Canadian Corporate Governance: Policy Options

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INTRODUCTION

Limited access to capital and high costs of capital are major competitive disadvantages. Pagano, Panetta and Zingales (1994) describe the extraordinary difficulties Italian firms have raising external capital, and attribute these problems to Italian firms' governance problems. Shleifer and Vishny (1995) point to even more extreme problems in post-socialist countries. Investors have no desire to see their money wasted or stolen. At the very least, investors who fear such things will demand very high returns on whatever capital they do provide. Good legal and regulatory infrastructure regarding corporate governance can go far to reassure investors, and therefore improve Canadian firms' access to low cost capital without penalizing investors.

Despite the long list of potential corporate governance problems brought up in this volume, many Canadian firms are well run. Typically, this is due to the ethical principles of those in charge. However, there are cases of questionable decisions by top managers ranging from self-interested transactions to outright theft. In a world where such behaviour is possible, investors cannot rely solely on the good principles of managers. There is a clear role for law. Standards of behaviour and accountability must be upheld, and be seen by investors to be upheld. Consequently, many of the policy options we recommend below involve improving disclosure and transparency as well as managers' conduct and accountability.

The structures of corporations and the laws that guide them have evolved powerful and concrete checks on managerial excesses. In this chapter, we examine some of these reminders to managers of their limits, and propose specific policy options governments might consider to strengthen them. These policy options are based on the studies in this volume and on the vast and rapidly growing empirical research literature on corporate governance. In addressing economic issues of the sorts raised in this volume, individual studies are seldom definitive. The mainstream position of the economics profession tends to shift only in response to very persuasive findings. This is a reasonable approach to public policy formulation as well. We therefore adopt a hands-off approach where we feel the evidence is inadequate. We advance concrete proposals only where we feel there is sufficiently convincing evidence to justify them. At the end of this chapter, we reflect on this philosophy of corporate governance regulation, and explain why we feel it to be appropriate for Canada in the coming years.

OPTIONS FOR IMPROVING CANADIAN CORPORATE GOVERNANCE

Managerial Equity Ownership

If managers themselves own shares in their corporation, they should be less willing to make decisions that might reduce share prices. Thus share values should generally be higher when managers own more stock. In some range, though, increased management ownership entrenches management. Consequently, in that range, share values should fall as management ownership rises. This pattern has been found in data for large U.S. firms by Morck *et al*. (1988), and is illustrated in figure 1. Share value rises with management ownership of stock except in the range between 5% and 20%, suggesting that this is the range where entrenchment sets in.

[figure 1 goes here]

Other studies have confirmed this general shape, though there is disagreement on exactly what ownership levels correspond to entrenchment. For example, McConnell and Servaes (1990) place the entrenchment range around 40%, however, they use smaller firms for most of their analysis. They also fail to find the upward sloping segment beyond 20%. Both their result in this range, and that of Morck et al. (1988) are tenuous due to the relative rarity of publicly traded closely held firms in the United States.

The chapter by Amoako-Adu and Smith contains a similar analysis for Canadian firms. They are unable to discern any statistically significant pattern in the data for firms with insider ownership below 20%. This might reflect the scarcity of Canadian firms in that range or the fact that stakes below 20% generally need not be disclosed in Canada, or both. Among firms with more than 20% managerial ownership, they find a positive relationship with share value similar to that found by Morck *et al.* (1988). The chapter by Rao and Lee-Sing finds no linear relationship between insider ownership and firm performance, but does not search for a nonlinear relationship of the sort shown in figure 1. The chapter by Jog and Tulpule divides firms into four groups ranging from very low to very high insider ownership and finds no difference in their long term returns to shareholders or their accounting performance. As they recognize, a limitation of their stock market analysis is that it looks at *returns*. If the stock prices of some of their firms, say the widely-held ones, were depressed due to their ownership structures by roughly the same amount through the period they studied, they would find exactly the result as they found. Their study does, however, show that there has been no statistically significant change in the relative pricing of stocks in widely vs. closely-held firms between 1977 and 1981. Also, their accounting based results are not strictly comparable to Rao and Lee-Sing or other studies in the research literature because Jog and Tulpule's results are not compared with industry and firm size benchmarks.

Overall, we share Barone-Adesi's lack of surprise that results found in the U.S. do not hold up in Canada. There are many institutional differences between the two countries (Daniels and MacIntosh, 1991). Canadian managers are relatively free of class action suits by shareholders. They can use dual class shares to retain control despite issuing large amounts of equity. Friendly sales of control are harder here because of legislated equal opportunity rules. Institutions tend to be more passive on corporate performance issues. These differences make management entrenchment easier in Canada. The Smith and Amoaku-Adu chapter and Rao and Lee-Sing chapters are consistent with the view that most Canadian firms already have entrenched management, so further increasing insider ownership is more likely to increase than depress share prices. That is, Canadian firms are in the rightmost section of figure one. Share values are already depressed by full entrenchment, so further increasing insider holdings can do no more harm. If managers are equally entrenched by holding 50% and 60%, it might be better it they own 60% so their personal interests are marginally closer to the firm's.

If this view were supported by overwhelming evidence, it would suggest a policy of actively encouraging greater insider ownership among firms that already have dominant shareholders. However, the evidence is not yet overwhelming. For instance the chapter by Jog and Tulpule is not supportive of this, although their methodology is aimed at addressing other issues and is ill suited to answering this question. We feel the evidence remains too equivocal to support a robust policy recommendation, and we therefore make the more modest suggestion:

Policy Implication I: *Government should neither encourage nor discourage any level of insider ownership.*

Outsiders on the Board of Directors

The Canada Business Corporations Act currently requires that there be at least two unrelated directors on the boards of public firms. These outsiders can, in theory, monitor management and prevent, or at least publicize, decisions that might depress share values. Weisbach (1988) shows that U.S. firms whose boards have majorities of outsiders are more likely to sack their C.E.O.s in response to unusually poor financial performance than are firms with insider dominated boards. Also, Rosenstein and Wyatt (1990) find that U.S. firms' share prices rise on the news that outsiders are coming to their boards. However, Hermalin and Weisbach (1991) find no statistically meaningful relation between outsiders on the board and share values. These findings can be reconciled if outside directors have little impact under normal circumstances, but do force action if performance is very bad. Despite this decidedly mixed evidence, Toronto Stock Exchange Committee on Corporate Governance in Canada (the "Dey Committee") (of which one of us --Daniels -- was a member) recommended that a majority of all directors of listed companies be unrelated.

It is important to note that Weisbach's (1988) result is for the U.S. where most firms are widely-held. In Canada, where most firms are closely-held and the top managers are arguably entrenched, does having outsiders on the board matter?

The evidence presented in this book is that it does not seem to. The Amoaku-Adu and Smith chapter as well as that by Gagnon and St. Pierre both find no statistically discernible relation between the fraction of outsiders on the board and firm performance. Rao and Lee-Sing actually find a positive relation between several performance measures and the fraction of *insiders* on the board. These findings are consistent with recent work by Hermalin and Weisbach (1995), who argue that rules requiring a certain fraction of the board be outsiders are likely to be ineffective because dominant shareholders and managers can always find compliant and passive outsiders. They argue that outside directors must be given both more power and stronger incentives if they are to improve economy-wide corporate governance.

However, it may be too early to give up on outside directors. Amoaku-Adu and Smith make the very valid point that Canadian disclosure rules often fail to establish whether outside directors are truly independent. For example, unrelated directors who are also the firm or a controlling shareholder's lawyers or accountants, or who are executives of companies that do business (suppliers or customers) with it, cannot be considered truly independent. They are less likely than truly independent directors to challenge the C.E.O. for fear of jeopardizing lucrative business interests.

The Dey Committee recommended that the board be charged with the task of determining who among its members was unrelated, and then be required to disclose publicly the basis upon which that decision was made (subsequently adopted in TSE Bylaw No. 636). While this recommendation would confer considerable latitude on shareholders and directors to craft governance arrangements tailored to specific circumstances, it comes at the cost of engendering some confusion among investors about what exactly it means to be "unrelated". Therefore, in response to the issue raised by Amoaku-Adu and Smith, we suggest the following policy:

Policy Implication II: *The current requirement in the <u>Canada Business Corporation Act</u> that there be a minimum of two public directors on the boards of public companies should be retained. However, the definition of an outside director should be greatly tightened. For a firm to characterize a director as an outside director (in accordance with the <u>Canada Business</u>*

Corporations Act), that director should have no commercial links of any kind with the firm or its controlling shareholder(s). In other words, an outside director should be truly independent of management and owners. The controlling shareholder or the firm's lawyers, its advertising account managers, the executives of firms dependent on it for business, etc. should not count as outside directors. We further recommend firms disclose all their directors' commercial links, direct or indirect, with the firm and with all entities controlled by the firm's controlling shareholder.

Hermalin and Weisbach (1995) point out that mandating a particular number of outside directors alone is unlikely to improve corporate governance. They argue that outside directors must also be given sufficient power to influence management and sufficient incentives to use that power.

Part of the incentives outside directors face arises out of director liability rules, which we deal with at length below. As we suggest there, director liability cannot be overused as an incentive mechanism without deterring good outside directors from serving on boards. Director liability must be invoked only in a carefully limited set of circumstances, or it is likely to be counterproductive. Therefore, another milder yet more pervasive incentive scheme is needed. We believe changes in director compensation might serve in this capacity.

Paying outside directors solely in shares or options on publicly traded shares would increase their attention to shareholders' interests. This would address the incentive issue raised by Hermalin and Weisbach (1995), and thus might lead to outside directors having a stronger impact on firm performance. Although outside directors' compensation is usually quite modest, linking it to the price of publicly traded shares would be an important symbolic reminder to directors of where their discretionary duty lies. We therefore suggest that governments adopt the following requirement:

Policy Implication III: *Outside directors should be paid solely in publicly traded stock or stock options. If options are used, their exercise prices should not be adjusted ex-post when the share price falls. This practice, regrettably common in C.E.O. compensation schemes, defeats the entire purpose of option based compensation schemes: linking pay to performance. A better way of maintaining proper incentives as the market fluctuates is to explicitly define the exercise price as the value of a portfolio of the stocks of other firms in the industry. This would result in directors' pay rising when the shares of their company outperform the benchmark portfolio of shares of industry rival firms. Director compensation, and how it is determined, should be fully disclosed.*

The effect of this requirement is to empower shareholders by giving directors stronger incentives to safeguard shareholders' interests.

An issue repeatedly brought up in this context is shareholders' alleged myopia. Directors, the argument goes, should not be paid in options or stock because shareholders' perspective is too short term, and the rosy long-term prospects of the board's plans are thus beyond markets' collective ken. The chapter in this book by Giamarino documents the large and increasingly conclusive empirical literature on this issue and thoroughly debunks the folk wisdom that shareholders are more myopic than managers. The data fairly conclusively shows share prices responding sensibly to changes in firms' long-term prospects. Tales to the contrary simply do not stand up to close scrutiny.[1]

[1]Also, the fact that we are proposing linking performance to how the firm's shares do relative to other similar firms means the directors are insulated from the effects of overall market fluctuations due to alleged myopia.

A related issue in giving directors relative performance based compensation is: would directors serve in a firm where continued poor performance was likely while a turnaround was engineered? A basic compensation could be build into options by setting their exercise prices below the current stock price. (We feel the Toronto Stock Exchange rule that now prevents this to be inadvisable, and recommend it be changed.) If the directors then oversee a continued price decline relative to the shares of other firms in the same industry that renders their options worthless, this means investors are collectively unimpressed by the board's long-term turnaround strategy. In such a case, shareholders would presumably be relieved if the directors responsible quit or were replaced. Presumably, not paying them would hasten the former and render the latter unnecessary. If firms are unable to persuade directors to sign on initially, shareholders interests would be better served by offering directors more options or stock, rather than by offering them cash. In our view, there is no economic justification for a guaranteed component in directors' compensation. After all, the people in whose interests the directors are supposed to act, the shareholders, have no guaranteed compensation either. We believe most directors would welcome a switch to options as compensation if it were accompanied by the rationalization of director liability we suggest.

Two dangers in paying potentially unscrupulous directors in options or stock are insider trading and stock price manipulation. Directors might exercise their stock options when they know the stock is overvalued, and thus harm public shareholders; or they might actively orchestrate information releases or discretionary accruals in earnings to buoy up the share price around exercise dates. There is considerable evidence in the accounting research literature that firms manipulate information releases and accounting data in this way for other purposes. One straightforward way to address this problem is to require that directors' stock and options compensation be frozen until well after they have left the board. If directors had to wait, say, two years after leaving the board before they could trade or exercise the stocks or options they received as compensation, their information advantage over ordinary shareholders would be largely dissipated.

Under the set of proposals we advance below, outside directors' jobs are likely to become tougher. We therefore feel that public companies should regularly review their directorial compensation arrangements to ensure that the level of compensation received by directors corresponds to the time, energy, and commitment required of directors in a rapidly changing, highly complex business environment.

The Size of the Board

Are smaller boards better? The chapter by Rao and Lee-Sing finds a negative correlation between board size and performance. There is also a strong feeling by many directors we have spoken with that the boards of some large Canadian corporations are too large to allow effective decision making. Yet we feel legislating the number of directors on boards is not advisable. We feel large boards are a symptom of deeper governance problems rather than a fundamental cause of poor corporate governance. Rather than encumber firms with a constellation of laws aimed at such symptoms, we feel public policy should take aim at the root causes of poor corporate governance. We believe the positive recommendations in this chapter would address these root causes and thus empower shareholders to demand smaller boards where they might improve performance. This would allow shareholders to tailor governance structures to distinct corporate settings.

Policy Implication IV: *Governments should not attempt to control the sizes of boards.*

Separation of Powers

In this volume, Rao and Lee-Sing find that in almost two-thirds of the Canadian firms they study the C.E.O. does not act as chairperson of the board. In contrast, in the U.S. firms they examine, the C.E.O. is also the chairperson of the board roughly 60% of the time.

Among students of constitutional law, separation of powers is widely believed to be an essential component of good government. Power in the public sector must not be concentrated in too few hands, or some day a mistake in the electorate's judgment might confer on a rascal unchecked scope for villainy. Does this recipe for good government translate into one for good corporate governance?

There is some evidence that it does. Morck et al. (1989) find that boards are more likely to replace C.E.O.'s following unusually bad corporate performance if the C.E.O. is not also serving as both president and chairperson of the board. Where the three titles are held by one man, poor firm performance tends to increase the odds not of the C.E.O.'s being sacked, but of a hostile takeover. Perhaps too much power in the C.E.O.'s hands paralyses the board and leaves the firm vulnerable to more drastic remedies to poor governance like takeovers. However, takeovers are expensive to mount, and are thus only a last resort for managerial control.

In this volume, Rao and Lee-Sing find that a relationship between firms' general performance and a separation of powers exists neither in U.S. nor Canadian data. (In fact, they actually find a positive relation between *concentration* of power and firm growth.) They do not explore whether or not Canadian boards might be more willing to sack C.E.O.s subsequent to very poor performance, though.

Policy Implication V: *Governments should not attempt to legislate a separation of the roles of C.E.O. and chairperson of the board.*

Allowing one brilliant executive to assume greater power by acting as C.E.O. and chairperson of the board may benefit shareholders by avoiding needless discussion and speeding up decisions. However, the same can be said of dictatorships. The purpose of democracy is arguably to restrain great men, and that is also the purpose of shareholder democracy. Yet despite this, we feel a legislative requirement that these roles be separate is unnecessary and might well be ineffective. A dominant C.E.O. is as likely to find a compliant and passive chairperson of the board as she is to find compliant and passive outside directors.

The purpose of separating the roles of chairperson and C.E.O. is to foster a climate in which dissident directors can confront a CEO or a controlling shareholder. Below, in the section on board liability, we propose better disclosure and conduct committees as better ways to do this. This, we feel, leads to a better general strategy of making sure shareholders are empowered and informed. Then let them elect whom they please as chairperson of the board.

C.E.O. Compensation

In Canada and the United States, C.E.O. compensation has become a hot topic. As Elitzur and Halpern point out, C.E.O. pay in the U.S. is thought by many to be too high and more importantly, too unrelated to corporate performance. Presumably, most shareholders would not mind high C.E.O. compensation if it resulted in superb performance. If C.E.O.s can continue to earn the same compensation no matter how well they run their companies, this is clearly a problem.

It is important to emphasize that this problem is mainly confined to widely-held firms. In closely-held firms, especially where the dominant shareholder is also the C.E.O., the firm's fortunes are closely tied to the C.E.O.'s. Tying pay to firm performance through salaries, bonuses or option plans is redundant.

Canada does contain some widely-held firms, and sometimes the managers of closely-held firms are not their dominant shareholders. In such cases, tying executive compensation to firm performance makes sense. Elitzur and Halpern argue in this volume that C.E.O. pay is not closely enough tied to performance in these firms. We do not believe mandating a greater tie is wise. A better policy is to empower shareholders in more basic ways, and then let them demand different compensation packages for C.E.O.'s.

One alternative shareholders should reconsider is stock options. These have deservedly earned a bad name in recent years because of boards willingness to rewrite their terms at the C.E.O.'s request. For example, if a C.E.O. were given options to buy his company's stock at $50 and the share price fell to $25, the board too often happily rewrites the options to let the C.E.O. buy at $20. C.E.O.s and boards rightly understand that the C.E.O. cannot be held responsible for every movement in the firm's stock price. However, freely adjusting options in this way can protect the C.E.O. from stock price declines that are her responsibility.

To sidestep this, we suggest that firms pay their C.E.O.s in options with adjustable exercise prices tied to the stock price performance of rival firms. The C.E.O.'s stock option could let her buy a share of her company's stock at a price that moves up and down with the share prices of other firms in the industry. This would adjust the terms of the option when industry-wide or economy-wide factors hit the share price, yet would still hold the C.E.O. accountable when the firm's share price alone rises or falls.

Policy Implication VI: *C.E.O.s should be paid in stock options. These should partially or completely replace salaries, not supplement them. Boards should not be allowed to revise the terms of such options after they are issued. To protect the C.E.O.s from price fluctuations beyond her control, her options' exercise prices should move automatically with industry or market indexes. A C.E.O. compensated in this way should not be subject to excess compensation suits if she achieves superior performance relative to their industry rivals. C.E.O. compensation and the way it is determined should be disclosed.*

It is important that the C.E.O. share some of shareholders' downside risk. Therefore C.E.O.s' options should originally be in-the-money. This should be done so as to produce expected compensation sufficient to attract and retain well qualified C.E.O.s. Although we understand the sentiments that led to it, we believe the current TSE rule forbidding in-the-money options should be changed. It prevents options from replacing salary and bonuses, yet leaves open the possibility of huge amounts of compensation.

We recommend against tying C.E.O. pay to accounting performance measures such as earnings. These are too subject to manipulation. By timing accruals, for example, managers can manipulate current earnings to almost any extent desired. The study by Elitzur and Halpern provides a quick overview of the extensive empirical evidence that this does occur.

If C.E.O.s' pay is to depend more on their firms' stock market performance, C.E.O.s must be allowed very high pay when their firms' performance is superior. There has recently been much grumbling in Canada about the magnitude of C.E.O. pay. In the U.S. many lawsuits by shareholders against managers take the form of excess compensation suits. Jensen (1990) He argues that the real scandal is not the size of C.E.O.s' pay, but its failure to reflect firm performance. He argues that the fear of excess compensation lawsuits explains why C.E.O. pay is not well tied to performance in the U.S. C.E.O.s there are unwilling to accept low pay when performance is poor because they doubt that they will keep high pay when performance is good. Some have argued that C.E.O. pay should not be disclosed to let it be more tied to performance without raising shareholders' ire. We believe this would be unwise.

It is in the public interest that shareholders know how much money top insiders are taking from the firm. We therefore endorse strongly the recent changes to the Regulations under the Ontario Securities Act, which require more extensive and detailed disclosure of executive compensation practices. However, while there is value in disclosure, it is also in the public interest that good management be rewarded. Thus, when a top manager receives very high compensation from an option based incentive scheme that appeared reasonable when instituted and that shareholders accepted at the time, lawsuits alleging excess compensation should not be allowed.[2]

We do not believe government should mandate the way C.E.O.s are paid. Our suggestion of options with moving exercise prices is mainly to shareholders and boards. It is important, however, that governments continue to require disclosure of C.E.O. and top executive compensation, and that the courts not hear excess compensation suits where high compensation is due to superior performance.

Director Liability

There has been a growing trend toward increased directors' liability in Canada. In contrast to the United States, Canadian legislatures are inclined to back up explicitly legislated corporate duties and obligations with explicit liability for directors. One commentator recently counted no less than 106 different federal and provincial statutes that impose personal liability on directors and officers in Ontario. There has also been growth in nonstatutory, typically tort-based, liabilities. This expansion in liability has occurred without any substantial change in the corporate law duty of care which governs the liability of directors and officers for negligence.

The rationale alleged for these duties is straightforward: directors must have strong incentives to monitor corporate activities and prevent corporate wrongdoing. However, while it can be argued that there is a need for increased control of corporate wrongdoing in Canada, it is not at all clear that the imposition of personal liability on directors is an effective way to address this goal. Directorial liability not only fails to provide consistent and compassionate levels of recovery to injured stakeholders (owing to vagaries in the personal resources of directors), but further it may bias directorial decision-making to low risk, unimaginative projects (Daniels, 1994). In a setting of intense competitive pressures, a board gripped by liability fear is an uninspired instrument for vigorous and creative leadership. Even worse, liability fear may cause the board to resign when its leadership and expertise are most in demand (when a firm is near insolvency) and the threat to

[2]Exceptions might be made if there is a showing of corporate waste, that is, a demonstration that corporate resources were paid out to corporate management without any corresponding benefit to the firm.

stakeholder interests is greatest -- the so-called "board overboard" phenomenon (Daniels, 1993). Indeed, fear of personal liability under provincial employment standards legislation has resulted in *en masse* resignations of board members from several troubled public companies in Canada (PWA, Westar).

These problems are accentuated by various infirmities in Canadian director and officer insurance policies. Daniels and Hutton (1993) find that as a specialty or fringe line of insurance, director and officer coverage is subject to abrupt and quite dramatic fluctuations in supply, as measured by several variables: price and deductible increases, growth in coverage exclusions, and compression of coverage periods. The use of these restrictions means that at some points in the insurance-cycle, coverage for certain D&O liability risks is unavailable at any price. For example, in 1987, 91% of the insurance policies written in Canada excluded liability for pollution and environmental damage and 17% excluded liability for actions taken by various regulatory agencies. Furthermore, most insurance policies were written on a claims made basis and allowed for only relatively short discovery periods after termination. The net effect of these restrictions is to make risk-shifting by insurance an extremely speculative strategy for most directors.

Because of these problems, we make the following recommendation:

Policy Implication VII: *Directors should be liable for explicitly legislated corporate responsibilities provided that the directors' act or omission is the reasonably proximate cause of the harm in question. This liability should never be absolute -- it should always be subject to a due diligence defence. Directors and officers who apply a reasonable effort to uncover and prevent potential harm to shareholders should be protected from lawsuits. Directors who go on the record opposing decisions later found to have harmed shareholders should be protected from lawsuits arising out of those decisions. We endorse the recommendation of the Dey Committee that the governmental departments responsible for the administration of corporate law in their jurisdiction undertake systematic and comprehensive reviews of all legislation that imposes personal liability on directors and officers to ensure that the provision is cost-effective as measured against the policy goals sought.*

It is our expectation that much of this legislation will not justify its costs. In cases where social responsibility, the environment or other broader public objectives are being backed up with director liability, such liability should be capped, at least for outside directors. It might also be reasonable to cap outside directors' liability for breach of duty of care, as this duty can be somewhat open ended. We would not, however, limit the exposure of directors for either oppressive conduct or a breach of the duty of loyalty, both of which involve aspects of self-dealing.

Generally, there has not been an expansion in the scope of liability under the corporate law duty of care. This is desirable, as by and large, courts are ill-equipped to second guess directorial business decisions. The danger is that, to point the finger at someone when corporations lose money, shareholders will vie to hold directors and officers responsible for actions that were perfectly responsible at the time that they were made. Corporate decision making is inherently about risk taking, and it is undesirable for directors to be held liable for legitimate risks that later go sour. This is why courts have traditionally strained against the imposition of liability for business decisions and judgments that are well informed and not tainted by any hint of self-interest, and this is one reason we believe director liability should be precisely defined and subject to a due diligence defence.

Another is the serious risk of deterring competent outsiders from accepting positions on boards when liability rules are too strict. The responsibility of directors and officers should be limited to what they can reasonably be expected to control. There are better tools for improving corporate governance than broad and open-ended liability for officers and directors. This is especially true for outside directors who benefit little from firms' exploitation of their shareholders yet bear huge liabilities. This situation probably deters highly qualified people from serving as directors, especially in troubled firms where there is a high likelihood of legal actions. Yet these are the firms where competent outsiders are most needed.

We believe the directors' responsibility should be simple and clear: maximize share value. The large empirical literature discussed by Giamarino suggests that the allegations of shareholder myopia and related criticisms of financial markets are largely unjustified. Although financial markets may be subject to occasional irrational fluctuations, share prices for the most part move in response to investors' rational perceptions of firms' performance and future prospects. Share prices are valuable, though admittedly imperfect, measures of how well shareholders think the firm is doing. No other such gauge of shareholders views is available outside annual shareholder meetings. Therefore, we feel the law should recognize financial markets as delivering a democratic, but sometimes imperfect, expression of shareholders' opinions. Thus,

Policy Implication VIII: *The shareholders' interests in a derivative suite should be defined as the maximal current share value.*

Although earlier studies came to conflicting conclusions, there is now fairly widespread acceptance that management entrenchment devices like poison pills lower share prices. We concur with Huson's suggestion that these sorts of effects be factored into valuation calculations in such suits. Debate about poison pills is not yet over, though. In cases where managers use them to up tender offer prices, poison pills may actually benefit shareholders.[3]

Controlling Shareholders

Canada is a closely-held economy, and dealing with controlling shareholders is therefore the central issue in Canadian corporate governance. The policy implications in this section are the most important in this book. The studies in this volume do not point to pervasive problems related to controlling shareholders, however the same methodological problems that we raised in interpreting them as to the desirability of fostering more or less concentrated ownership apply here too. Also, Holderness and Sheehan (1988) point out that different types of dominant shareholders may have different effects on firm performance. Along these lines, Morck and Stangeland (1995) find that Canadian firms' performance is depressed when the controlling shareholder is an heir, but not otherwise. Moreover, the studies of U.S. large blockholders cited by Holderness also are grounds for concern. Finally, there is a large body of empirical evidence from other countries, reviewed at length in Shleifer and Vishny (1995), that dominant shareholders do extract significant value from firms they control. The preponderance of evidence, we believe, supports an active public policy in this area.

[3]A recent study by Comment and Schwert (1995) takes this view.

The high level of share ownership concentration in Canada makes problems between controlling and minority shareholders the crucial axis of agency conflict. The problem is not one of managerial fidelity to shareholders, but rather of fidelity to some shareholders (controllers) at the expense of others (minorities) (Daniels and MacIntosh, 1991). As MacIntosh and Schwartz argue in their chapter for this volume, controlling shareholders usually make the corporation's managers work harder, but the rub is that the fruits of that effort may not not go equally to all shareholders -- the controlling shareholder can siphon off a disproportionate share.

In this setting, it is indeed ironic that Canadian courts were loathe to develop (in contrast to their American counterparts) a clear fiduciary duty from majority to minority shareholders (see MacIntosh, 1993, for a thorough discussion of this issue). Indeed, in a closely-held economy such as ours, a clear fiduciary duty of dominant shareholders to minority shareholders along the lines of French law, as described by Barone-Adesi, might seem appropriate.

This lacuna has been redressed through the adoption of the statutory oppression remedy in federal and provincial corporate law and through the development of a range of minority shareholder protections in provincial securities law, such as OSC Policy 9.1, which sets out disclosure, valuation, disinterested director review, and shareholder approval requirements for insider bids, issuer bids, going private transactions, and related party transactions.

Although it may seem that having multiple and overlapping instruments available to redress controlling shareholder abuses would strengthen the protections available to minority shareholders, there are several infirmities with the current system that hobble its general effectiveness. First, there are simply too many different instruments in the minority shareholders' arsenal, which engenders overlap and confusion. Depending on whether a minority shareholder's action against a controlling shareholder is framed as an alleged breach of securities law, the corporate fiduciary duty, or the oppression remedy, different consequences will ensue. This is due to the different substantive rights and remedies contained in each, the different modes of prosecution (public for securities law, private for corporate law), and the different fora for resolution (administrative review and possibly a hearing for securities law, courts for corporate law). Second, and related to the first, the multiplicity of instruments hobbles the creation of an extensive body of precedent under any single instrument. Consequently, it is difficult for both controlling and minority shareholders to know how the law will balance their respective interests in particular circumstances. Third, we are concerned that OSC Policy 9.1 has subverted the incentive (indeed capacity) of shareholders and directors of Canadian corporations to negotiate directly the resolution of disputes over related party transactions. The very detailed code of conduct elaborated in OSC Policy 9.1 has insinuated OSC staff into the heart of disputes over self-dealing transactions, attenuating the need for those parties with the economic stakes to do the jawboning with controlling shareholders and management over related party transactions (Daniels and Waitzer, 1994). It has further undercut the incentive for board members to take the responsibility for crafting review processes for self-interested transactions tailored to specific circumstances. In this respect, we can imagine that in some circumstances the policy is far too stringent (in prescribing directorial review and disinterested shareholder voting), whereas in others it is too lax (for significant transactions that are less than the 25% market capitalization tripwire for its non-disclosure obligations).

We regard the rationalization of the system of minority shareholder protection to be an urgent priority for the federal government, given the need to protect the integrity of the federal corporate law regime and to reduce costs for Canadian shareholders. Currently, the substantive rights and remedies set out in OSC Policy 9.1 trenches on the corporate governance regime contemplated by the Canada Business Corporation Act. That is not to say, however, that the current corporate law regime alone affords adequate protection to minority shareholders. There is a need for the federal government to review its own legislative scheme to see what modifications are appropriate in light of the corporate and investor communities' experience with both the oppression remedy and OSC Policy 9.1.

Policy Implication IX: *The federal government should commence a review of the various federal and provincial regulatory initiatives affecting minority shareholder rights to ensure that minority shareholders enjoy effective and rational protection against abuse by controlling shareholders. The oppression remedy in Canadian law is very close to a fiduciary duty of controlling shareholders to minority shareholders. Perhaps the whole existing set of duties of controlling shareholders to minority shareholders should be consolidated into a clear fiduciary duty.*

As part of the review of the existing regime of minority shareholder protections, the federal government should consider the suitability of expanding the disclosure and directorial voting provisions respecting interested material contracts or transactions to include those contracts or transactions involving the corporation and controlling shareholders.

We also believe that a fundamental underpinning of an effective system of shareholder protection is disinterested directorial responsibility for vetting self-interested transactions, subject to external oversight by investors. The quality of disinterested review would be enhanced if a special committee of the board were to monitor and review the corporation's activities with controlling shareholders, other entities the controlling shareholders control, and other insiders (non-shareholder officers and directors) to ensure fairness to minority shareholders. This would permit some institutional experience and memory to be amassed with respect to non-arm's length transactions and contracts.

Policy Implication X: *The boards of directors of any public Canadian companies with a dominant shareholder should be required to have a "conduct review committee" to approve significant non-arm's length transactions and contracts. This committee should be composed entirely of outside directors. Members of the conduct committee and other members of the board should be liable when they deliberately or negligently allow improper non-arm's length transactions or contracts occur.*

Conduct review committee approval could substitute for minority shareholder votes in many, perhaps most, cases. This would address a key criticism of Ontario's rule 9.1, that its requirements for shareholder consultation are too onerous and costly.

This suggestion also speaks to an issue raised above in connection with requiring a certain number of outside directors on the board: fostering a climate where the C.E.O. can be challenged. This might work for the boards of widely-held firm, but we believe the full boards of closely-held firms are unlikely to ever provide such climates. Consequently, we believe that good corporate governance in a closely-held economy requires establishing a new forum where the C.E.O. is not dominant.

If controlling shareholders' duties toward minority shareholders are to have any real content, minority shareholders must know when and how their interests might be threatened. Therefore we believe another critical issue is the timely disclosure of related party transactions.

Policy Implication XI: *Timely and full disclosure to all shareholders of all but de minimis contracts and transactions proposed between controlling shareholders, or entities they control, and the corporation should be mandated.*

Institutional Investors

A theme of several chapters in this book is the recent growth in power and importance of institutional investors. The chapter by Rao and Lee-Sing shows that institutional investors now control 38% of the dollar value of the Canadian firms in their study. While this is less than the comparable figure for the United States, 53%, it is nonetheless large - and it is growing rapidly.

Public pension funds, like the Ontario Teachers fund, and private pension fund managers, like Jarislowsky and Fraser, now control multibillion dollar stock portfolios. By threatening to use their substantial equity blocks to back takeovers or proxy challenges by dissident shareholders, these large institutional investors can displace managers they feel are not serving the shareholders. And pension fund managers themselves can be replaced if they allow their beneficiaries' retirement funds to earn less than a maximal return. In the United States, these sorts of institutional investors have caused a revolution in corporate governance, much to the dismay of many top corporate managers. The chapter by Foerster examines pension funds in Canada, and argues that the same is likely to happen here. The chapter by MacIntosh and Schwartz finds a correlation between institutional ownership and corporate performance. This leads them to be relatively optimistic over the contribution that institutional ownership can make to the Canadian system of corporate governance. However, that by Rao and Lee-Sing finds no relationship between institutional ownership of Canadian firms, and either indicators of corporate strategy like R&D spending and foreign market penetration, or general performance indicators like return on assets or firm growth. Among U.S. firms, in contrast, they do find a link between high institutional ownership and good general performance. This is consistent with McConnell and Servaes (1990) who also document a relationship between institutional investors' stakes and high market to book ratios in U.S. firms. Many other studies argue for similar links.

However, as the chapter by Patry and Poitevin explains, an increasing number of studies suggest institutional investors are overrated. A key issue here is the great difficulties pension fund managers have in knowing enough about diverse business operations to have meaningful input into business decisions. In the 1960's, conglomerates were touted as ways for a single team of superb managers to run numerous disparate businesses. The conglomerates of that era were largely failures. *Post mortem* examinations show problems in managing diverse divisions and subsidiaries as the prime cause. Perhaps all the best conglomerate managers moved on to pension funds?

Expecting pension funds to be a Holy Grail of good corporate governance may well be unrealistic. However, even if pension fund managers only take measured and focused action to prod recalcitrant directors to do their jobs, substantial improvements in corporate governance might result. Some studies critical of pension funds and other investors seem to doubt that even this is likely. They point to serious governance problems within pension funds that may seriously undermine their effectiveness.

Who run pension funds? What incentives do they face? How well to they do their jobs? These are critical questions that have largely gone unasked in Canada, despite the fact that pension fund managers regularly make multibillion dollar decisions that affect the retirement security of millions of people, and that constrain the decisions of large corporations.

In public sector funds, there is a nagging fear that those in control of pension funds might be there more for their political connections than for their financial expertise. Romano (1994) finds that public sector pension funds earn statistically significantly lower returns than private sector funds, and attributes this to politically motivated "local initiative" investments.

In corporate pension funds, Lakonishok *et al*. (1991) present disturbing evidence that pension fund managers choose portfolio managers less for the performance of their investments than for their abilities to generate good excuses when their portfolios do poorly. Lakonishok *et al*. (1991, 1992) document surprisingly poor portfolio returns on corporate pension funds. In general, corporate pension funds would do better on a risk adjusted basis to simply buy and hold broad market indices. Lakonishok *et al.* argue that conflicts of interest between plan beneficiaries, plan sponsors, and portfolio managers are responsible. Corporate treasurers may be more interested in expanding the influence of the corporate treasurer's office than in earning optimal returns. Portfolio managers may be more interested in pleasing the corporate treasurer and thus getting their investment contracts renewed than in producing optimal financial returns.

In Canada, the very clout of institutional investors, particularly public pension funds, may be a problem. Fearing the public scrutiny that will accompany any vigorous action, even in circumstances where it is appropriate, public fund managers may shun activism that is not in response to a discrete, management initiated transaction, like a poison pill plan or a change in corporate capital structure.

If pension funds themselves have governance problems, giving them important watchdog roles over corporate governance may be akin to setting the fox to guard the henhouse. Before they can adequately fill such a role, public and private sector pension fund managers incentives must be aligned properly. This suggests a need to clarify the underlying economic purpose of both public and private pension funds: to provide retirees with financial security. Pension fund portfolios should be managed to benefit the beneficiaries, not politicians, political insiders, corporate treasurers, or fund managers.

Ultimately, the most powerful way of making sure pension funds are managed in their beneficiaries' interests would be to introduce competition for beneficiaries' pension dollars. This could be done by letting employees choose to allocate their pension money among several portfolio's, each with stated investment strategies and performance records. It is even conceivable that pension fund management might be completely divorced from corporate management. Employees of Bell Canada could choose to put their money in any certified pension fund, not just those assigned contracts by Bell Canada. This amounts to moving toward more defined contribution pension plans and away from classical defined benefit plans.

Defined contribution or money purchase plans are akin to R.R.S.P.s, but here either the employer alone or both the employer and employee make regular contributions. The beneficiary gets whatever these contributions grow to by the time she retires. The employee can allocate her share of the asset pool as she chooses among several investment funds associated with the pension plan.

In defined benefit plans, the employer promises a specific level of benefits related to the retirees' years of service, top five years' wages, etc. Either the employer alone or both the employer and employee make regular contributions. The investment strategy and the responsibility for shortfalls theoretically rest with the employer only. In practice, when defined benefit plans become seriously underfunded, the employees are often either asked for higher contributions or given lower defined benefits. Both occurred recently for public sector employees in Alberta. Even when the contributions come solely from the employer, they and the benefits they pay for are parts of labour contract negotiations and are subject to change. It is arguable that there is really no such thing as a pure defined benefit plan, in that employees potentially pay some costs for poor investment performance in all pension plans.

Hybrid plans, part defined benefit and part defined contribution, are also common. Most corporate plans are *de facto* defined contribution plans with defined benefit floors. Employers make "voluntary inflation adjustments"in the defined benefit when the fund's assets do well, but guarantee a basic floor level of payments, or even a basic partial inflation adjustment, when they do poorly. In such plans, the employees gain the benefits of good pension fund management and so should worry about the fund's investment strategy.

From a detached economic standpoint, defined contribution plans are usually preferable. This is because the beneficiaries' property rights are clearly defined: they own the fund's assets. In defined benefit plans, although the employer is the *de jure* owner of the fund's assets, real property rights are vague. Since it is not clear who bears the costs of poor performance and gains the benefits of good performance, no-one has a clear incentive to press for good pension fund governance.

Given the advantage of defined contribution plans, why are most large pension plans defined benefit plans? First, the sponsors retain control of the assets in defined contribution plans. Pension fund investment strategies can be altered to benefit the firm or government that sponsors them, often to the detriment of the beneficiaries, whose contributions must be higher or whose benefits will be lower. Second, defined benefit plans provide corporations with tax-free savings accounts. Bodie et al. (1985) show that U.S. companies with extra cash overfund their defined benefit pension plans so that in times of cash shortfalls they can adjust their contributions downward. This is accomplished by strategically altering the actuarial assumptions used to calculate the firm's contribution. Third, defined benefit plans are more forgiving of poor portfolio management because the ownership of the assets being managed is muddier. Do they belong to the beneficiaries or the employer? Finally, defined benefit plans offer employees a false sense of security by promising a fixed dollar amount per year during their retirements. In fact, new securities like Government of Canada inflation indexed bonds, allow portfolio manager of defined contribution schemes to offer even more security.

We believe none of these reasons justifies the current reliance on defined benefit plans. We therefore feel a shift to defined contribution plans would be in the broad public interest.

Policy Implication XII: *Corporate and public sector pension plans should be shifted away from a defined benefit system and toward a defined contribution system. This could be accomplished by requiring that all pension plans offer beneficiaries an actuarially fair defined contribution option. Beneficiaries of defined contribution plans should be given as much choice as possible in how their pension dollars are invested.*

In defined contribution plans, the ownership of the pension assets is clear. They are the sole property of the beneficiaries. The pension funds' managers should then be acting solely for the beneficiaries. Thus, we make the following recommendation.

Policy Implication XIII: *The fiduciary duty of the pension fund managers to the beneficiaries of* *pension funds should be clarified and strengthened. This fiduciary duty should be to maximize the value of the portfolio while exercising prudent risk management. Pension fund top managers who deliberately or negligently fail to do this should be liable to class action lawsuits by the beneficiaries. A reasonable effort to fulfil these duties should constitute a defense against such lawsuits.*

To further insure that pension fund top managers represent beneficiaries, we would like to see more democracy within pension funds. Pension funds' top managers should not be appointed by corporate management or politicians. If shareholders elect the directors charged with safeguarding their interests, should not pension plan beneficiaries have analogous power? If C.E.O.s must disclose their compensation, ought not the same to apply to pension fund managers?

Policy Implication XIV: *The top managers of corporate and public sector pension funds should be elected by the beneficiaries. The compensations of top pension fund managers should be disclosed to beneficiaries.*

A system allowing proxy challenges could let outsiders challenge the fund's management strategy. In short, what we are proposing is the *corporatization* of public and corporate pension funds. Pension funds should be run like firms, and their top decision makers should have responsibilities and liabilities similar to those of a board of directors.

If beneficiaries are to challenge the decisions of pension fund managers, they need information about the performance and composition of the funds' assets must be available.

Policy Implication XV: *Pension funds should disclose information about the performance and contents of their portfolios to beneficiaries on a quarterly basis. The length of time the fund has held each asset should also be disclosed. The individual components of market index portfolios need not be specified. These reports should be subject to uniform accounting standards and audited.*

One cost of such a disclosure rule is that it might possibly deter innovative forms of fund management because of the risk that expensive investment strategies adopted by some fund managers would be appropriated by others -- the public goods problem. Nevertheless, particularly in the time sensitive environment of capital markets, we are sceptical that historical reporting of investments would unduly compromise innovating firms.

An important issue that arises here is so-called *window dressing* by fund managers. This occurs when fund managers sell their dogs to buy stocks that have done well just prior to reporting the contents of their portfolios. This results in the funds selling low and buying high - not exactly the formula for financial success. Lakonishok *et al.* (1991) report that this practice is widespread among pension funds in the U.S. because having high performers in the portfolio shows that fund managers chose some investments well even though others were less profitable. (Some suggest that this explains the positive correlation between institutional ownership and firm performance some studies have found.) Apparently this increases the portfolio manager's chances of retaining the investment contract with the fund sponsor. To halt this practice, we propose that pension funds disclose the dates they acquired the assets in their portfolios too.

It is our hope that these reporting requirements would push more pension funds toward holding more index portfolios. We agree with Patry and Poitevin's conclusion, supported by Weisbach, that pension funds ought to be indexed more than they are. However, we believe this to be a symptom of deeper governance problems. We believe our suggestions in this section would address the deeper cause of this symptom. They would improve pension fund governance so that pension funds would move to index more of their portfolios on their own. There are valid reasons for pursuing more complex investing strategies, and pension funds should have some flexibility in this regard. Preventing pension funds from following such strategies by requiring a certain level of indexing would, in our view, be a mistake.

Despite overblown claims and legitimate questions, pension funds and other institutional investors probably can become a strong force for better corporate governance in Canada. However, at present the impact of Canadian institutional investors may be undermined by a range of legal impediments that limit their voice in corporate governance matters. For instance, there is concern that the shareholder proposal process, which is meant to lower dissident shareholders' costs of communicating with all shareholders by letting them piggyback on management's information circular, may be of limited value in disputes over corporate governance. This is because of a belief that such matters are for the purpose of "promoting general economic, political, racial, religious, social or similar causes". The corporation can refuse to circulate such a proposal. There is also concern with the 200 word limitation on the size of the statement that can be made in support of a proposal. Finally, there is concern with the breadth of the definition of "solicitation" set out in the proxy rules of Canadian corporate legislation. The issue is that this definition could require large dissident shareholders talking with each other in contemplation of activism to file a dissident proxy circular, which is extremely costly (MacIntosh, 1993).

While the precise effect of these legislative restrictions on institutional voice is a matter of dispute, we believe that little is to be lost by the relaxation of these rules, especially given our earlier recommendation that there be heightened disclosure of institutional ownership in Canada. As is clear from our earlier discussion, we regard informed, measured, and responsible institutional shareholder activism to be one of the linchpins of a modern system of corporate governance. We feel that, given the right legal framework, Canadian institutions can play a constructive and responsible role in the system of corporate governance. This accounts for our reticence to codify rigid governance structures in corporate legislation that are inappropriate in a range of settings. By empowering large institutional shareholders to play a role in corporate governance, governmental corporate and securities regulators will be able to play a more passive, enabling role in Canadian corporate governance. Such a regime is much more likely to result in optimal governance arrangements than one driven by governmental or quasi-governmental actors. Therefore, we recommend the following:

Policy Implication XVI: *The federal government, in association with the provincial securities commissions, should establish a joint task force to systematically review corporate and securities legislation with a view to removing any unnecessary impediments to institutional shareholder voice.*

Key issues to consider in this review should be the status of institutional investors as insiders or controlling shareholders, and institutional investors' ability to communicate with each other to address corporate governance problems. When institutional investors take large stakes in companies, but do not become involved in detailed management decisions, there should be a way for them to avoid being designated as controlling shareholders, and they should be free to communicate among themselves about certain general corporate governance problems that affect all shareholders. One can envision situations where pension funds might truly become controlling shareholders and might oppress minority investors. However, the circumstances under which a founding family is designated as a controlling shareholder and those under which a pension fund should be so designated should perhaps be different.

One important factor that lessens the positive impact of mutual and pension funds on corporate governance in this country is the rules restricting foreign securities in their portfolios (Daniels and MacIntosh, 1991; Daniels and Halpern, 1995). Although the use of derivatives allows pension funds to reproduce the risk characteristics of foreign portfolios, the fact remains that they are restricted to the basic return they can earn in Canada.

This confinement of mutual and pension funds to Canadian investments has two effects on corporate governance. The positive effect is that, since mutual and pension funds have few other places to put their money, they cannot simply sell out when a firm has management problems. They have little choice but to intervene to try to improve the governance of their investments. The negative effect is that if they cannot improve the governance of firms whose stock they own, they are still stuck owning it and still have only a limited pool of other Canadian companies as possible alternative investments. If there are intractable governance problems in many of them, they may be forced to hold stocks they would otherwise shun. This allows poorly governed firms to raise capital by issuing securities on artificially favourable terms, which, in turn, enables corporations to make investment and operating decisions that are economically perverse. Indeed, we suspect that such mercantilist policies have had a devastating impact on the growth and development of the Canadian economy.

On balance, we believe the foreign investment restrictions on Canadian mutual and pension funds are detrimental. The additional fact that they prevent mutual and pension funds from diversifying as much as they otherwise would (although derivatives help here), tips the verdict firmly on the side of free international capital flows.

There is yet another reason for allowing Canadian mutual and pension funds to diversify freely. It would not necessarily be economically healthy for Canadian finance to become completely dominated by pension funds. Might small shareholders need protection from oppression by large funds as much as from any other large shareholder? We think the answer at present is no. This is because mutual and pension funds are generally not inside parties to the sorts of corporate decisions that raise concerns about oppressive non-arms-length transactions, for example asset transfers, securities issues, and the like. If mutual and pension funds' assets continue to increase rapidly and their portfolio choices remain largely restricted to Canadian securities, there is perhaps a danger that the funds might come to so dominate Canadian finance that small investors might be slighted. In our opinion, this is another argument for allowing Canadian mutual and pension funds to diversify internationally without restrictions.

Policy Implication XVII: *Canadian mutual and pension funds should be free to invest as much or as little of their money in Canada as they see fit.*

We recognize that adopting this policy would affect governments' finances as well as corporate finance. Governments can finance their deficits more easily when they can draw on captive investors. It should be recognized that the current Canadian content rule is a hidden tax on Canadian savings. If Canadian governments can obtain funds on better terms because pension money is forced to remain here, that means Canadians' retirement savings are earning less than they would if invested at globally competitive rates. Current thinking in public finance favours consumption taxes, or taxes on the part of income people spend on consumption goods. Taxes on savings are seen as bad because they discourage capital formation. Although public sector governance is beyond the scope of this study, we speculate that Canadian governments might have been forced to begin their current fiscal house cleaning sooner if they had to compete for capital in global markets, and that the task would not have become as great as it is.

Complex Firms like Conglomerates and Multinationals with Public Shares

The main feature of these firms that raises corporate governance related concerns is the ease with which money can be transferred between parts of the group of companies, when each of the parts has a different set of shareholders. This is the same basic problem that causes concern in closely-held firms in general, but in spades. These problems are best addressed through the initiatives we discuss earlier in respect of controlling shareholders. The most important in this context are that multinationals' subsidiaries and firms in conglomerate groups have conduct committees and disclosure the details of non-arms-length transactions.

Requirements that Canadian citizens serve on the boards of the Canadian subsidiaries of multinationals are unlikely to have any real effect unless the Canadians are completely unrelated to the multinational. By choosing Canadian employees or the multinational or Canadian employees of firms dependent on the multinational for business, the force of this rule can be largely dissipated. The chapter by Rao and Lee-Sing finds no strong correlation between the nationality of board members and firm performance. (They actually find weak and mixed evidence that *more* foreign directors might boost performance.) There would seem to be no strong case for continuing with this requirement unless it is strengthened to require completely unrelated Canadian directors. Even then, it is more important that the directors be unrelated than that they be Canadian.

If it is felt to be important for political reasons to require Canadian citizens in key positions in multinationals' Canadian subsidiaries, Policy Implication X could be modified to require that the outside directors on the conduct committee be Canadian citizens. However, the citizenship of directors is economically unimportant. What is critical to the economic basis of Canadian corporate governance law is that directors be subject to lawsuits by Canadian shareholders.

Policy Implication XVIII: *Directors should be suable.*

Directors resident in the United States and other developed countries are not judgement proof. Canadians can sue in foreign courts. The important issue is that shareholders know what they are getting into. If a company moves to allows its directors to permanently reside outside Canada, this should require one time shareholder approval and should be clearly disclosed in the prospectuses of all new securities.

We see no problem in the proposal, mentioned in the Canada Business Corporations Act Discussion Paper on Directors' and Other Corporate Residency Issues (August 1995), to allow shareholder meetings outside Canada. Again, the key issue is that shareholder know what they are getting into. We therefore suggest that one time shareholder approval be required and that the prospectuses for all new securities state disclose this practice. We also see no problem in the same discussion paper's suggestion that the Canada Business Corporations Act allow certain records to be kept outside of Canada as long as these records are readily available electronically. However, there are some suggestions in that discussion paper that we feel would be very inadvisable. One is the suggestion that nonresident directors post a bond. We feel this to be unnecessary. If a security's prospectus clearly states that directors can reside abroad, the investors know what they are getting into. Another inadvisable proposal is that director residency requirements be replaced with a "community interest clause" requiring director attention to "stakeholders" rather than shareholders. Although directors have clear duties to make sure the firm honours its contractual and other legal duties to all its stakeholders, a general discretionary duty (like that to shareholders) would serve only corporate insiders. We argue at length in the introductory chapter that a duty to all stakeholders is too multidimensional and vague to be a serious constraint on directors' actions. Boards can always find some group whose interests are promoted by even the most foolhardy decision. Theoretical accountability to everyone boils down to real accountability to no-one.

Whistle Blowers

Even with the best audited financial statements and the most principled directors possible, it is still conceivable that corporate insiders might bilk shareholders directly or expose their firm to lawsuits by violating environmental rules, etc. In such cases, protecting whistle blowers is in the public's as well as shareholders' interests. The United States government pays a bounty to whistle blowers who expose fraud in government contracting. This is why so many cases of $700 toilet seats and $400 hammers come to light there. There is a strong case for laws protecting whistle blowers from retribution in both the public and private sectors. However, retribution can take subtle and intangible forms, so such laws might be impossible to enforce. This supports the idea, developed in the chapter by Daniels and Howse, of offering a bounty to potential whistle blowers.

Policy Implication XIX: *Protect whistle blowers from reprisals. Offer them bounties where public money is concerned. Permit shareholders to vote to offer bounties in private firms.*

Takeovers and Friendly Sales of Control

One of the distinctive features of the Canadian corporate law regime (in comparison to the United States) is the inclusion of friendly sales of control within the statutory takeover regime. For instance, the Ontario Securities Act precludes any party who wishes to purchase control from a controlling shareholder or group of shareholders at a premium in excess of 115% of a baseline market price from doing so, unless such an acquisition occurs pursuant to an offer made to all shareholders in accordance with the takeover regime, meaning that the bid is subject to minimum bid periods and a pro rata take up, among other things. The purpose of such a rule is to promote fairness for minority shareholders, by ensuring that they have an equal opportunity with the controlling shareholder to share the control premium when there is a change in control. The equal opportunity rule is also thought to deter sales of control to opportunistic acquirors who want to loot the corporation by transferring corporate assets to themselves on unfair terms. Because the rule prevents a controlling shareholder from cashing out her position completely (at a high premium), she will be bound to take the plight of minority shareholders into account when parting with a part of a control block. Nevertheless, against these alleged benefits, the rule imposes significant costs. An existing controlling shareholder might not want to hold any equity after control is relinquished. If so, he will be forced to either to take a more modest control premium (i.e., to the 115% ceiling) or to encourage the acquiror to buy all of the outstanding shares. In tandem, both effects operate in the direction of increasing the cost of control transfers, thereby discouraging their frequency.

We believe that the problems occasioned by entrenchment of lacklustre controlling shareholders are significant and severe. Therefore, we think that a more appropriate way of dealing with the prospect of *ex post* looting by an acquiring shareholder is through the various disclosure and review mechanisms we have identified above in our discussion of controlling shareholders. We believe that such selective, substantive review, backed up by shareholder oversight, will provide effective and more nuanced constraints on self-dealing activities by acquiring shareholders. We are also dubious of the claims to equal sharing of control premia rooted in general ethical norms or in specific shareholder expectations. In robust, efficient capital markets, the price of a company's shares will include a discount for minority status.

Policy Implication XX: *The application of the takeover rules in provincial securities legislation to friendly sales of control should be revoked.*

Disclosure

Although we do not feel the use of a certain threshold of ownership, like 20%, to trigger a mandated takeover bid for 100% of a firm's stock is economically defensible, we do feel the disclosure of large shareholders' stakes is reasonable. Minority shareholders need to know who the large shareholders are, and the public should know which companies are subject to influence by which institutional investors.

In the United States, section 13d of the Williams Act requires the stakes of all shareholders who own more than 5% of a publicly traded firm to be disclosed. In Canada, disclosure is only required of stakes greater than 10%. This means Canadian shareholders and managers often do not know who the shareholders of the corporation are. In the U.S., investors reaching the 5% threshold must declare their intentions if they are launching a takeover. This makes sense because most U.S. firms are widely-held and shareholders with stakes greater than 5% are rare compared to here.

Rule 13d is criticized because early disclosure of a takeover in the works causes the share price to rise, making pursuing the takeover more expensive for the acquiror. In Canada, provincial requirements that trigger automatic takeover bids for 100% of a company's stock when an investor's stake exceeds 20% create the same problem. In both cases, attempts to protect small shareholders may actually have harmed them by deterring takeovers.

A very large body of empirical work, alluded to throughout this volume, supports the claim that the possibility of a takeover stimulates good corporate governance. This means takeovers must be a credible threat to poor managers. Thus, the public interest is served by allowing secret accumulation of stock in preparation for a takeover.

There is an offsetting public interest in the full disclosure of significant shareholdings. In the highly concentrated Canadian economy, many large public pension funds in Canada have quite staggering clout. In some of the largest widely-held corporations in Canada, single pension funds own between five and ten percent of the outstanding voting stock -- sometimes even more. Inevitably, as these institutions become more activist, the sheer size of their holdings will raise important and legitimate concerns regarding concentrated economic and political power. In this respect, we believe that the harsh glare of public scrutiny is the best way to ensure that institutional investors, like the corporations in which they have invested, are operating in a constructive and responsible manner. Therefore, we propose the following.

Policy Implication XXI: *The identities and stakes of all shareholders holding in excess of 5% of the voting shares of Canadian public companies should be disclosed.*

We do not recommend that a 5% stake trigger a bid for control. Nor do we recommend that it mandate a declaration of intentions regarding a possible future takeover.

Banks and corporate governance

In Germany, Japan, and some other countries, banks own large blocks of stock and play an active role in the governance of nonfinancial companies. It is common in these for directors to be appointed by banks and for banks to be intimately involved in the strategic and tactical decisions of firms whose stock they own. Sheard, Kang and Shivdasani, Kaplan and Minton, and others argue that this bank oversight is a powerful stimulus to good corporate governance and that it might largely obviate the need for takeovers, pension funds, etc. However, Hoshi, Kashyap and Sharfstein (1988) and Morck and Nakamura (1994) present less rosy views of this system, arguing that it effectively entrenches a network of insiders and depresses share prices. The chapter by Morck and Nakamura in this volume traces the somewhat tainted historical development of bank cantered financial systems in Germany and Japan, and examines some of the potentially serious problems of such systems.

Could more equity ownership by Canadian banks improve corporate governance here? The chapter by Amoaku-Adu and Smith finds no consistent pattern in Canadian data relating firm performance to a firm having directors affiliated with financial institutions. The chapter by Morck and Nakamura finds a negative relation between firm performance and the presence of directors affiliated with Canadian banks. Although this could reflect banks and other financial institutions taking a more active role in the governance of troubled firms, and thereby perhaps performing a useful service, we must conclude that there is no compelling evidence supporting a broader role for banks or other financial institutions in Canadian corporate governance. It is probably more socially useful to explore other options for improving corporate governance here.

Policy Implication XXII: *Banks' role in corporate governance should not be expanded.*

Public Policy Objectives and Corporate Governance

The decisions of Canada's large corporations can either support or undermine governments' abilities to pursue their objectives. In the past, governments have used targeted taxes and subsidies to influence firms' decisions. This has caused enormous increases in the complexity of the tax code, leading many to conclude that it is hopelessly capricious. Recently, some have advocated using director liability as an alternative tool to achieve social policy objectives.

The chapter by .Nakamura, Cragg and Sayers argues that this is an inefficient approach to realizing such objectives. All the arguments for precise and well-defined liability raised in the section of this chapter on director liability apply in spades here. Exposing directors to liability for back wages, environmental damage, or failure to achieve social policy objects is likely only to deter competent directors from accepting seats on board. Directors must be able to control the things for which they are made liable.

We believe mandated disclosure relating of firms' contributions to public policy objectives is a much more appropriate course. It is also likely to be more effective.

For example, it is commonly alleged that North American shareholders have short time horizons and that this results in lower R&D spending than in Japan or other countries where managers are free to have long term outlooks. The chapter in this volume by Giammarino presents fairly conclusive evidence that R&D spending raises share values, not just in the long term, but immediately. Thus we have a case where both public policy and shareholders appear to want more R&D spending. The absence of a requirement that Canadian firms disclose their R&D spending serves only to protect managers of firms that do little R&D from scrutiny by shareholders. We therefore suggest the following.

Policy Implication XXIII: *Firms should be required to disclose their research and development spending. Those that do no R&D should be required to say so.*

We believe other social policy objectives might be approached the same way. If worker retraining is a national priority, companies might be required to disclose their annual spending on this. If the social policy objective is actually important to the public, consumers can choose to support companies with their business in response to their disclosures.

Governance in Non-Profit Enterprises

The chapter by Hirshhorn raises the issue of accountability in not-for-profit firms. Increasing fiscal pressure on all levels of government makes improved governance at not-for-profit institutions like hospitals and universities critical. There is also growing reliance on not-for-profit delivery of goods and services due to the increasing willingness of the state to contract out certain public goods and services to the third or not-for-profit sector. Thus, we think it incumbent upon Canadian governments to undertake a comprehensive review of the adequacy of the legislative framework for nonprofits to determine the adequacy and effectiveness of the mechanisms of accountability to both donors and beneficiaries. This legislation should be updated regularly in light of changing practices and demands.

Policy Implication XXIV: *Both the federal and the provincial governments should establish special advisory committees composed of professional advisors to and representatives of various not-for-profit organizations, as well as independent experts, to review and suggest changes to legislation concerning the governance of nonprofit institutions such as public service organizations, hospitals and universities.*

Hirschhorn's suggestions of independent reviews and stringent reporting requirements for nonprofits should serve as a starting point for such a review. A central issue the review should address is to whom should the directors of a nonprofit organization be accountable. Should hospitals be run in the interests of patients (the customers), physicians (the skilled workers), or taxpayers (the providers of capital)? Should the directors of nonprofit organizations have fiduciary duties toward any of these parties? A comprehensive examination of the governance of Canada's hospitals, universities, crown corporations, and other nonprofit organizations is long overdue. The motivation for such an endeavour should not be any allegation of wrongdoing or waste, but the simple facts that these institutions are tremendously important and that government is running out of money.

Arbitration

If shareholders' rights and pension fund beneficiaries' rights are to have any real content, they must be enforceable at reasonable cost and in a reasonable time frame. The various proposals we have advanced in this chapter aim at creating new legal rights and obligations and at clarifying and sometimes modifying old ones. Canada's legal system is already cumbersome and clogged. We do not want new corporate governance rules to merely add to the logjam.

We are also sceptical of the current adversary legal system's ability to provide fair, prompt and reasonable settlements to corporate governance disputes. Long and costly legal battles deter shareholders from challenging corporate insiders. Since the managers can use the shareholders' money to pay legal bills, they have greater staying power. The formal legal system tips the balance too far in favour of big players.

The United Kingdom has developed an interesting way of dealing with this problem. The Cadbury Report, a detailed investigation into British corporate governance, established arbitration, rather than the formal adversary legal system, as the way to resolve corporate governance disputes. We feel a system of compulsory arbitration would be sensible here too.

Policy Implication XXV: *Corporate governance disputes should be settled by arbitration. They should only enter the legal system if the arbitration process is not properly followed.*

One option is for government to mandate compulsory arbitration. An alternate approach, more *laissez faire* in style, would let firms include clauses in their corporate charters binding them, their directors, and their managers, to the decisions of arbitration committees. Shareholders would then be informed in prospectuses, proxies and annual reports about whether the firm has so bound itself. Shareholder pressure would probably quickly result in near universal acceptance of arbitration.

The arbitration committees should follow the laws and regulations established by governments. In corporate governance disputes, some variant of the following process might be used. The two sides might each name one arbitrator, and the two arbitrators might then name a third. Arbitration committees could then hear and rule on corporate governance disputes quickly and cheaply. Analogous systems could be established to arbitrate disputes about pension fund governance.

A Public Policy Philosophy on Corporate Governance

The accelerating integration of world financial markets is fast making distinctions between the corporate governance systems of different countries irrelevant. If Canadian companies fail to provide adequate corporate governance, Canadian investors will simply move their money abroad. Canadian companies will soon be forced to compete with rivals from all over the world. The company with the best governance, all else equal, will win. Therefore, the best way for the Canadian government to improve corporate governance in this country is to open Canada up to international competition quickly rather than slowly, and to prevent poorly governed firms from surviving off subsidies or other government favors.

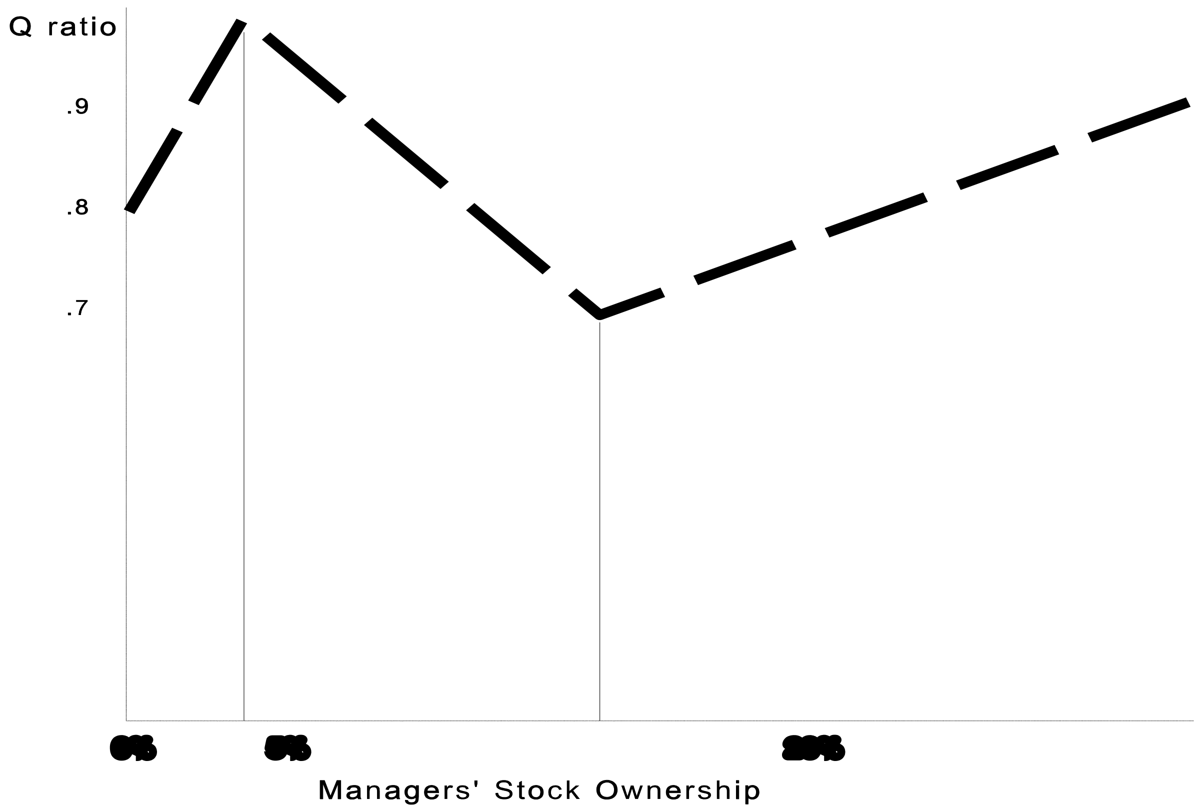
Coercive corporate governance rules should be used to promote general societal goals like more R&D, increased worker training, or low unemployment. The goal of reducing unemployment was not served by Ontario's rules making directors personally liable for back wages. The only effect was to encourage directors to resign when they feared the firm might be nearing trouble. But those are precisely the times when having a well functioning board is most important. R&D spending has been fairly conclusively shown to increase share values, not just in the long run, but immediately. The link between a well trained work force and high share prices is less well documented, but common sense says it should exist too. By first getting the legal and economic environment right and then letting boards, C.E.O.s, institutional investors, and other players in corporate governance focus on boosting share prices, government will indirectly promote these broader goals.

Therefore, most of our specific recommendations are different ways of saying "do not interfere too much in firms' internal affairs". Do not legislate the structure of the board or its size; do not favor any particular ownership structure; etc. If government sticks to free market policies, Canadian firms will find that better corporate governance is in the card whether they like it or not.

A free market economy depends on visibly fair legal and economic systems. For political and historical reasons, concentration of economic power is a concern in this country. It is therefore reasonable to require full disclosure and outside oversight where there is a possibility of unprincipled behavior by powerful insiders. It is for this reason that whistle blowers should be protected. It is why we advise full disclosure of compensation paid to insiders. It is also why we strongly recommend that conduct committees review non-arms-length transactions, and that the details of such transactions be disclosed.

In the global economy, no country can make its corporate governance laws too onerous without encouraging companies to find other friendlier jurisdictions in which to do business. It cannot make them too lax or investors will find other places to buy stock. This balance imposes a comforting, practical constraint on law makers.

Figure 1. The relation between management equity ownership and firms' Q (or market to book) ratios for large U.S. firms.



source: Morck *et al*. (1988).

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