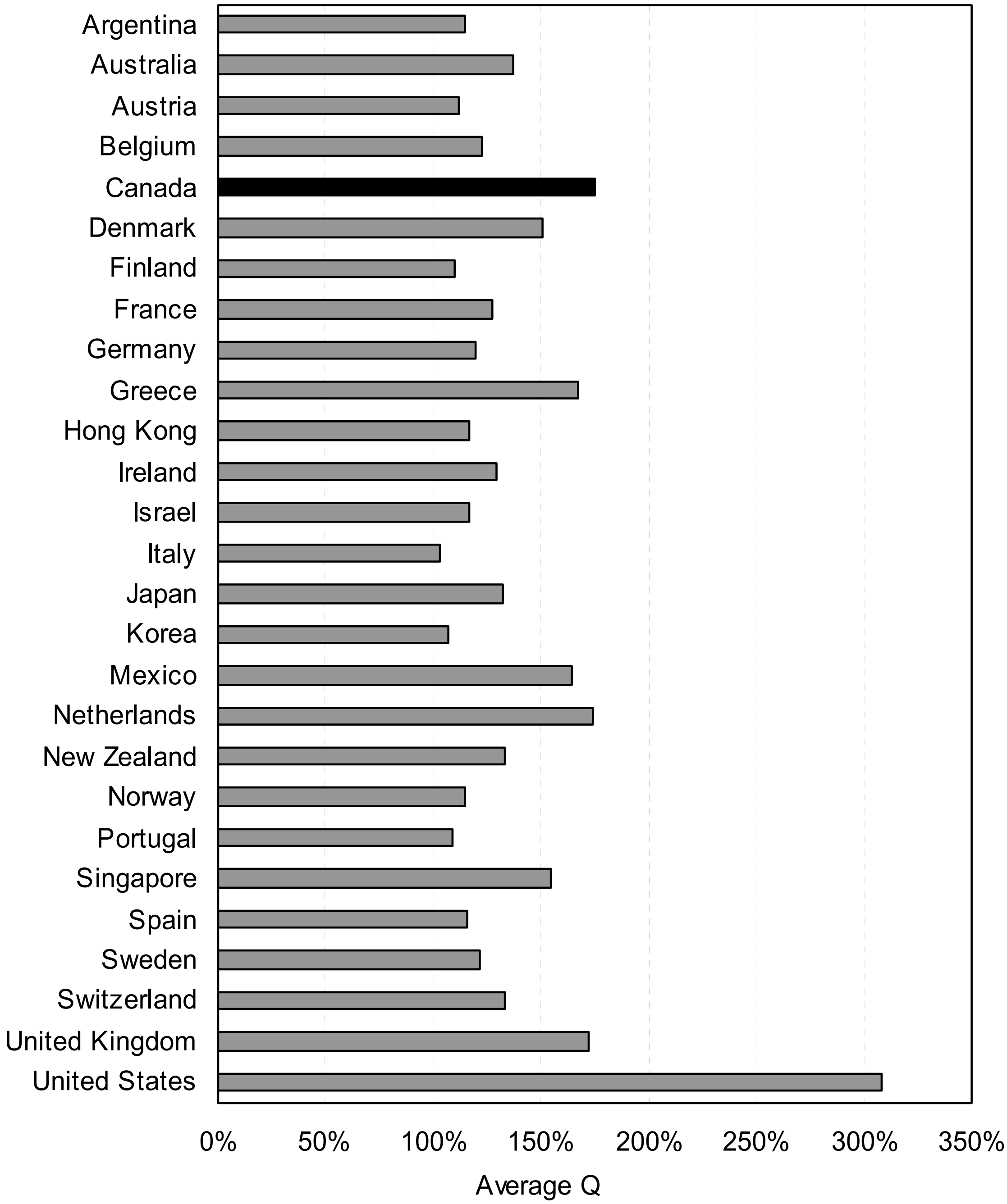
But the simplest and most direct measure of the success of a stock market is probably simply its size relative to the size of its economy. Stock markets that protect investors' private property rights well should attract business and grow disproportionately. Stock markets that do not should decline. Figure 11 shows the total market capitalization of each country's stock market as a fraction of gross domestic product. By this metric, Canada has the tenth best stock markets in the world, lagging behind the United States, United Kingdom, and Ireland; as well as a number of Asian markets. Nonetheless, Canadian markets rank well above those of most countries in the world.

Finally, Wurgler (2000) constructs an especially critical measure of how well each country's stock markets, banks, and other financial institutions target the economy's capital. The social purpose of a stock market is to direct the economy's capital to firms and sectors that have the highest value uses for it, and to keep capital away from low value uses.

[39] See Morck *et al.* (1988) for a detailed discussion of these distortions and how to correct for them.

Figure 10. Company Valuation

Company valuation is measured as Average Tobin's *Q*, the ratio of the market value of assets to their replacement values at the end of the most recent fiscal year available in WorldScope's 1997 database. The market value of assets is proxied by the book value of assets minus the book value of equity minus deferred taxes plus the market value of common stock. The replacement value of assets is proxied by the book value of assets.



Source: La Porta et al. (2002)

Figure 11. Stock Market Size Relative to Economy Size

A larger stock market in proportion to the size of a country's economy, measured here by gross domestic product, is indicative of the level of trust investors have in their stock market.

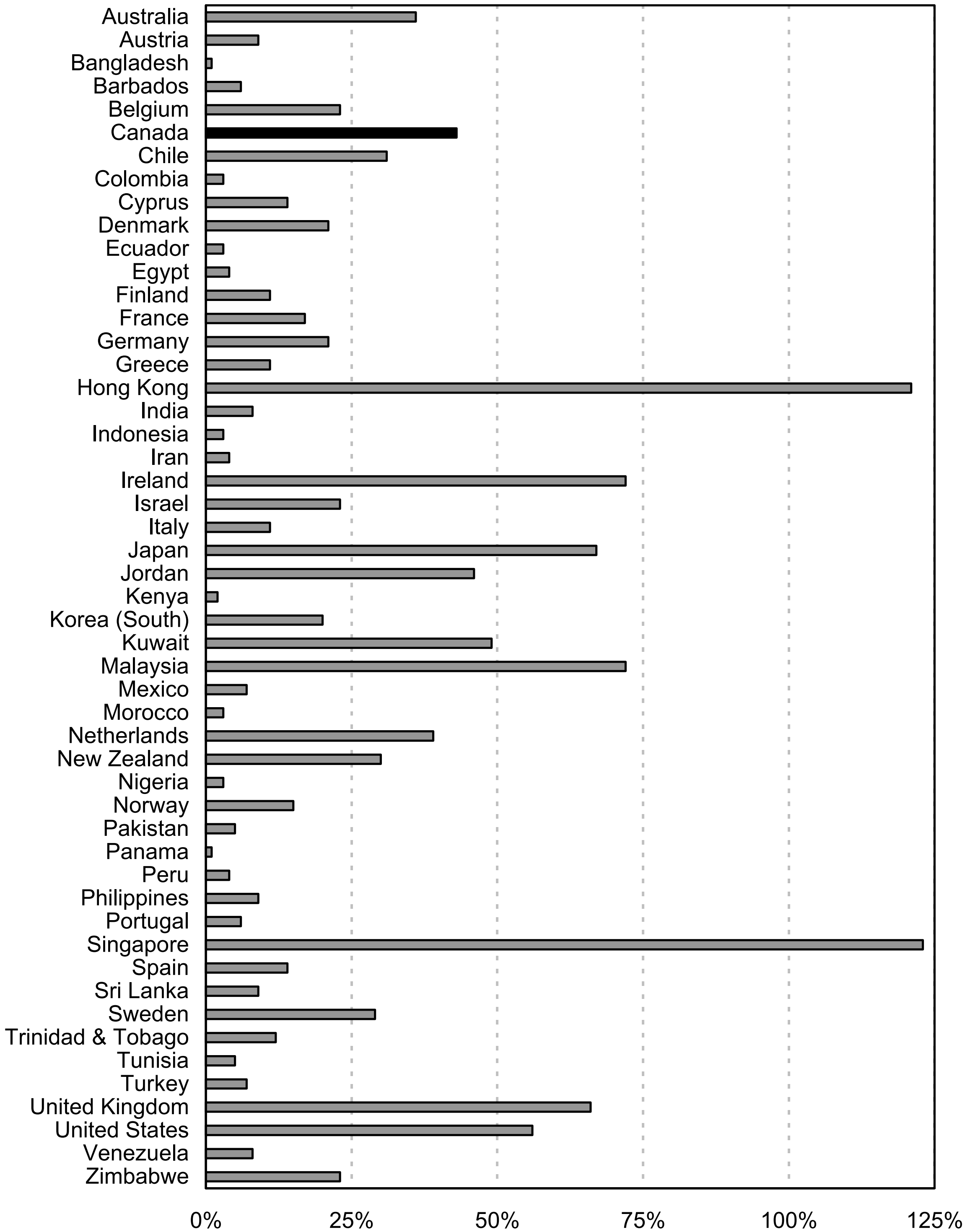
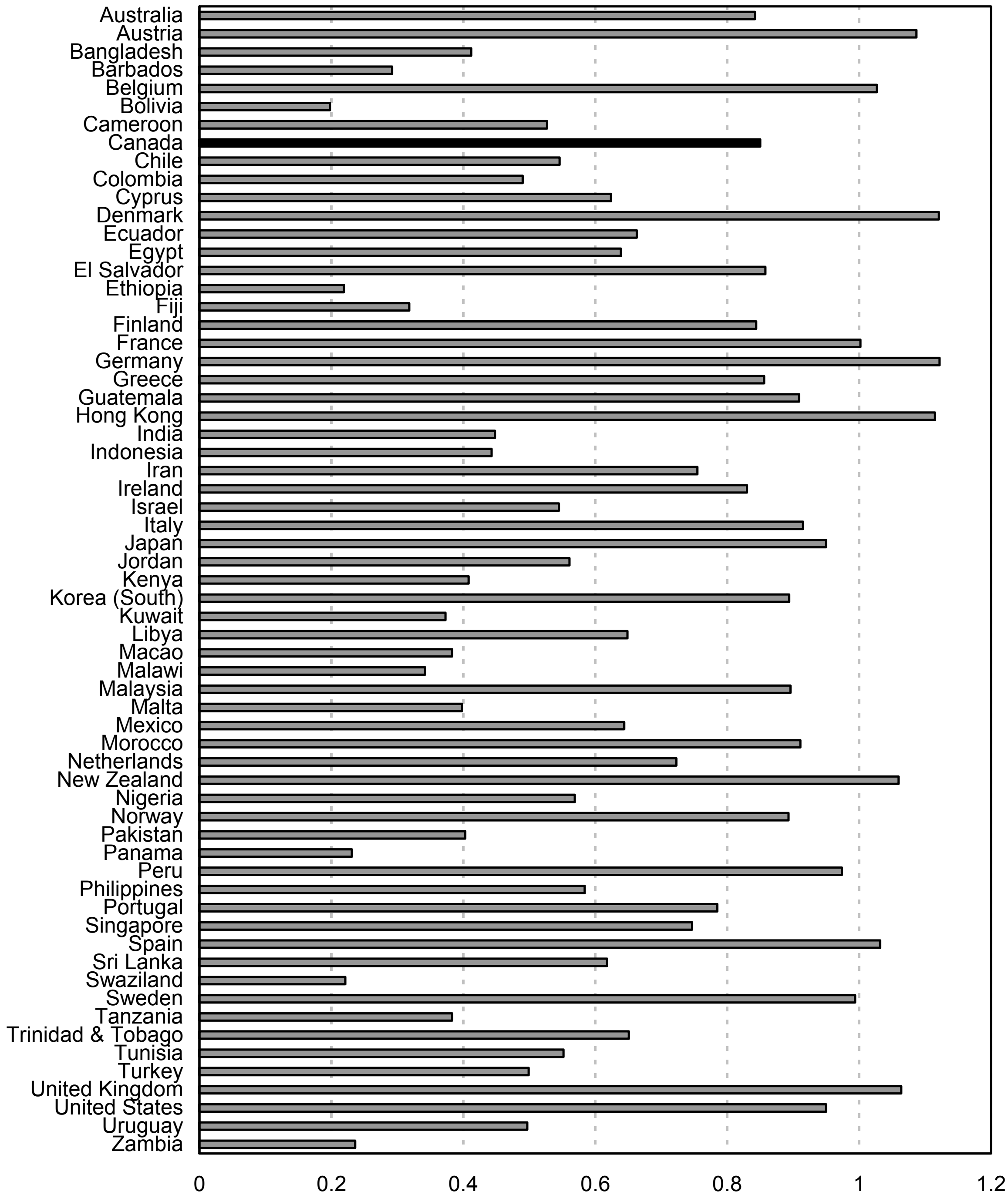


Figure 12. The Functional Efficiency of the Financial System

Higher values indicate that capital moves more quickly towards high value-added industries. Lower values means capital spreads through the economy more randomly.



Source: Wurgler (2000).

Wurgler measures the value added associated with additional capital for each industry in a large sample of countries and then asks whether capital flows more strongly to higher value uses in each country. Figure 12 illustrates his findings. Canada's financial system ranks only in the top third in the world by this metric, number twenty-one out of sixty-three countries covered. It is important to note that this measure, though it is closer to what politicians and the public should really care about when evaluating the financial system, is a combined performance measure for the country's stock markets and financial institutions. Canada's B+ grade here could reflect on her banks, or even her state controlled investment vehicles, more than on her stock markets.

The bottom line from all of these comparisons is that Canada's stock markets place well, ranking near the top most of these metrics. However, Canada is generally not *at the top*, and as the eminent barrister, Richard J. Balfour of Torys LLP, reminded the symposium; we can still do things to improve Canadian corporate governance. In an increasingly globalized world, Canadian institutions cannot rest content with findings that they are "good enough". Canadian governments, regulators, and institutions, as well as Canadian corporations must compete with their foreign counterparts. More efficient governments, regulators, and institutions are just as important to our standard of living as more efficient corporations.

International Best Practice

What constitutes international best practice? Two approaches complement each other to help answer this question. First, we can generalize experience about what works and does not work elsewhere in the economy to the regulation of the stock market. As

Christina Wolf, an economist with the British Columbia Securities Commission, stressed, our experience elsewhere generally favors market-based solutions. Second, we can look to empirical findings in the academic literature. We can look at the simplest measure of the success of a country's stock markets in the previous section, their size relative to GDP, and ask which legal and regulatory approaches go with successful stock markets. It turns out that the two approaches are surprisingly concordant.

Corporate Governance and the Free Market

In a deeply insightful presentation at the Symposium, Peter Wallison of the American Enterprise Institute remarked that "companies are not little democratic republics." This is clearly true, for few companies, say, maintain standing armies. Although some trappings of democracy have long been part of corporate governance, such as the election of directors and shareholder votes on critical issues, companies are not nation states. The deeper issue Peter Wallison raises is the proper role of democracy in one of the most fundamental components of a free market economy, the joint stock company. One-party states, without exception, are failed states. If democratic competition is good in the political arena, there is no reason to think ill of it in board elections. Proxy contests have been shown to raise firm value unambiguously.[40] Shareholders like democracy and rush to buy when they see it in action. But the problem with democracy is that nine addle-pates can outvote the one person who knows the facts. Both republics and corporations therefore limit the scope of democracy. Peter Wallison's question is about where that limit ought to lie in a joint stock company.

[40] See Westin *et al.* (2002) for an overview.

One reason that corporations might need less democracy is that their governance is constrained by market forces. Can we simply "leave corporate governance to the market"? After all, investors who dislike a company's governance practices can sell their shares. In fact, we see this in action in numerous studies that show poor governance depressing share prices. "Selling out" is less attractive to citizens of a republic who dislike the current government. Much commerce probably did move from B.C. and Ontario to Alberta when the former provinces elected socialist governments. But moving bricks and mortar is expensive, so the freedom to "sell out" really is a substantive difference between a republic and a company. Since shareholders can take their business elsewhere, why do they need protection?

The problem with this argument is that shareholders can only sell out after management has launched the firm on foolhardy or self-serving trajectories. The share price is already fallen when the public shareholders learn of folly or villainy. Selling out at this point is more than a bit like barring the gate after the horses escape. The market tells prospective buyers the stock is worth less, but current shareholders must lump their losses and move on. Perhaps the first round of investors ought not to have paid much for the shares in the initial public offering. But low initial public offering (IPO) prices because of a pervasive fear of poor governance are an unacceptable burden on a national economy in this age of globalization.

Still, the past century saw an unequivocal triumph of free markets over state planning. Confidence in the power and dexterity of markets is clearly justified. But the reconstruction of market economies in post-socialist states teaches us that free markets can not function in a vacuum. Experience in Russia, Eastern Europe, and Central Asia shows that product markets collapse if suppliers cannot sue deadbeat customers, and if customers cannot sue deceptive advertisers. Debt markets in Russia, the Ukraine, and Central Asia are stunted because no bankruptcy laws proscribe consequences for deceitful or injudicious borrowers. Rules, regulations, fines, and prosecutions are integral to any legal system. Paradoxically, free markets are creatures that cannot live without them.

The current corporate governance debate should be about what sorts of laws, regulations, duties, burdens of proof, and so on ought to be imposed on corporate insiders to make them responsible to the shareholders who elected them. Since shareholders want their investments' value as high as possible, this coincides with making the stock market perform efficiently its task of allocating capital to firms with growth opportunities – and of keeping capital away from firms bereft of such opportunities. The latter include well positioned firms with insiders too nescient or inveracious to be trusted with capital, as well as firms in dying industries and regions.

It is unfortunate that discussions of corporate governance tend to focus on minor issues, like whether or not Canada ought to have rules like the Sarbanes-Oxley Act imposes in the United States. A clear theme throughout the symposium was that we need to move beyond this. Our focus ought to be on developing a process that leads to continual improvement in corporate governance subject to an appreciation of the true costs of each possible reform. Such a process is not only possible, but is already emerging at the Toronto Stock Exchange and elsewhere. Moreover, this emerging process has firm foundations in economic theory.

The Free Market Economics of Regulation

James Buchanan won the Nobel Prize in Economics in 1986 for his work on public choice economics. Buchanan argued that governments ought to compete with each other for tax revenues from capital, skilled labor, and entrepreneurs. He based his theory of government finance on the private clubs of London.[41] Without contradicting the many reformers who disparage the clubbiness of corporate governance, we humbly propose that corporate governance laws and regulations have a lot to learn from private clubs.

The purpose of government is to provide public goods. Public goods are goods that can be provided most economically when they are shared widely. Classic examples of public goods include military protection and legal systems. Armies of mercenary thugs employed by individual Russian tycoons or Afghan warlords can provide a private sector approximation to state armies and courts. But national armies and state-financed judiciaries seem both more economically efficient in the long run and more desirable in the eyes of the broader populace. National armies protect the entire citizenry from foreign invasion, and the public courts protect honest citizens from villains.

Governments provide public goods more efficiently because free-rider problems distort the markets for such goods. People could voluntarily pay "invasion insurance" each year to support a privately financed army. But it would be very difficult for such an army to protect my property from an invasion, while standing aside to let a foreign power bomb my neighbor's house because he let his insurance lapse. In practice, those of us who pay for the army must pay to protect our free-riding neighbors as well as ourselves. The only people willing to pay for private armies are thus the very wealthy, and they can

[41] See Buchanan (1965).

perhaps be forgiven for demanding control over their armies. Warlords are merely the next step along.

Corporate governance rules are a part of the legal and regulatory system, and so are also public good. A public shareholder who spends her own money suing corporate insiders for wrongdoing bears substantial up-front investigation and legal expenses. If she succeeds, she must rest content with the gratitude of her fellow shareholders – who obtain a free ride at her expense. Only the wealthiest shareholders – tycoons and old money families – are likely to pay such costs. Entrusting corporate governance to corporate insiders is a bit like entrusting the army to warlords. It seems to miss the point.

Institutional investors, well endowed outsiders, are increasingly also willing to pay the costs of monitoring and disciplining wayward corporate insiders. Indeed, many students of corporate governance have high hopes for institutional investors. These aspirations seem warranted in the short term at least, for Ontario Teachers, OMERS, and the Canadian Coalition for Good Governance appear to be instilling deeper reflection among corporate insiders.

But institutional investors are no magic potion for good governance, for pension funds and other institutional investors are, themselves, vulnerable to certain governance problems. Romano (1993) shows that public sector pension funds' investment decisions are often skewed by pressure from political masters, to the detriment of their beneficiaries. Lakonishok et al. (1991, 1992) show that pension fund trustees are often fooled by fund managers' "window dressing" – selling dogs and buying recent winners to spruce up a portfolio just before a reporting period ends. More ominously, if pension fund managers become seriously powerful forces in corporate governance, it is only a matter of time until they become "insiders". We feel we risk little in predicting a future round of scandals involving the ineptitude or larceny of institutional investor insiders, though this is probably be many years off. For now, though, the Canadian Coalition for Good Governance is clearly on the side of the widows, orphans, and angels.

Buchanan's Noble Prize-winning perspective on capitalism is modeled on the private clubs of early 20th century London, where gentlemen paid dues to clubs that provided different ranges of services and environments.[42] Vegetarians could join a club whose chefs created culinary delights free of animal products. Photography enthusiasts could join clubs whose dinning rooms adjoined fully-equipped dark rooms. Cigar smokers could join clubs that provided a new range of exotic stogies each month. Hundreds of clubs catered to different combinations of tastes and wealth. Clubs with offerings insufficiently attractive to justify their costs to a sufficient membership either changed or folded.

Buchanan argues for a similar sort of competition between governments, especially at the local and provincial levels. Governments offer particular quantities and qualities of different public goods at different prices. If people like the range of public goods Alberta offers, and find their price in taxes and other fees acceptable, they migrate to Alberta. This grows the Alberta tax base. If people find that the range of public goods Nova Scotia offers does not correspond to their needs, and find their price in taxes and other fees unacceptable, they leave. This shrinks the Nova Scotia tax base. Just as Buchanan's London clubs compete for members, governments compete for taxpayers. While this economic model underlies the "Alberta Advantage" philosophy of the Klein

[42] See Buchanan (1965) for the original exposition of the idea, and Buchanan (1999) for its relevance in a variety of situations.

government, other provincial governments have been singularly uninterested in it. This is profoundly disturbing, for an understanding that governments must compete with each other is fundamental to insuring prosperity in the globalizing world of the 21st century. In her address to the symposium, Barbara Stymiest, Chief Executive Officer of the TSX Group, made it clear that the Toronto Stock Exchange grasps this fundamental point: Ontario became Canada's undisputed financial hub by providing investors and issuers better regulation sooner. Now, in a second round of competition, Canadian regulators must serve *both* investors and issuers better than their counterparts in other countries – or savings and business will migrate elsewhere.

Although Buchanan does not discuss corporate governance, his general arguments apply. To see how, suppose Canadian markets adopt corporate governance rules that are both less costly to comply with and less able to protect shareholders than those in the United States.

If Canadian investors value the public good inherent in US shareholder protection, they move their savings to US markets, letting the United States levy taxes on their dividend income. As Canadian investors rebalance their portfolios into US stocks, demand for those stocks rises. Canadian issuers move their listings to the United States if the higher proceeds of their US issues compensate for the higher costs of US regulations.

Likewise, if Canadian issuers dislike the high costs of US corporate governance public goods, they can keep their issues here, depriving the United States of at least some of the tax base US listings would have provided. But if Canadian investors dislike the corporate governance regulations here, they price those issues at a discount. Canadian issuers move their listings to the US if that discount grows large enough to compensate for the higher costs of US regulations.

If enough capital moves one way or the other, either the United States or Canada must change its ways or see its stock markets fold – like London clubs unable to attract sufficient membership. If ample capital remains in both markets, both survive – just as a wide range of distinctive London clubs survived because enough people retained memberships in them.

Barbara Stymiest described to the symposium the clear benefits of a system of "mutual recognition" as the basis for increased securities trading across national and regulatory borders. This would allow one market, such as the United States, to change directions abruptly, as with Sarbanes Oxley, without throwing other markets into disarray. Karen Hamilton, the Executive General Manager of Issuers and Market Integrity and Chair of the ASX Corporate Governance Council, argued for a mutual recognition system as well, and indicated that Australia intends to uphold its own version of "comply or explain". Paul Arlman, the Secretary General of the Federation of European Securities Exchanges told the symposium how European exchanges, exhausted by unsuccessful attempts to establish a common regulatory system, had defaulted to mutual recognition – and how this turned out to be a very good thing. John Pierce, the Chief Executive of The Quoted Companies Alliance, echoed this. He also indicated that the United Kingdom has recently reaffirmed its commitment to the "comply or explain" approach in its recent review of corporate governance practices, chaired by Derek Higgs. Thus, there seems to be broad support for the idea that national, or even regional markets should provide high levels of disclosure and clearly delineate property rights, but leave enforcement to investors.

Mutual Recognition as a Mechanism for Evolving towards Best Practice

Thoughtful observers of the current corporate governance debate discern two opposing philosophies. One philosophy, *harmonization*, aims at implementing common global best practice standards. The United States Securities and Exchange Commission seems the current champion of this approach, arguing that other countries must evolve toward the higher standards prevailing in that country. The second, *mutual recognition*, envisions different markets and regulators following different approaches. This allows experimentation and lets more successful jurisdictions serve as role models for other jurisdictions.

Harmonization makes sense if best practice is clear to everyone and common to all situations. Some aspects of corporate governance seem close to fitting this requirement. Full disclosure according to sensible accounting standards is hard to knock. Proscriptions against insider self-dealing, looting, fraud, and so on are also fairly unambiguously clear best practices to which all serious markets in all serious jurisdictions must conform. America does have the largest and deepest capital markets in the world in absolute terms, and the seventh largest relative to GDP. A good part of US practices probably therefore rates consideration for this category. But much of the discussion about corporate governance reforms involves changes where best practice is far from clear, and where it is far from clear that any practice is universally best.

Where honest differences exist as to what constitutes best practice, the logic of public choice economics demands mutual recognition. Political economy realities will certainly cause different markets to take different directions. Sarbanes Oxley is but one example of such unilateralism. As a result, issuers must not only cope with change in one country but grapple with quite different changes in other markets that they may operate in. How, in the midst of proliferating change at the national level, can global markets continue to evolve and eventually operate on a reasonable playing field needed for fair competition and continued global progress?

One increasingly self-evident approach is to apply our understanding of the development of technology to the development of regulation and law. Technological progress is known to be driven by a process economists call *creative destruction*. Creative new firms continually arise to take market share from stagnant old firms that either copy the innovator or are quickly destroyed. Creative destruction is now thought to be responsible for the greater part of economic growth in the developed world for the past several generations.[43] It is increasingly evident that the success of free market economies at harnessing creative destruction – and the abject failure of centrally planned economies to do this – ultimately won the Cold War for the West.

Although harmonization and mutual recognition appear to be opposing philosophies, they are probably better thought of as complementary interactions in a healthy regulatory system. This is because globalization and deregulation make it possible to unleash creative destruction in spheres other than technological development – spheres like corporate governance regulation and law.

[43] See Landes (1969) for an early exposition.

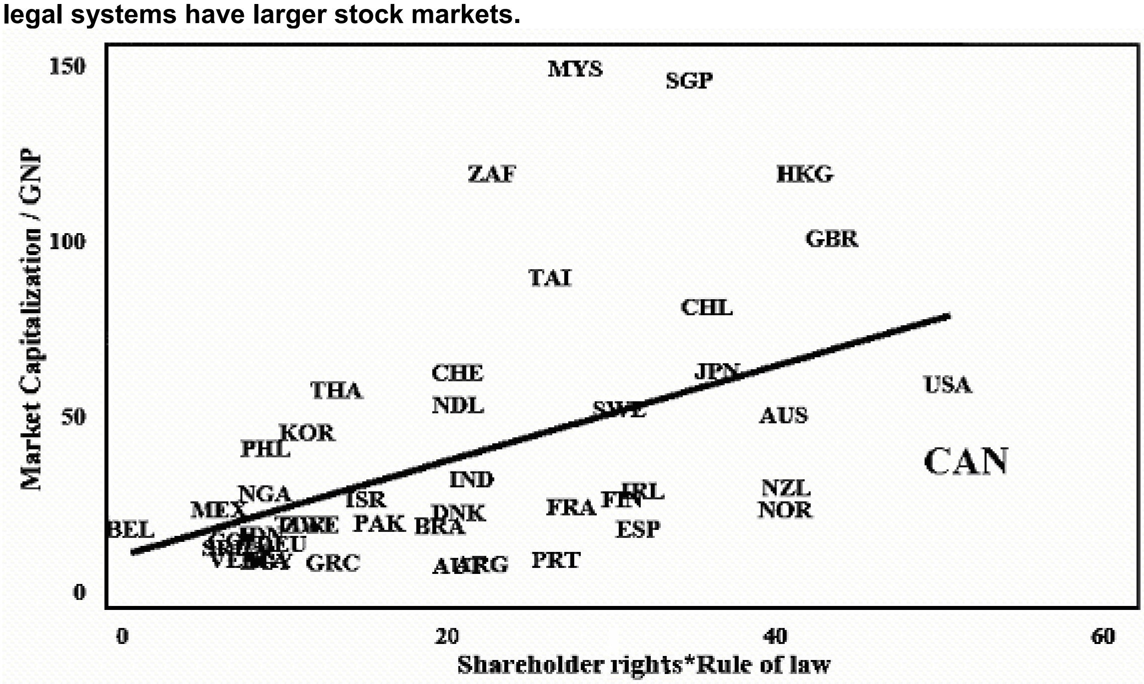
If different jurisdictions are free to adopt different mechanisms to protect shareholders' private property rights in different ways and at different costs, capital should flow to the jurisdiction that provides the most valuable protection at the lowest cost. Stock markets, provinces, and countries plagued by repeated scandals will lose the interest of investors. Markets and jurisdictions that undertake expensive cosmetic fixes will lose issuers, and probably investors too, when further scandals emerge. Creative and imaginative regulators, who devise new lower cost ways of guaranteeing more trustworthy behavior by corporate insiders will preside over rapidly growing markets. Other regulators will have no choice but to imitate them or watch their markets be destroyed. Capital controls, barriers to investing abroad, discriminatory taxes, and so on might staunch the hemorrhage of capital for a time, ensuring a slower and more painful death.

What Is Emerging as International Best Practice?

Florencio López-de-Silanes, the Director of Yale University's International Institute of Corporate Governance, is a leading expert on the legal and regulatory frameworks surrounding the finance industry in different countries. His research relates measures of the success of a country's stock markets – like their size relative to GDP, their depth in terms of trading volume, and so on – to the legal and regulatory approaches to promoting good corporate governance applied in different countries.[44] He summarized his findings to the symposium in a series of graphs.

Corporate governance law and regulation are clearly related to financial market success. Figure 13 demonstrates this, showing a clear link between the size of a country's stock market and the strength of the property rights protection it accords public shareholders. The vertical axis is the total capitalization of a country's stock market as a fraction of its GDP. The horizontal axis is the number of property rights each country provides public shareholders, as illustrated in Figure 2, adjusted for the general respect the country provides for the rule of law. This adjustment, described in more detail in La Porta *et al.* (2003) is sensible because some countries may provide a large number of rights on paper, but have such chaotic or corrupt courts that the rights are effectively meaningless.

Figure 13. The Importance of Private Property Rights
Countries that provide stronger private property rights for public shareholders and better legal systems have larger stock markets.



Source: La Porta *et al.* (2003)

This pattern makes intuitive sense because *the fundamental problem of corporate governance* is making corporate insiders trustworthy stewards of public shareholders'

[44] See La Porta *et al.* (1997, 1998, 1999, 2000, 2000a, 2002, 2003).

savings. Public shareholders must trust controlling shareholders and professional managers to act both competently and honestly. The purpose of corporate governance regulation and law is to make it as easy as possible for competent and honest insiders to distinguish themselves clearly and correctly from inept or unscrupulous insiders in the eyes of public shareholders. Their success in this induces public shareholders to invest in stocks, and this willingness is what makes a financial market successful.

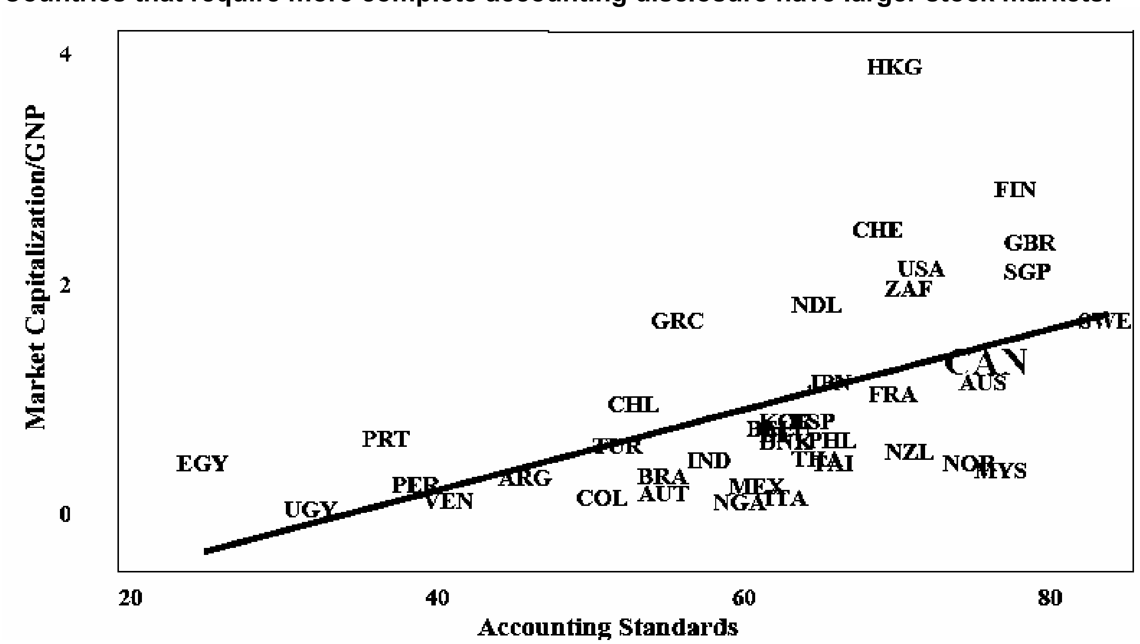
This highlights a critical feature of corporate governance regulation and law: They provide protection of public investors' private property rights in the companies they own. Unlike many other aspects of law and regulation, which limit private property rights for some general good; corporate governance regulation and law, like laws about land ownership, define the private property rights of individuals.

Although the central tendency in Figure 13 is clear, there is substantial dispersion around it. Some countries, like Malaysia (MYS) and Singapore (SGP) have markets substantially larger than their public shareholder property rights protection predicts. Others, like Canada (CAN), have smaller markets than the central tendency in Figure 10 suggests they ought to have. This sort of dispersion suggests that finer distinctions regarding the corporate governance regulations and laws of different countries might be useful.

One aspect of corporate governance regulation that is repeatedly highlighted is the importance of good disclosure rules. Public investors must be able to see what is happening to their property to know whether or not their property rights are secure. Sundry legal rights that give shareholders standing to sue insiders under various circumstances only matter if shareholders have enough information to understand whether those circumstances apply.

Figure 14 graphs the size of each country's stock market against a measure of the completeness of its accounting disclosure rules. Countries that require greater accounting disclosure have larger stock markets. Very thorough financial disclosure clearly qualifies as best practice.

Figure 14. The Importance of Accounting Disclosure
Countries that require more complete accounting disclosure have larger stock markets.



Source: La Porta *et al.* (2003)

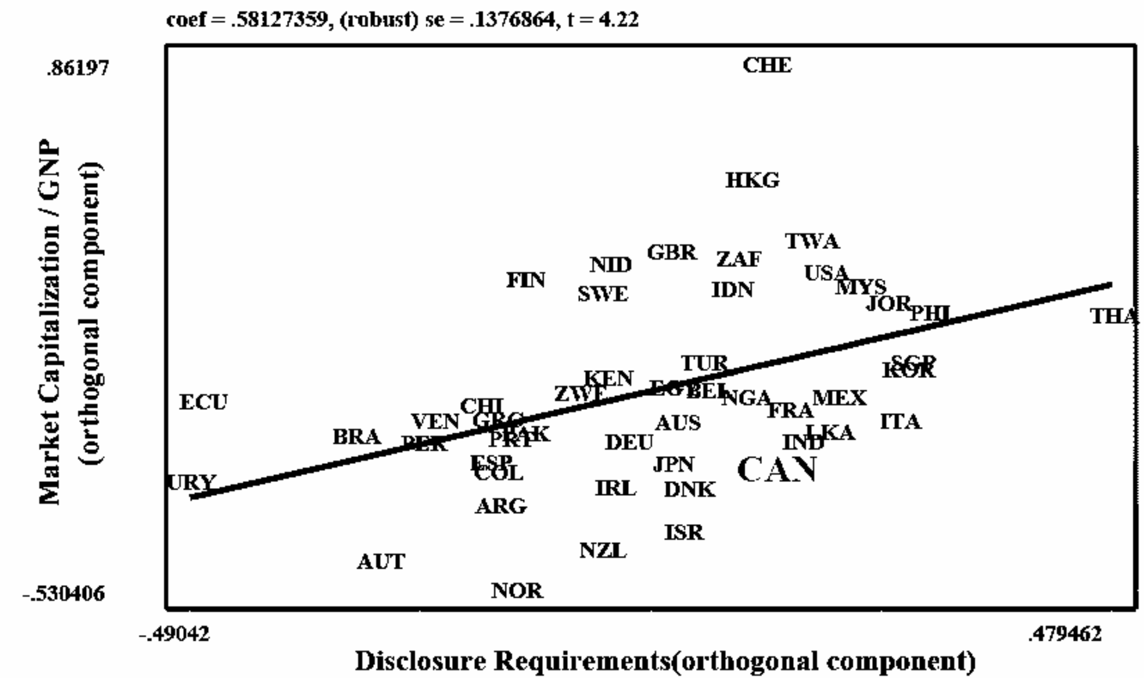
Other aspects of disclosure are also clearly important. Different countries have vastly different standards regarding requirements to disclose insiders' conflicts of interest, executive compensation, insider ownership, and related party transactions. These differences can be measured. La Porta *et al.* (2003) pose an identical series of scenarios involving a potential conflict of interest to leading securities lawyers in each of fifty countries with stock markets. After explaining each scenario, they ask the lawyer whether the conflict of interest would have to be disclosed in his or her country. Based on these answers, they rate each country on the thoroughness of its requirements for the disclosure of potential conflicts of interest. They then repeat this procedure to generate analogous ratings for how thoroughly each country is about requiring the disclosure of executive compensation, insider ownership, and related party transactions.

Country's that score well on one dimension of disclosure tend to score well on the others as well. This makes deciding which dimension of disclosure actually matters in explaining the size of a country's stock market problematic. A graph showing a tendency towards larger stock markets in countries that require more extensive disclosure of conflicts of interest might actually reflect a spurious correlation. If countries that require more extensive disclosure of conflicts of interest also require more extensive financial disclosure, it could be that the latter is just serving as an approximation of the former. Fortunately, statisticians have developed ways of dealing with these sorts of problems. La Porta *et al.* (2003) employ a technique that reveals the so-called *orthogonal components* of all of their disclosure measures. These are modified variables that are adjusted to neutralize spurious correlations of the type just describes. The subsequent graphs present orthogonal components so that we can be sure they illustrate the effects of only those variables shown on their axes, and not some spurious correlation.

Figure 15 graphs the orthogonal component of stock market size against that of a measure of how thoroughly a country mandates the disclosure of potential conflicts of interest. More complete disclosure of conflicts of interest correlates strongly with larger stock markets.

Figure 15. The Importance of Disclosing Conflicts of Interest

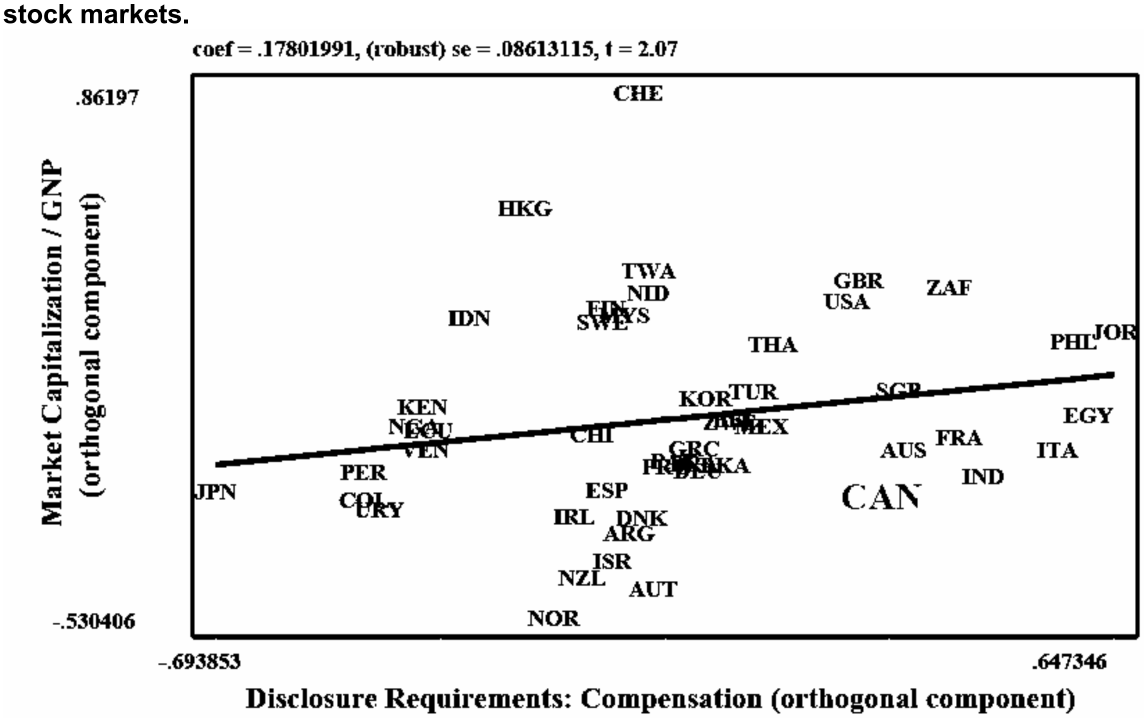
Countries that require more complete disclosure of possible conflicts of interest affecting controlling shareholders or professional managers have larger stock markets.



Source: La Porta *et al.* (2003).

Figure 16. The Importance of Disclosing Executive Compensation

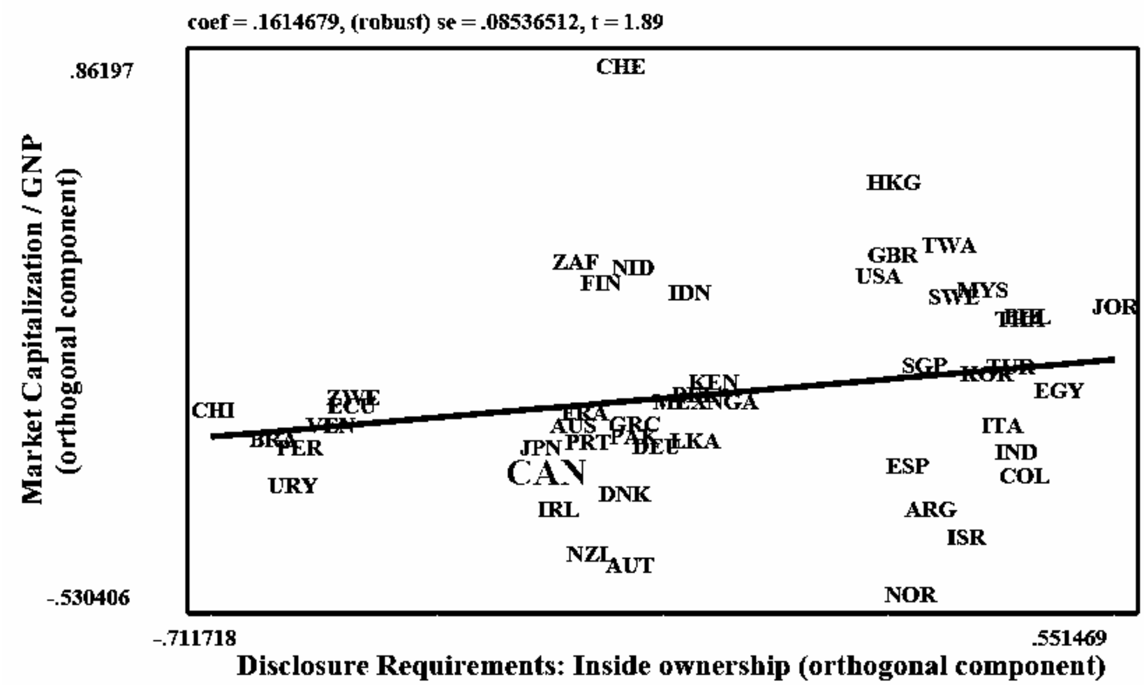
Countries that require more complete disclosure of executive compensation have larger stock markets.



Source: La Porta *et al.* (2003).

Figure 17. The Importance of Disclosing Insider Ownership

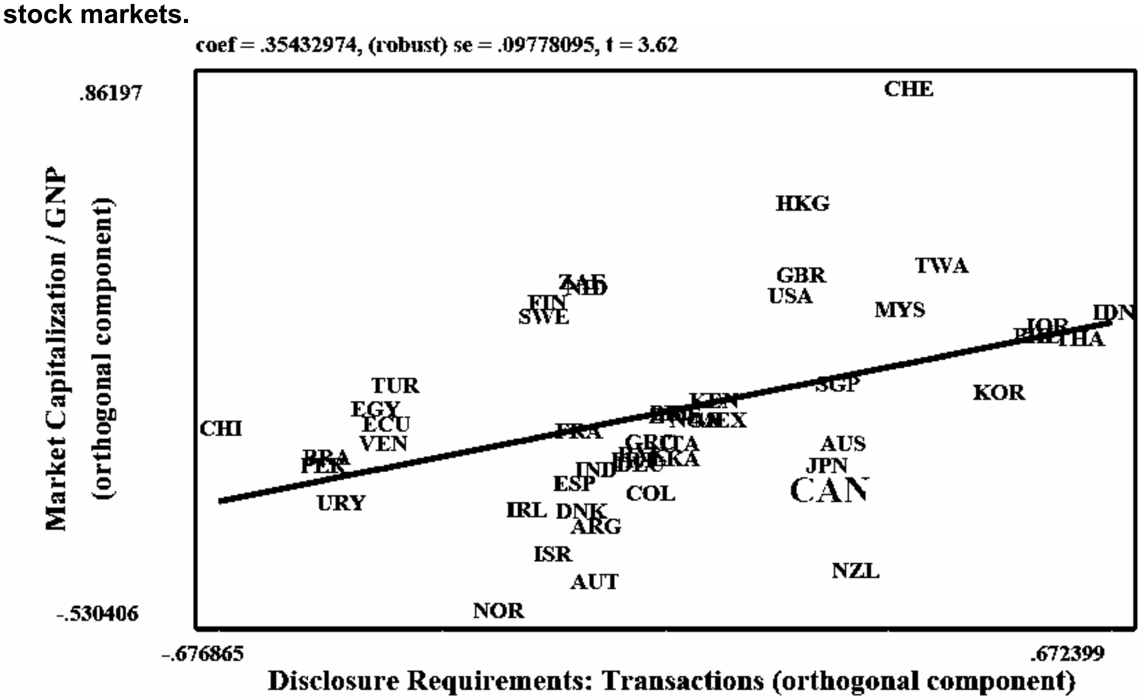
Countries that require more complete disclosure of insider ownership have larger stock markets.



Source: La Porta *et al.* (2003).

Figure 18. The Importance of Disclosing Related party Transactions

Countries that require more complete disclosure of related party transactions have larger stock markets.



Source: La Porta *et al.* (2003).

More through disclosure of executive compensation and insider ownership also each correlate with larger stock markets. Figures 16 and 17 both reveal significant tendencies towards larger stock markets relative to GDP in countries with better disclosure along these lines. However, the magnitudes of both effects, revealed by the slopes of the lines representing central tendencies, are substantially smaller than in Figure 15.

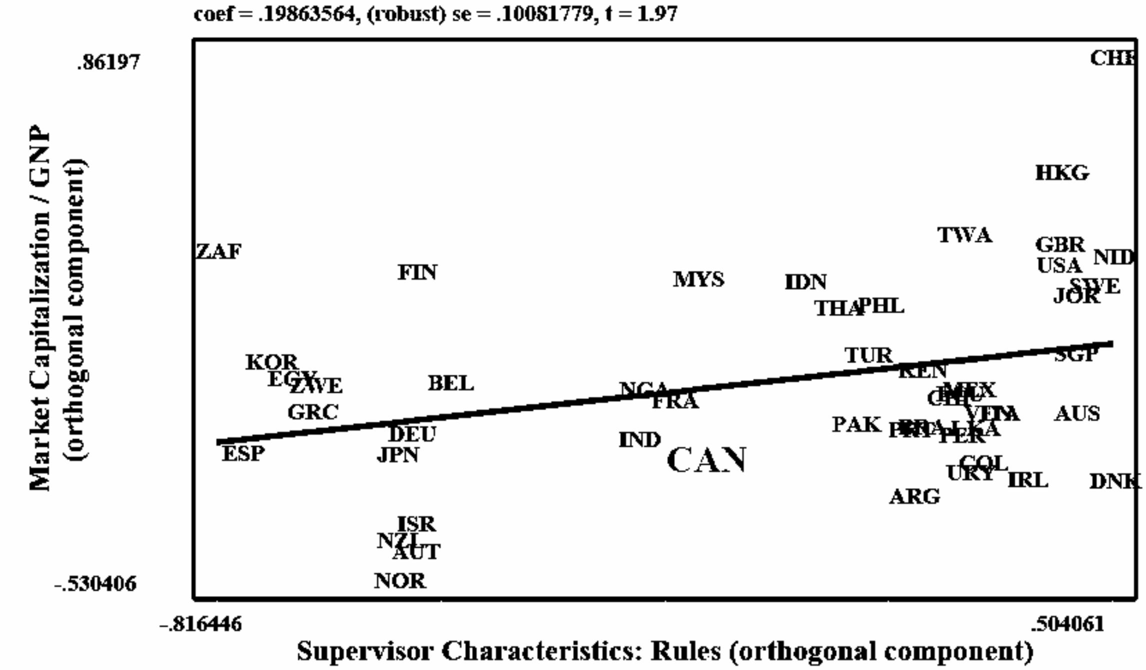
Another dimension of disclosure that correlates very strongly with stock market size is the disclosure of related party transactions. Figure 18 shows that countries that require more complete and more detailed disclosure of related party transactions have significantly larger stock markets relative to their GDPs. The greater steepness of the line indicates a more powerful effect than in Figures 16 and 17.

Thus, taking stock market size relative to GDP is a measure of the "success" of a country's regulatory system; international best practice entails very complete and detailed disclosure of financial data, conflicts of interest, executive compensation, insider ownership and related party transactions. Of these, financial data, conflicts of interest, and related party transactions are the most important, in that they have the greatest relationship with larger stock markets. These findings accord well with the Australian philosophy of "Disclosures Are Us!" emphasized in her address to the symposium by Karen Hamilton, the Executive General Manager, Issuers & Market Integrity and Chair of the Australian Stock Exchange Corporate Governance Council.

Another set of considerations in determining best practice regulation of stock markets is the nature of the powers granted to regulators. In some jurisdictions, regulators have broad powers to make rules. In others, legislatures retain this authority.

Figure 19. The Importance of Regulator Rule Making Powers

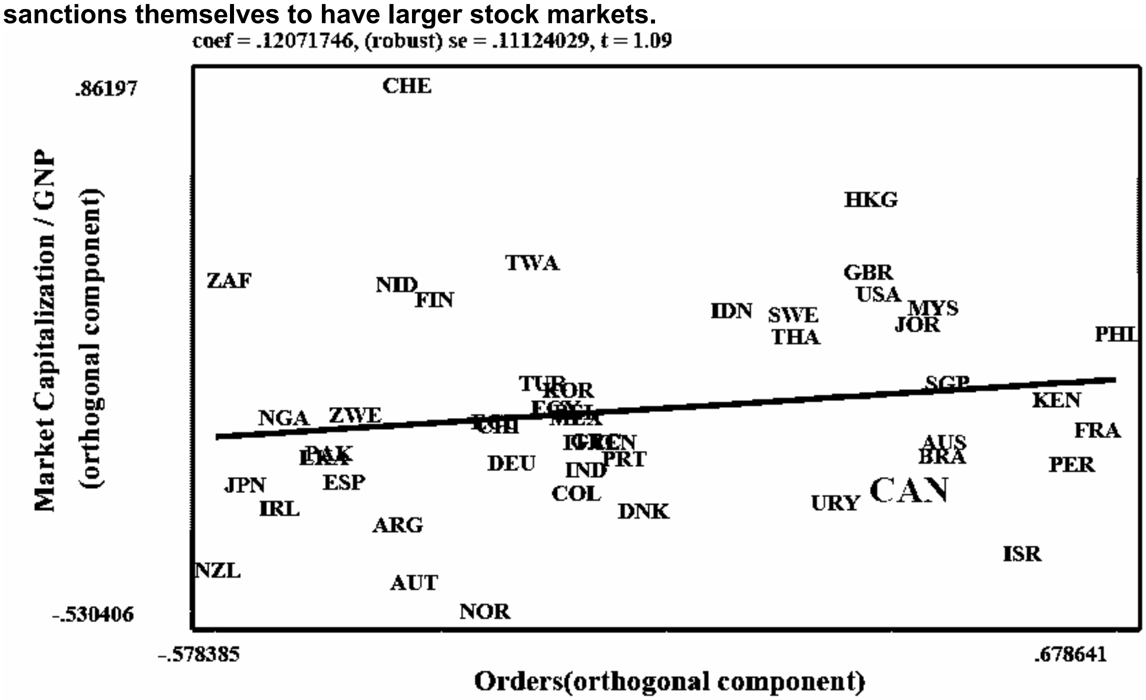
Countries that devolve rule making powers to regulators have larger stock markets.



Source: La Porta *et al.* (2003).

Figure 20. The Importance of Regulators Administering Sanctions

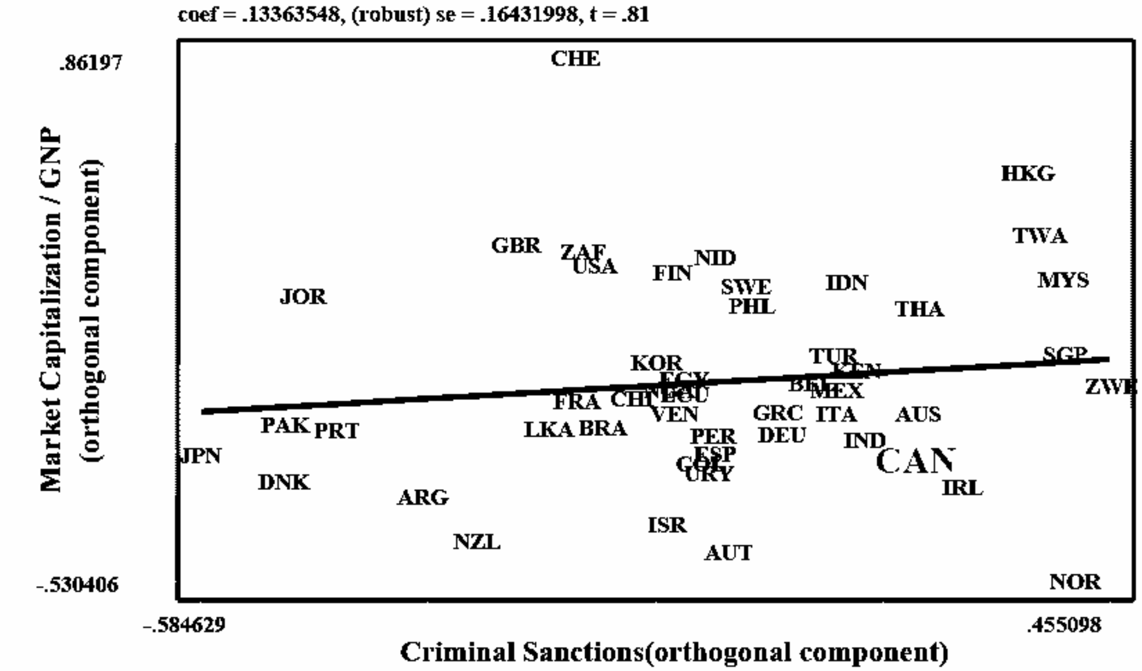
There is no statistically detectable tendency for countries that allow regulators to impose sanctions themselves to have larger stock markets.



Source: La Porta *et al.* (2003).

Figure 21. The Importance of Criminal Sanctions

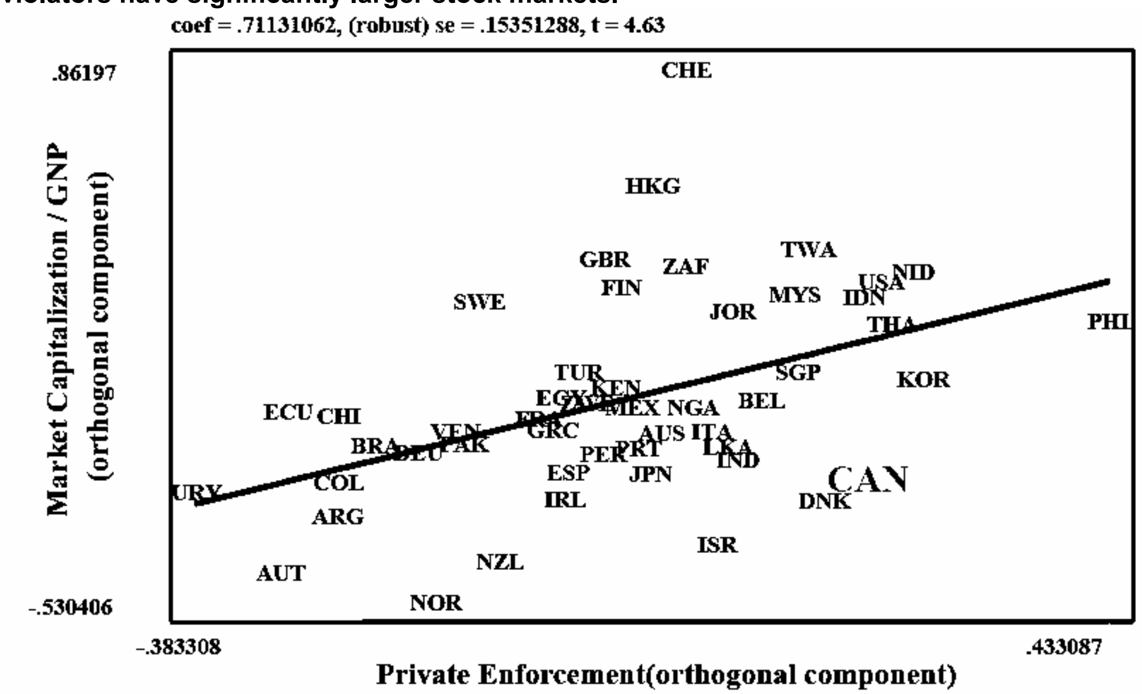
There is no statistically detectable relationship between regulators being able to pursue criminal sanctions and stock market size.



Source: La Porta *et al.* (2003).

Figure 22. The Importance of Private Legal Actions

Countries in which investors are empowered to pursue private legal actions against violators have significantly larger stock markets.



Source: La Porta *et al.* (2003).

In some jurisdictions the regulator can impose sanctions. In others, it must work through the courts. In some places, the regulator can pursue criminal sanctions, in others, only administrative penalties apply.

Figure 19 shows that devolving rule making power to regulators is associated with larger stock markets relative to GDP. In contrast, Figures 20 and 21 reveal no statistically detectable relationship between market size and either of letting regulators impose sanctions or letting them pursue criminal sanctions.[45] Investors do not seem to care greatly whether regulators have such powers or not.

In contrast, Figure 22 shows a very strong relationship between stock market size and the extent to which public investors, including institutional investors, can pursue private legal actions against violators. Indeed, La Porta *et al.* (2003) show that general measures of the extent to which public officials can pursue violators are essentially unrelated to stock market size, but that general measures of the extent to which aggrieved public investors can launch their own legal actions are very highly related to market size.

The bottom line here is that international best practice seems to entail governments, regulators, and markets mandating tough disclosure, clearly defining investors' property rights, and then letting wronged investors pursue justice through civil suits. Public shareholders seem unappreciative of official promises to enforce good governance.

La Porta *et al.* (2003) also poll lawyers in different countries with more sequences of scenarios to determine how readily the burden of proof can shift from the plaintiff to the defendant in lawsuits over corporate governance. Normally, in any lawsuit, the plaintiff bears the burden of proof. However, under some circumstances, once the plaintiff presents evidence sufficient to create a reasonable belief that wrongdoing occurred, the burden shifts to the defendant to prove his or her innocence.

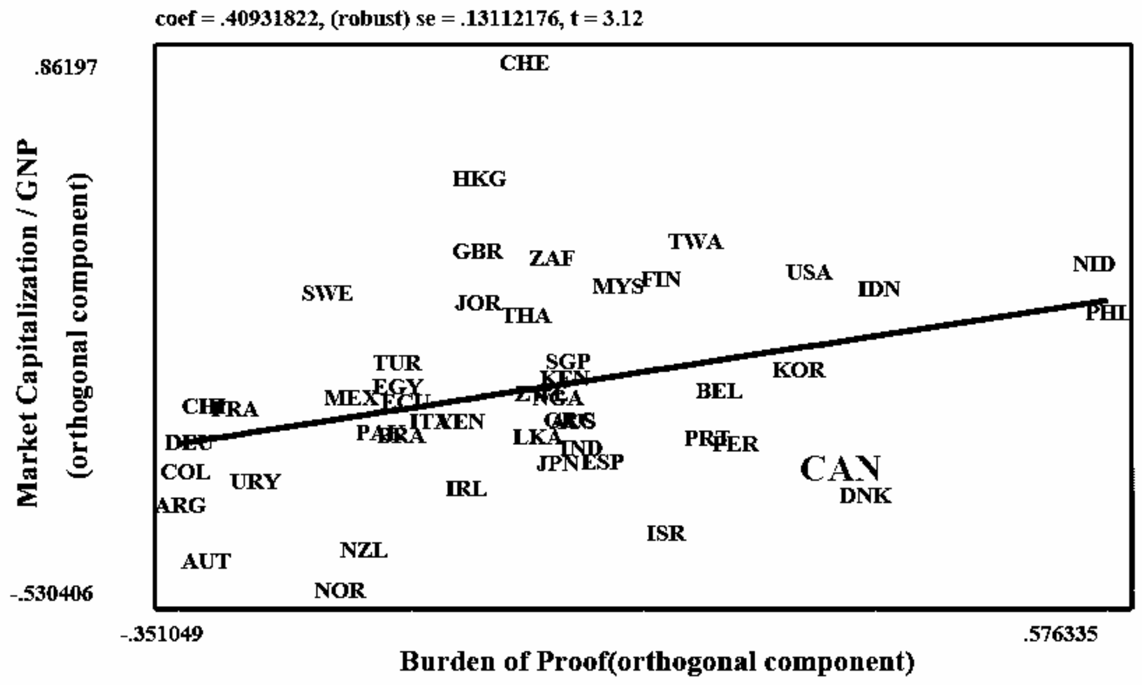
Legal scholars regard this shift as reasonable where the defendant has easy access to critical information and where the plaintiff confronts high cost to obtain the same information. Shifting the burden of proof improves the efficiency of the legal system if it places the burden on the party most easily able to produce critical evidence. Of course, such reasoning has limits. Clearly, the defendant cannot always be expected to bear the burden of proof, for this would violate the presumption of innocence, which underlies common law. The test the plaintiff must meet to shift the burden of proof to the defendant is therefore the critical issue. Different countries allow different thresholds. Figure 23 shows that countries that more readily allow the burden of proof to shift to the defendant in corporate governance lawsuits have larger stock markets.

The bottom line here is that, even with tough disclosure rules, public shareholders fear being unable to muster sufficient proof of wrongdoing to prevail when wronged by corporate insiders. Countries that shift the burden of proof to corporate insiders alleged to have misgoverned the firm apparently allay this fear, and consequently have larger stock markets. International best practice thus seems to entail establishing a low reasonable threshold for shifting the burden of proof to corporate insiders in governance related lawsuits.

[45] The t ratio at the top of the graph is a measure of the statistical significance of the relationship between stock market size and the variable in question. A t-ratio greater than two indicates statistical significance in the sense that random data would generate such a pattern less than five percent of the time.

Figure 23. The Burden of Proof

Countries in which aggrieved investors are more readily able to shift the burden of proof in civil actions to corporate insiders have significantly larger stock markets.

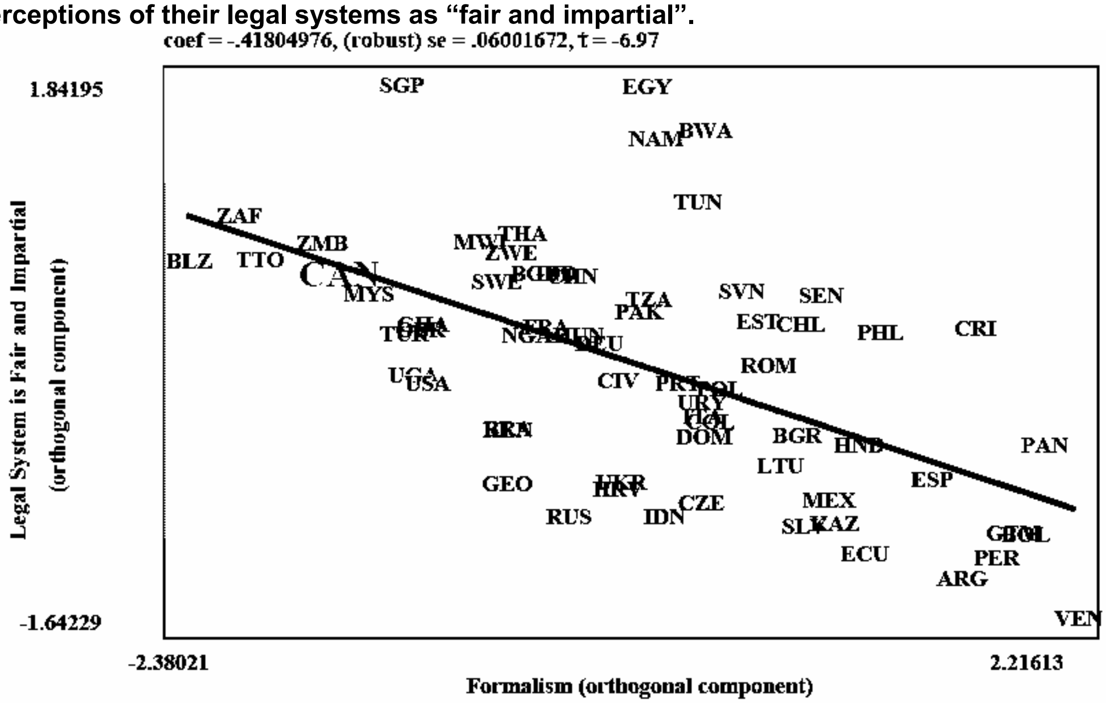


Source: La Porta *et al.* (2003).

Systems of regulations can provide detailed formal rules and regulations governing every aspect of the issues at hand, or they can hold forth general principles of good behavior and then rely on courts to interpret those principles in individual cases. Again, by polling lawyers in fifty countries, La Porta *et al.* (2003) construct a legal formalism index, which captures where different countries lie along this spectrum. Figure 24 graphs this index against a survey measure of the extent to which people believe their country's legal system to be "fair and impartial". Less formalistic legal systems are viewed as significantly more fair and impartial.

A key goal of corporate governance regulation and law is convincing public investors that listed companies are honestly and ably run, and that deviations from this standard will be caught and subjected to fair and impartial consequences. It therefore seems sensible to stick with general principles where possible, and to avoid detailed formalistic requirements. Best practice seems to require eschewing excessively formalistic legal and regulatory regimes.

Figure 24. The Problem of Legal Formalism
Countries whose legal systems are less formalistic have significantly greater public perceptions of their legal systems as "fair and impartial".



Source: La Porta *et al.* (2003).

Finally, other work shows that corporate takeovers, though they can be economically disruptive, are a force for good in the realm of corporate governance. Poor governance depresses share prices, essentially putting misgoverned firms "on sale" for potential raiders.[46] This threat appears to be important as a check on governance problems in widely held firms, for professional managers guilty of poor governance are in danger of being ousted by raiders.[47] Since takeovers are effective only in markets containing many widely held firms, evidence on their efficacy is available only for a few

[46] See Morck *et al.* (1989).

countries. Nonetheless, evidence is abundant that subjecting professional managers to a takeover threat, even a relatively distant one, improves performance; while insulating them from takeovers lessens performance.[48]

In summary, international best practice in corporate governance law and regulation seems to include the following:

1. Shareholders should have certain basic legal rights pursuable in institutions governed by the rule of law.[49] These include sanctions on officers and directors for actions that sacrifice shareholder wealth and on controlling shareholders for oppression, as well as meaningful voting rights at shareholder meetings and the right for substantial outside shareholders to call such meetings.

2. Complete and thorough disclosure of financial details, potential conflicts of interest, and details of related party transactions are all very important. Less critical, but still important, are detailed disclosure of executive compensation and insider ownership.

3. Shareholders should have the right to launch private actions against corporate insiders – officers, directors, and controlling shareholders - who practiced poor

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[47] See Morck *et al.* (1988).
[48] A voluminous literature on these issues is summarized by Shleifer and Vishny (1997).
[49] La Porta *et al.* stress the rights to mail in proxy votes, to refrain from depositing shares prior to the General Shareholders' Meeting, to establish cumulative voting or proportional representation of minorities on the board of directors, to sue controlling shareholders for oppression of minority shareholders, to sue professional managers in derivative lawsuits, for moderately large shareholders to call for an Extraordinary Shareholders' Meeting, and to retain preemptive rights unless they are waved at a shareholders meeting.

governance. The regulations under which such actions proceed should mandate general principles of conduct, rather than detailed formalistic requirements.

4. Giving regulators rule making powers makes sense; but relying on officials to administer the rules and to pursue civil or criminal actions does not.

5. Public shareholders, rather than officials, should be empowered to pursue legal actions. This can be made easier for shareholders in two ways. One way is mandated full disclosure. Another is shifting the burden of proof to the accused corporate insiders once the aggrieved public shareholders have made a strong enough case that grounds for concern exist. Both make sense.

6. Corporate takeovers should be encouraged. Hostile takeovers are mainly targeted at poor performers, and thus induce good performance by professional managers whose jobs are at stake. Antitakeover devices, like staggered boards and poison pills, can be detrimental to good governance unless shareholders can override them in Extraordinary Shareholders Meetings called to consider takeover bids.

A good strategy for regulators everywhere would be to accept these simple points as axiomatic to their corporate governance regimes. Beyond these basic points, different jurisdictions should be free to experiment with different approaches, for what constitutes best practice remains unclear.

We do not know how many independent directors belong on which committees. Nor do we know how executives should be compensated. It makes sense to separate the roles of Chairman and CEO, and – as John Pierce, Chief Executive of the Quoted Companies Alliance, reminded the symposium – many recent scandals involve overly centralizing governance responsibility in a single all-powerful chief executive. But econometric evidence on this point remains incomplete. Likewise, institutional investors can be a force for good governance, and probably ought to be empowered when they take this upon themselves. But many institutional investors are oddly silent on governance issues. It is unclear that empowering those particular institutional investors would be helpful.

Jurisdictions should provide for full mutual recognition, so that capital can flow into markets investors view as better regulated and out of markets investors view as worse regulated. This will help us, over time, identify best practices in these grey areas, and extend the list of basic points above.

Regulatory Capture and the Danger of a "Race towards the Bottom"

Several centuries of economic history teach us that competition leads to increasing value, falling costs, and rising standards. How could competition between regulators bode ill? One criticism of regulatory competition in general, and therefore of "mutual recognition" in stock market regulation, is that it triggers a "race to the bottom". This criticism, often heard in discussions of trade liberalization, highlights another aspect of regulation – the danger of *regulatory capture*.

Regulatory capture occurs when a regulator loses sight of its social purpose and comes to identify with the parties it regulates. Stigler (1971) argues that regulation often goes awry when the regulator is captured in this way by the entities it regulates. For example, postwar airline regulation, designed to ensure the safety of passengers, began laudably. But over time, the regulators' focus shifted from passenger safety to the economic viability of existing airlines. As this happened, the possibility that new airlines might arise was discounted. Likewise, the Canadian Radio and Television Commission began with a charge to develop Canadian programming, but arguably evolved into an apparatus for protecting the bottom lines of existing Canadian broadcasters. Stigler argues that such *regulatory capture* is an ever present danger with large, powerful regulators.

Securities regulators are charged with protecting public investors' private property rights by regulating corporate insiders. Regulatory capture, in this case, would involve regulators shifting their focus to protecting the interests of established listed firms or their insiders. Prospective new issuers, intent on getting maximal value for their shares, have a common interest with public investors in strong protection of investors' property rights. But insiders in established issuers that are not dependent on further securities issues may see such protection as costly and unwarranted interference with their freedom of action.

A race to the bottom might indeed ensue if securities regulators everywhere come to be captured by established issuers. However, this seems unlikely. As noted elsewhere, institutional investors are gathering ever increasing clout – both economically and politically. If regulators stray too far from their basic duties to protect investors' property rights, institutional investors of the twenty-first century seem posed to weigh in. As long as regulatory capture can be avoided in at least some stock markets, regulatory competition, like competition elsewhere in the economy, can be expected to lead to ever rising standards of corporate governance.

The American Problem

In many spheres, from information technology applications to taxpayer rights, the United States is widely regarded as the standard bearer of “global best practice”. Barbara Stymiest, CEO of the TSX Group, questioned whether US practices in the field of corporate governance ought to be our “guiding star”. Certainly, Enron, WorldCom, and other recent scandals taint the U.S. model.

Many speakers at the symposium criticized the American Securities and Exchange Commission (S.E.C.)for its unwillingness to subscribe to a broad international mutual recognition system. Participants from Canada, Australia, the European Union, and even the United States asserted that the S.E.C. believes United States practices *are* international best practices, and that other countries need only emulate its approach. In particular, Benn Steil, the André Meyer Senior Fellow and Director of International Economics at the Council on Foreign Relations in New York, remarked in his keynote speech that “If you speak to top SEC officials, you find that multiple standards to them imply unacceptable relativism.” He went on to quote SEC Commissioner, Roel C. Campos as having stated that "Foreign exchanges must make a compelling case for being treated unlike all others [i.e. United States exchanges] who seek to tap the disposable capital of U.S. investors". This was in reference to the desire of European exchanges that foreign stocks be offered directly to U.S. brokers and institutions electronically.

The United States does score well on the metrics discussed above in connection with the state of Canadian corporate governance. The property rights protection the United States accord is as good as that in Canada, and block and voting premiums are not much different in the two countries. But the US stock market is bigger than Canada's as a fraction of GDP, and dispersed ownership is more common in the United States than in Canada. American stocks also move more independently than Canadian stocks, and insider trading profits are substantially less in the United States.

It may well be that Canadian regulators and exchanges can learn a thing or two from their US counterparts. Certainly, insider trading abuses might be pursued more vigorously in Canada. Fuller disclosure of executive compensation also seems sensible here.

But even if United States markets are better regulated than those of any other country, it would still be folly for the whole world to converge on US practices. This is because we simply do not know what constitutes best practice as regards too many aspects of corporate governance. Forcing an international convergence to United States practices deprives all countries, including the United States, of the benefits of regulatory experimentation. Mutual recognition, and experimentation where we are unsure of best practice, should induce capital inflows into well run markets and capital flight from ill run ones.[50]

Given this simple application of free market economics, the attitude of the SEC is puzzling. If United States markets are actually the best regulated in the world, mutual recognition should attract a flood of capital into the United States. Why the SEC should need to protect American exchanges from additional capital is unclear.

The SEC's attitude is doubly puzzling, in that the principle of competitive regulation is well understood by other American regulators. Students of American regulation are fully aware of the virtues of regulatory experimentation as a means to develop better practices.[51] The idea that the fifty states are laboratories for developing better approaches to public policy is fundamental to the States Rights view of American Federalism. What seems difficult for American regulators is taking the next step, and accepting that international regulatory competition has the same virtues as interstate regulatory competition.

Figure 25 perhaps sheds some light on this question, for US investors have been spending substantially more money on foreign stocks than foreigners have been spending on US stocks since 1992. The American "equity deficit" peaked in 1999, and has been ebbing since. Perhaps US officials are concerned that mutual recognition would lead to an outflow of capital, and that this would harm US stock markets.

If the US stance on mutual recognition is concealed *regulator protectionism*, it is probably best to expose this. Just as sunlight is the best disinfectant for corporate governance blights, it also sanitizes governments and regulators. Since the United States stock markets are a huge part of the global economy, any mutual recognition system that does not include the SEC will be deficient. Over the long run, regulators in Canada and elsewhere need to make the case for mutual recognition directly to American investors.

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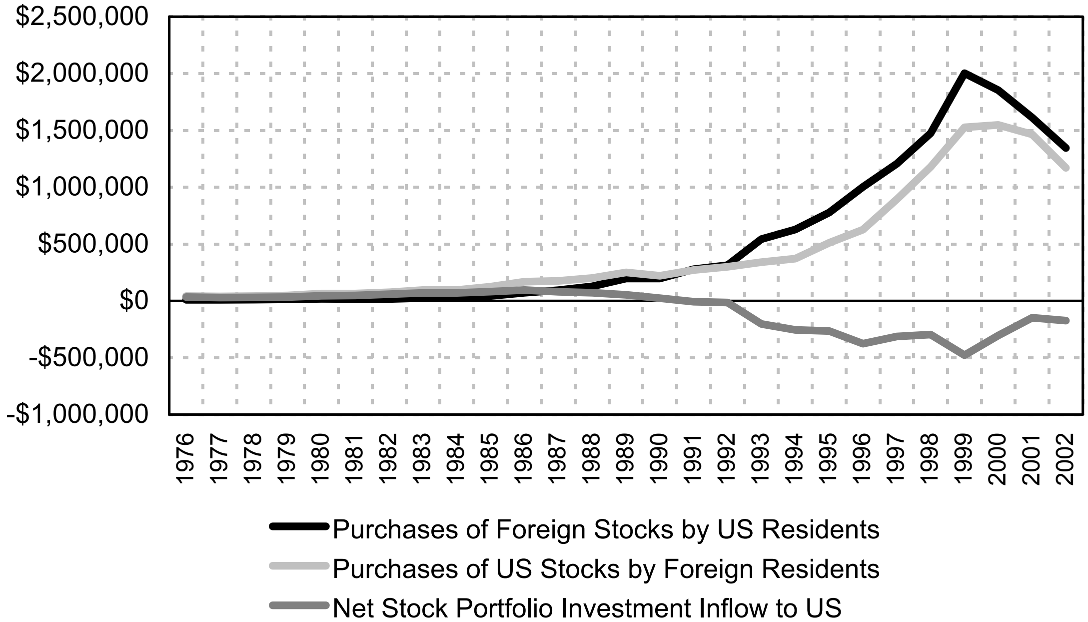
[50] These flows are subject to investors needs for cross-country diversification and other factors.

[51] Much of this literature follows from Buchanan's (1965) discussion of "clubs", as well as from Tiebout (1956). See also Buchanan (1995, 1999), Musgrave (1977), Buchanan and Musgrave (1999), Hayek (1939), Oates (1972) , and many others for discussions of fiscal federalism in the context of US states.

Figure 25. United States Stock Market Capital Inflows and Outflows
American investors spent more buying foreign stocks than foreigners spent buying American stocks from 1992 on. Data are in millions of dollars.



Source: US National income Accounts.

This is not an impossible task. The United States yielded to international regulatory competition in repealing the Foreign Interest Equalization Tax, which drove foreign bond issuers to London creating the Eurobond market, in permitting shelf registration because foreign competitors could raise capital faster than US firms, and in passing Rule 144-A to bring private investment back into the US. It seems likely that the United States will also ultimately yield to the economic logic of mutual recognition in the realm of corporate governance. But it took years for the American government and regulators to come to terms with each of the above mentioned pressures from abroad. We shouldn't hold our breaths for any sudden epiphany at the SEC on the current issues.

In the shorter run, regulators around the world must contend with the recent round of US reforms – Sarbanes-Oxley. Reforms in one country certainly can create pressure on other regulators to follow along. Clubs in London did imitate each other when one club hit upon a clearly attractive new offering. Many, though certainly not all, clubs followed a sort of "best practice" in a few key areas, but nonetheless varied considerably in the services they provided their members. But whether other countries need follow the United States in passing SOX-like reforms depends whether enough shareholders and issuers view the costs of the new rules as worthwhile. Ascertaining this will take a few years, and following the United States too closely on faith alone seems naïve.

A "To Do" List for Canadian Regulators and Exchanges

Canada's markets are well run and well regulated by global standards. The access to capital small Canadian firms enjoy is probably an important competitive advantage in the global economy. Changes to the way Canada's markets are run should be made cautiously.

Given these provisos, there nonetheless seem to be dimensions of Canadian corporate governance that could stand improvement. This could be accomplished with certain regulatory and legal reforms.

The Business Judgment Rule in Canada

The Business Judgment Rule is the principle whereby courts limit their willingness to second guess managers in day-to-day business decisions. As it stands, the Candian version of the Business Judgment Rule is criticized for being both too narrow and too broad. In one high profile case, a judge infuriated institutional investors by allowing the case to continue at great expense before invoking the Business Judgment Rule and denying the court's competence to second guess management.[52] Yet the Business Judgment Rule also provides uncertain protection to corporate insiders. This is because Canadian laws and regulations provide for personal officer and director liability under a wide variety of circumstances without providing a statutory "safe haven" – a clear standard of conduct that would leave them immune to liability. The existence of this broad range of statutory liabilities is a real disincentive to being a corporate director in Canada. It would make sense to implement a clearly demarcated *due diligence defense*. This would give directors a better sense of their duties, and judges a better sense of the permissible scope of the Business Judgment Rule.

Disclosure

Canadian disclosure standards for executive compensation and for the ownership stakes of large shareholders continue to provide investors with less information than US standards. While these are not necessarily the most critical aspects of disclosure, there is no apparent reason why Canadian listed firms need to protect investors from this information.

Formalism

The Canadian approach to corporate governance tends to be principle-based rather than formalistic, so that at least in theory, it is the economics of an issue that may drive corporate decision-making. This is likely to be an increasingly important advantage as

[52] Brant Investments Ltd. v. KeepRite Inc. et al. (1991), 3 O.R.(3d) 289 (C.A.) at 320.

procedures in the United States grow more formalistic and rules-based. Principles-based systems can be subverted if regulators and courts take lax views of the principles. Formalistic approaches can be subverted if the laws and regulations become a game in which clever scoundrels and lawyers seek to best each other. Figure 24 shows that less formalism seems to endow laws and regulations with greater public confidence. Canada should therefore be wary of excessive formalism, and Canadian regulators and courts must apply principles based regulation vigorously to prevent formalistic initiatives from gaining political support, as with Sarbanes Oxley in the United States.

Fiduciary Duty and Minority Shareholder Protection

Richard Balfour, of Torys LLP, highlighted an area in which Canadian practices are often thought to be superior to United States practices, but may actually be deficient – or at least similar in that superiority in one area compensates for deficiencies in another. The Canada Business Corporations Act (CBCA) is often cited as providing better protection for minority shareholders. Indeed, there are greater voting protections under corporate legislation, more votes, more super majority votes, more class votes, and so on under the CBCA than under Delaware legislation. But the most prominent and often cited difference is that the CBCA provides a statutory remedy for *oppression*, the abuse of public shareholders by a controlling shareholder, by allowing the former to sue the latter.

This *oppression remedy* is often regarded as an instance of Canada having established best practice. However, this may be a misunderstanding of the situation. In The United States, *fiduciary duties are owed directly to shareholders*, but in Canada, *fiduciary duties are owed to the legal person of the corporation* and courts have been reluctant to infer a duty directly to shareholders. The oppression remedy can be seen as a statutory supplement to this underdevelopment of Canadian corporate law. The reluctance of Canadian courts to identify the legal person of a corporation with its owners is puzzling.

Indeed, minority shareholders in Canada do not always look well protected. Recent high profile minority "squeeze out" cases, such as those involving Dupont of Canada and Domo Tarkette, are highlighted by some institutional investors as exercises in legalistic formalism that circumvent the intent of the law.[53] Also, corporate insiders usually hire the financial firm that does independent valuations in such cases. Conflicts of interest might be perceived to mar such an arrangement, even if all parties are scrupulous. Perhaps independent directors, or even institutional minority shareholders, should choose the firm doing the valuation. Or perhaps both should commission evaluations.

Insider Trading

One metric on which Canadian stock markets perform particularly poorly is insider trading. Bris (2000) measures the gains to insider trading in a large number of countries, and the results are displayed in Figure 8. Canadian insiders appear to do quite well – not exactly a ringing endorsement of Canadian regulation. McNally and Smith (2003) look at Canadian insider trading in more detail, and find a statistically significant increase in insider sales just before the release of bad information. "In contrast to the scarcity of prosecutions," McNally and Smith "find large-scale evidence of insider trading and

[53] Submission by Stephen Jarislowsky to the Wise Persons Committee to Review the Structure of Securities Regulation in Canada. See http://www.wise-averties.ca/submitted_en.asp?file=sub_jar.

reporting violations. For example, from 1987 to 2000, approximately 50 percent of firms engaging in stock buybacks do not disclose their trades to the Ontario Securities Commission as required under the OSA. Furthermore, the volume of insider trading is much higher than expected before material news announcements."

While the OSC is laudably moving to introduce tougher sanctions against insider trading, it is deeply puzzling why this problem has persisted for so long.

Institutional Investors

The growing power of institutional investors in Canada is probably going to be a very significant factor in the next few years and, in fact, may trump whatever policies emerge from the current governance debate in Canada. Certainly, institutional investors now largely set the agendas for corporate governance regulators in both the United States and United Kingdom. The *Canadian Coalition for Good Governance* quite credibly vows to do the same here.

Research shows that institutional investors play an economically significant role in corporate governance in the United States, and took a leading role in dismantling the complex holding company's structure and virtually eliminating super voting shares in the United Kingdom. in the 1970s and '80s.[54] John Pierce spoke of the still rising importance of United Kingdom institutional investors, and their outlining of best practice guides in areas such as directors' contracts, employee share schemes, option schemes, and other non-executive director issues. He also noted that they are becoming more robust in their public attitudes and their voting recommendations. Will Canada's institutional investors,

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[54] See Shleifer and Vishny (1997) for the United States and Franks, Mayer, and Rossi (2003) for the United Kingdom.

like Stephen Jarislowsky, force a similar change in the landscape in corporate Canada? Who knows? But one can surely wish them well.

Yet many institutional investors seem loath to press too strongly for good corporate governance. John Pierce expressed this succinctly when he noted that "[institutional] investors need to act like owners". Corporate pension funds, workers compensation funds, and other large pools of capital have been largely absent from public discussions of corporate governance in Canada, despite the huge portfolios they hold. Perhaps institutional investors need governance guidelines of their own. A clear duty of pension fund trustees, workers compensation boards, and other institutional investors to maximize the portfolio wealth of their beneficiaries seems reasonable, as does a requirement that institutional investors disclose their ownership stakes and voting decisions at the shareholder meetings of firms they hold.

Sarbanes-Oxley – Conspicuous in its Absence from the "To Do" List

The United States Congress responded to the first wave of corporate scandals following the dot.com bubble by enacting the Sarbanes-Oxley Act. Sarbanes Oxley imposes three requirements: A Public Company Accounting Oversight Board, a requirement that auditors inform boards of alternate possible accounting options for financial statements, and a requirement that CEOs and CFOs certify the accuracy of their financial statements. Peter Wallison argued cogently that these requirements, especially the first, are likely to be unduly costly, and will undermine the global competitiveness of US firms. We await future research quantifying these costs, but he makes a plausible case.

In June 2003, the CSA, an umbrella group of Canadian securities commissions, released for comment three proposed rules intended to improve investor confidence inspired by Sarbanes-Oxley. Many symposium participants expressed a deep suspicion that following the United States in this direction would be a mistake. Indeed, several symposium participants expressed deep reservations about the virtue of the Sarbanes Oxley reforms, arguing that they were likely to be costly to issuers, of little value to investors, and a distraction from dealing with more fundamental issues. Moreover, several participants argued that activist institutional investors, notably the Canadian Council for Good Governance, are likely to take an increasingly tough stance against inept or self-serving corporate insiders regardless of whether or not Sarbanes-Oxley type reforms are applied in Canada.

A common sense emerged among the symposium participants that Sarbanes–Oxley ought to be studied for a while, rather than emulated immediately. It may well be that United States exchanges, regulators, and legislators will come to appreciate the problems in these reforms, and that they will be modified soon. This points to waiting for US practices to settle down as a reasonable strategy for the moment.

A "Try It" List

There was substantial discussion in the symposium about other reforms that might or might not make sense. These generally pertain to the grey area of corporate governance law and regulations: Reforms that seem sensible in principle, but for which empirical evidence remains incomplete.

Outside Directors and Non-Executive Chairs

The beginning parts of this discussion stressed empirical findings in human psychology that might apply to situations in corporate boardrooms. Humans have an innate tendency to fall into line behind a strong leader. This instinct probably prevents many directors from challenging CEOs embarking upon questionable ventures. One way to encourage such challenges is to create a situation in which rival authority figures vie for leadership. If two rival authority figures are present, our instinct to obey fades and rational thought is reestablished.[55] Vocal outside directors, and especially non-executive chairs, seem likely candidates for this role. Thus, separating the roles of Chair and CEO and requiring a non-executive chair seems sensible. This is an area where the TSX has commendably taken a lead in market standards.

Econometric research has failed to reveal a clear link between the presence of such outsiders and enhanced corporate performance. As noted above, one explanation is that these results from psychology do not generalize to boardrooms. Another, which seems likelier, is that many directors classified as outsiders actually have some financial, personal, or other relationship with the CEO.

This raises the question of how we can insure that outside, independent, or non-executive directors – and chairs – actually are free of any obligation to the CEO. Since the CEO typically invites all these potential alternative authority figures to stand for election, a degree of obligation seems almost automatic. Perhaps mechanisms ought to be considered whereby institutional investors can promote their own independent candidates to boards. This need not entail full fledged proxy contests. Rather, it might

[55] See Milgram (1973).

be made normal procedure in shareholder meetings for large institutional investors to nominate director candidates.

Business Groups of Listed Companies

The economic rational for corporate groups in developed economies is obscure, especially in developed economies like Canada.[56] International best practice recognizes that such structures invite certain governance problems, and mandates disclosing conflicts of interest, disclosing details of related party transactions, and empowering public shareholders to pursue oppression suits against controlling shareholders.

But some countries have gone much farther. The United States and United Kingdom both took measures to unwind such groups decades ago. The United States did this in the 1930s by legislating that all firms in public utilities industries be free standing, and by subjecting intercorporate dividends to double taxation.[57] Although large corporate groups were commonplace in the United States at the beginning of the 1930s, they had disappeared entirely by the end of that decade. In the United Kingdom, institutional investor pressure led the London Stock Exchange to impose a takeover rule that requires bidders to purchase one hundred percent of a target company's stock if they purchase thirty percent or more. This quickly made corporate groups uneconomical in the United Kingdom.[58]

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[56] See Khanna and Palepu (2000). Such groups may serve useful purposes in developing economies by creating links between firms that substitute for poorly functioning markets. No such rational exists to explain groups in developed economies. Roe (2002) suggests that pyramidal groups protect shareholders from leftist governments. This seems more plausible for controlling than public shareholders.

[57] See Morck (2003).

[58] See Franks *et al.* (2003).

It may be that best practice entails following the United States and United Kingdom in forcing the disassembly of such groups or their consolidating into a single listed company. Further work is needed to say for sure, but current studies point in that direction.

Small Companies

Canada's stock markets are important sources of financing for small companies, especially in the natural resources sectors. Participants in the symposium concurred that regulators should avoid imposing steep compliance costs on such companies.

Nonetheless, John Pierce indicated that QCA argued that corporate governance matters to the survival of smaller public companies in the markets of the future. He pointed out that demonstrable best practice ought to attract a wider audience of institutional investors, and that this should contribute to a lower cost of capital, which is a prime objective for small, growing companies.

Nevertheless, imposing fixed regulatory burdens on all companies eats up a larger fraction of small companies' bottom lines. Regulators should therefore look for innovative ways to help well governed small companies distinguish themselves from ill governed small companies. One possibility is accepting (and publishing) tax returns in lieu of audited financial statements. Tax accounting could be made to better resemble financial accounting so as to lessen paper burdens on small issuers. Another is the pruning of unnecessary or unnecessarily costly old regulations. Other jurisdictions, such as Australia, are clearly concerned about lessening compliance costs. Canadian regulators should watch for good ideas from foreign regulators.

Conclusions

Corporate governance is important. Good corporate governance helps firms raise equity capital on better terms. Good governance widens and deepens financial markets. And good governance is linked to high national standards of living.

Exchanges, regulators, and legislators should focus on making Canadian equity markets trustworthy places for investors to put their savings. Rules should be applied judiciously, and kept simple and clear so that corporate insiders, judges, and investors know what is expected of them. Compliance should be expected, and severe actions should be taken against parties who fail to comply, as for example, seems overdue regarding insider trading. Canadian corporate governance law and regulation should encompass a nucleus of clear best practice, but should experiment in areas where best practice is unclear.

The discussion of the recent Sarbanes Oxley reforms in the United States was largely critical. Terrance Corcoran, the Editor-in-Chief of the Financial Post, summarized the sense of the symposium thus: "If the US wants to burden its capital markets with costly, unworkable, unnecessary, troublesome regulations, such as Sarbanes-Oxley … that's an advantage for other countries, including Canada." While other countries can clearly learn from United States experience, much regulation in that country seems inappropriate as a role model.

A forced march towards any one set of standards is both unwise and unlikely. Initially, European regulators sought to harmonize rules across its national markets. The Commission finally despaired of this approach in the mid 1980s, and adopted as second best solution – mutual recognition and home country control – as a way to push the agenda forward. In retrospect, it seems likely that this was actually a first best solution because it actually pushes best practice into new markets and forces exchanges to regulate cost effectively to attract issuers and investors. This concept of "competitive regulation and mutual recognition", in one form or another, emerged independently in Canada, the European Union and elsewhere, and now seems poised to assume international importance, at least as regards the regulation of corporate governance.

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