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SHAREHOLDER DEMOCRACY IN CANADA

Randall Morck

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ABSTRACT

The federal government stands poised to exercise its constitutional right to regulate financial markets, an area traditionally left to competing provincial securities commissions. The current state of securities regulation renders impotent US-style takeover defences, such as poison pills and staggered boards, but allows voting caps and pyramiding in their stead. Various federal securities regulation models are weighted in light of the current state of their needed complementary institutions. One option, for which Canada is relatively well prepared, is the British model of activist independent institutional investors and mandatory takeover bids.

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Introduction

Democracy matters. Political democracy lets voters remove politicians whose policies or ethics displease them. Economists increasingly appreciate that shareholder democracy also matters. Economies generate greater prosperity if small shareholders can remove top insiders corporate whose policies or ethics displease them. Like political democracy, shareholder democracy works differently in different countries, and shareholder democracy in Canada is remarkably stunted compared to that in the United States and United Kingdom, despite a shared Common Law heritage.

This democratic deficit matters. Millions of middle-class Canadian savers now shares. Canadian workers have amassed huge pension funds since the 1970s, and these funds are now major shareholders in great Canadian companies. As First Nations win large land rights settlements, they too are becoming potential major players in the stock market. Shareholder democracy could be a major tool for empowering not only workers and retirees but previously marginalized elements of society and the whole of the middle class.

In theory, big business in Canada should be more democratic than ever, and more democratic than American big business. Canadian institutional investors are huge and growing. Workers' pension funds and middle-class investors should be voting CEOs in and out of office, demanding explanations, and marching corporate auditors to and fro. Canadian courts and regulators have emasculated the poison pills and staggered boards that limit American shareholders' power over American corporate managers (Gompers, Ishii and Metrick 2003; Bebchuk and Cohen 2005), so Canadian corporations should be more democratic than their American cousins.

In practice, the typical big Canadian corporation is arguably less democratic than in the past, and less democratic than its peers in both America and Great Britain. This is because corporate insiders dominate the shareholder meetings of listed Canadian firms to an extent generally not seen in either the United States or the United Kingdom, and because Canadian legislatures, courts, regulators, and exchanges accept and passively perpetuate this.

Shareholder democracy, like political democracy, is not an end per se; but a means to ensure good governance. If a benevolent dictator created a paradise on earth, citizens might acquiesce to a dearth of plebiscites; and if dictatorial tycoons' corporations were unrivalled creators of wealth, high-paying jobs, and tax revenues, a democratic deficit in their shareholder meetings might be acceptable. But a large and growing body of evidence shows Canadian corporations underperforming across the board.

This is no coincidence, for much empirical evidence links shareholder democracy to firm and economy performance. Top corporate insiders who are more accountable to shareholders appear to deliver better firm performance in the United States, across countries, and in Canada.

This chapter argues that Canada's lawmakers and courts seem little concerned about shareholders meagre rights, but deeply worried that influential corporate insiders might object to stronger oversight. With federal securities regulation on the horizon, reforms to enhance shareholder democracy are feasible as ways to invigorate the economy – elevating shareholder wealth, creating jobs, and fattening the government tax coffers that pay for social programs.

The Performance of Canada's Corporate Sector

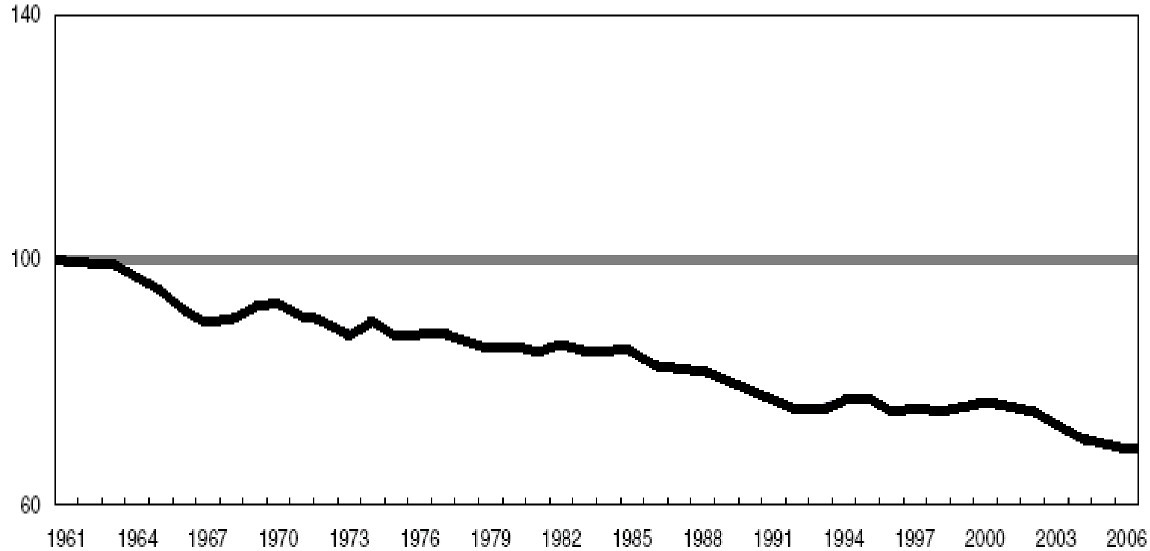
Despite escaping the worst effects of the 2007 financial panic, Canadian firms have a long track record of underperformance relative to their American peers. A firm's performance can be measured in many ways, and Canadian big business is remarkably consistent in underperforming across alternative measures.

One set of metrics gauge firms' *productivity*: their ability to turn given amounts of inputs, including labour and capital, into more economically valuable outputs. Economists favour this measure because it accords with their notion of efficiency as avoiding waste. Using the country's workforce and savings to produce fewer or shoddier goods and services than could be produced is wasteful, and thus poor corporate performance.

Figure 1 summarizes Canadian firms' lagging productivity. Canadian firms need more inputs – workers and physical capital – to produce the same output as their US rivals. The figure shows a deficit against not just America, but against all other major industrialized countries too. The deficit is clearly not a data fluke – it is evident across many different techniques for measuring productivity (Baldwin, Gu and Yan 2008). It's not that American firms are unusually productive: something is retarding Canadian firms.

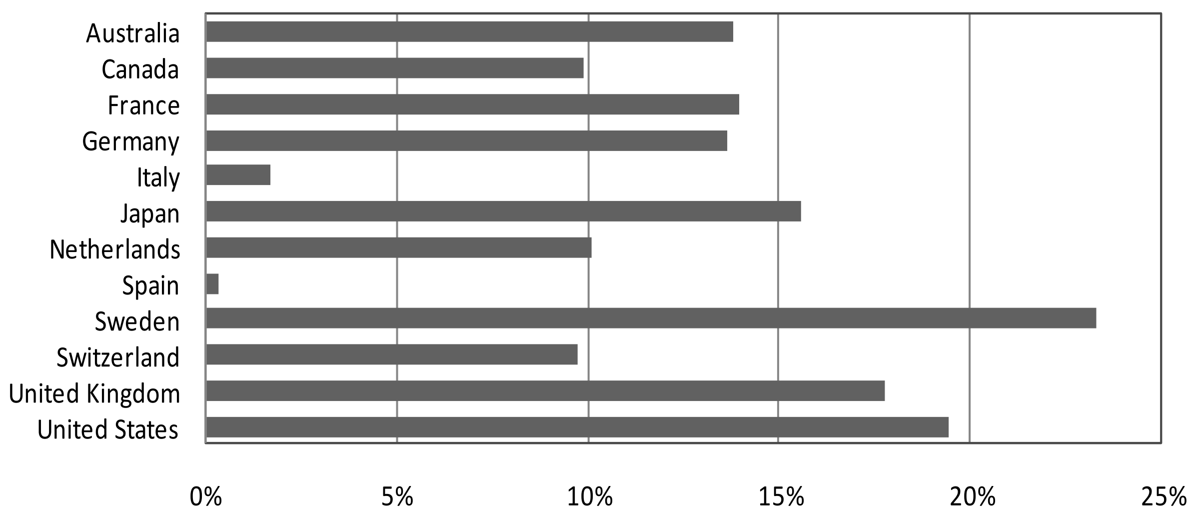
Though ardent neoclassical economists might dissent, productivity is not always the best performance gauge. Perhaps Canadian businesses are less productive, but excel in other ways?

FIGURE 1
Productivity
A. Relative Total Factor Productivity, Canada vs. the United States over Time, Both Set to 100 in 1961



Source: Statistics Canada (2007), Catalogue no. 15-206.

B. Percentage Growth in Total Factor Productivity, Canada vs. Other Major Industrialized Countries from 1995 to 2008 or most recent year.



Total factor productivity measures the increase in "value-added" by each country's business sector over and above the cost of its inputs. Higher productivity growth means a country's businesses are making higher value outputs, using lower value inputs, or both. Productivity is a central measure of the extent to which a country's business sector is contributes to overall economic prosperity. Data are available through 2008 for all countries except for Australia, Japan, the Netherlands, Switzerland and the U.K, whose data ends in 2007.. *Source*: www.oecd.org.

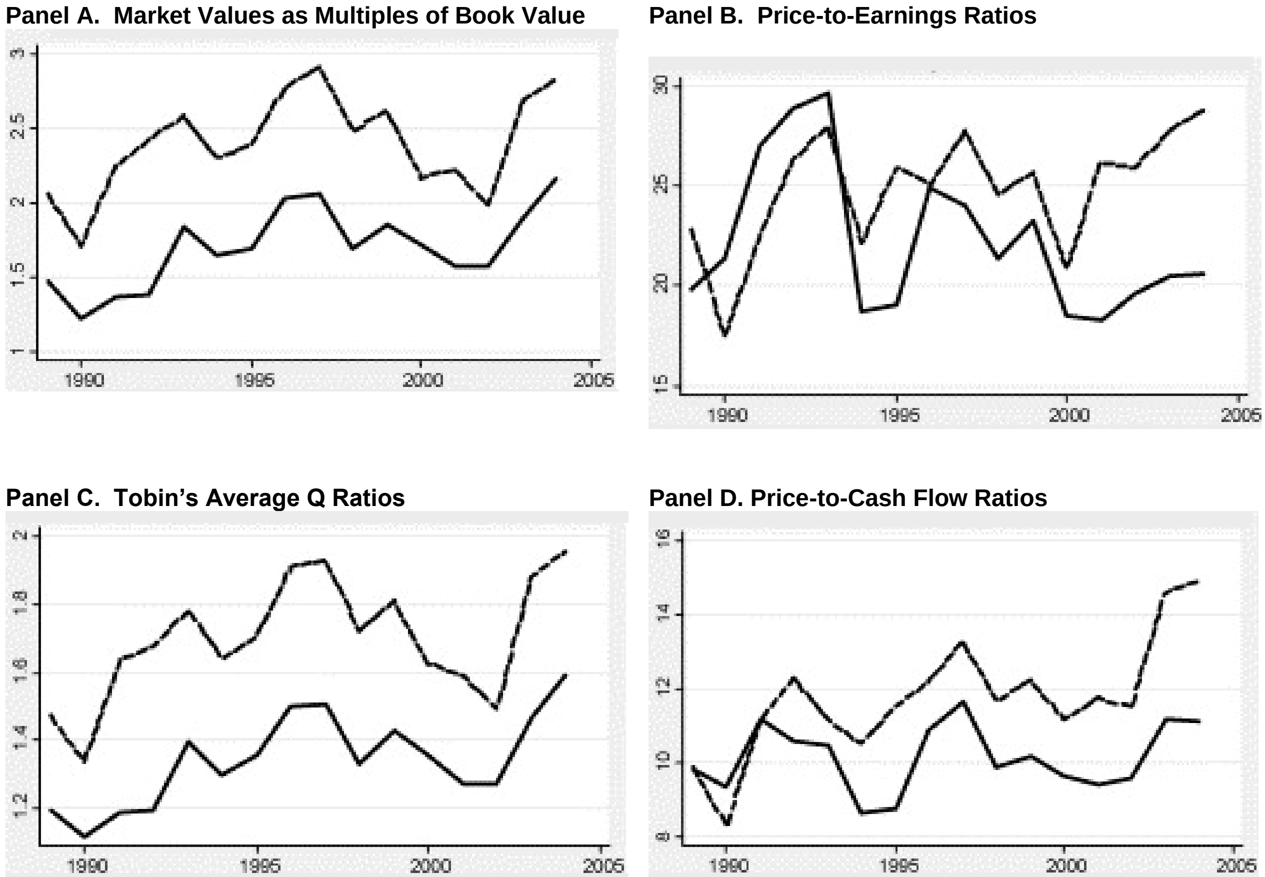
One alternative performance measure is *shareholder value* – how high the share price is relative to what it might be under the best possible management. This metric seems as obvious to financial analysts as productivity seems to neoclassical economists – shareholders own businesses, this metric says businesses should be run to make shareholders rich.

Perhaps Canada's firms are less productive but create more wealth for their shareholders? This too can be checked. Figure 2 summarizes a recent study contrasting the shareholder wealth created by listed Canadian firms to that created by comparable listed American firms. It shows that Canadian firms are markedly less effective at creating shareholder value.

But shareholder value creation, like productivity, might still not be the right metric. A recent film entitled *The Corporation*, based on the book *The Corporation: The Pathological Pursuit of Profit and Power* by Joel Bakan, and starring Elaine Bernard, Paul Weiler's colleague at Harvard Law School's Labor and Worklife Program, delightfully pillories a narrow-minded focus on shareholder value. The film holds that ethical judgment, not blind pursuit of profit or wealth, should motivate those entrusted with the governance of a country's great corporations.

This conclusion is hard to argue with, but easy to argue about. Of course, corporations should be run ethically, but what does that mean? The most outspoken advocates of ethical behaviour in any country are often its most religious citizens, but no one would seriously advocate turning Canada's great corporations over to priests or ministers, let alone televangelists. An ethical metre-stick of corporate performance needs to be both easily readable and marked in a way acceptable to the majority of citizens in a democracy. At present, we are in only the earliest stages of building a better metre-stick.

FIGURE 2
The Canada Discount: Shareholder value of Canadian Firms (Solid lines) Versus US Firms (Dotted Lines) of Similar Size and in Similar Industries, 1989–2004.



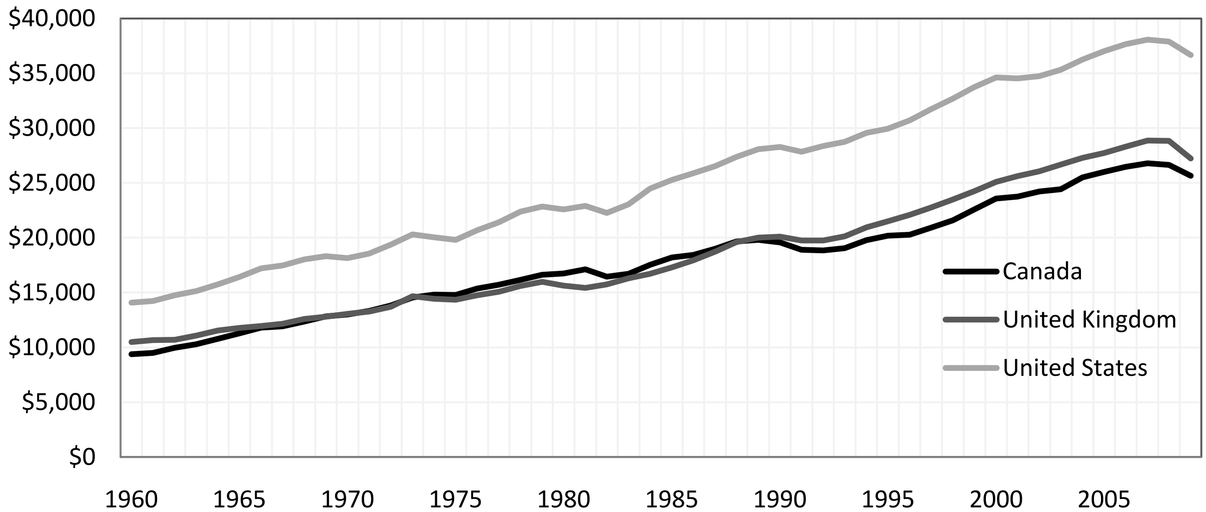
Shareholder value is expressed relative to four commonly used benchmarks. Panel A presents mean ratios of shareholder value over book value of assets. Panel B uses mean price-earnings ratios, estimated as calendar year-end share price over earnings during the previous 12 months. Panel C presents Tobin's average q ratios, estimated as total assets plus market value of equity minus book value of equity, scaled by total assets. Panel D displays price-cash flow ratios, computed as the sum of long-term debt, debt in current liabilities, preferred stock and market value of equity scaled by operating income before depreciation. In all cases, stock prices are at calendar year-end and balance sheet items are at the most recent fiscal year-end. *Source*: King and Segal (2008).

Such a metre-stick ought perhaps to consider how well a firm serves its employees. This too can be measured. Perhaps Canadian firms post lower productivity and generate less shareholder wealth but pay their employees more. But Figure 3 shows Canadian per capita income below that of the United States, and hovering at levels comparable with those of Britain.

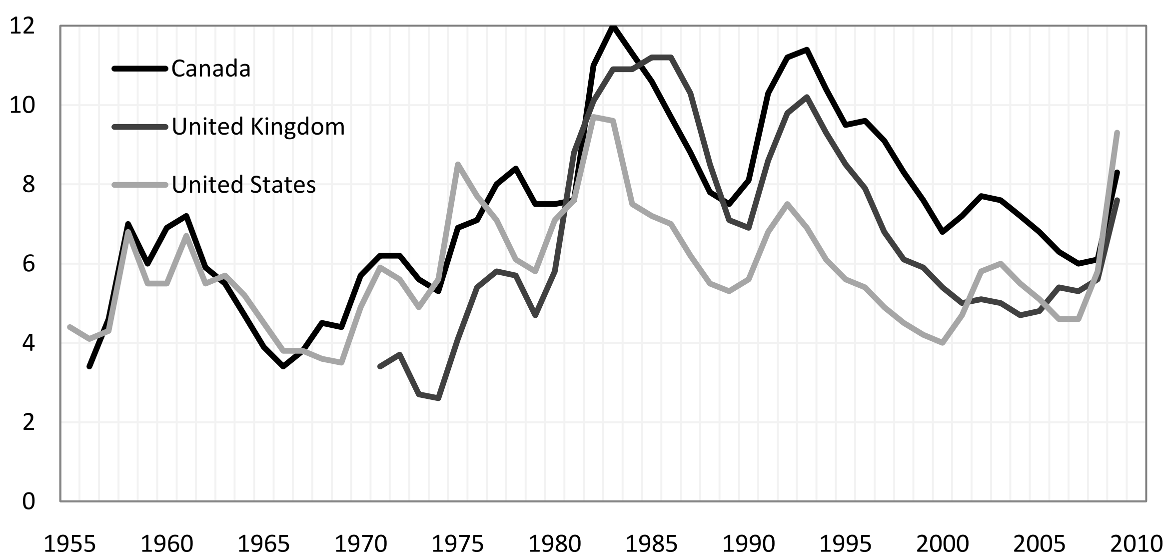
Another possible metric is overall employment. Perhaps Canada's great corporations post low productivity, generate little wealth for their shareholders, and pay their workers less, but keep more workers on to limit unemployment. This too can be checked. But Panel B ofFigure 3 shows Canada's unemployment rate worse than in either the US or UK until the recent crisis.

FIGURE 3
Canadian Wages and Unemployment Rate Compared

A. Real Per Capita GDPs, in Constant 2000 US dollars at of Canada and the United States, , Converted to Constant 2000 US Dollars at Purchasing Power Parity



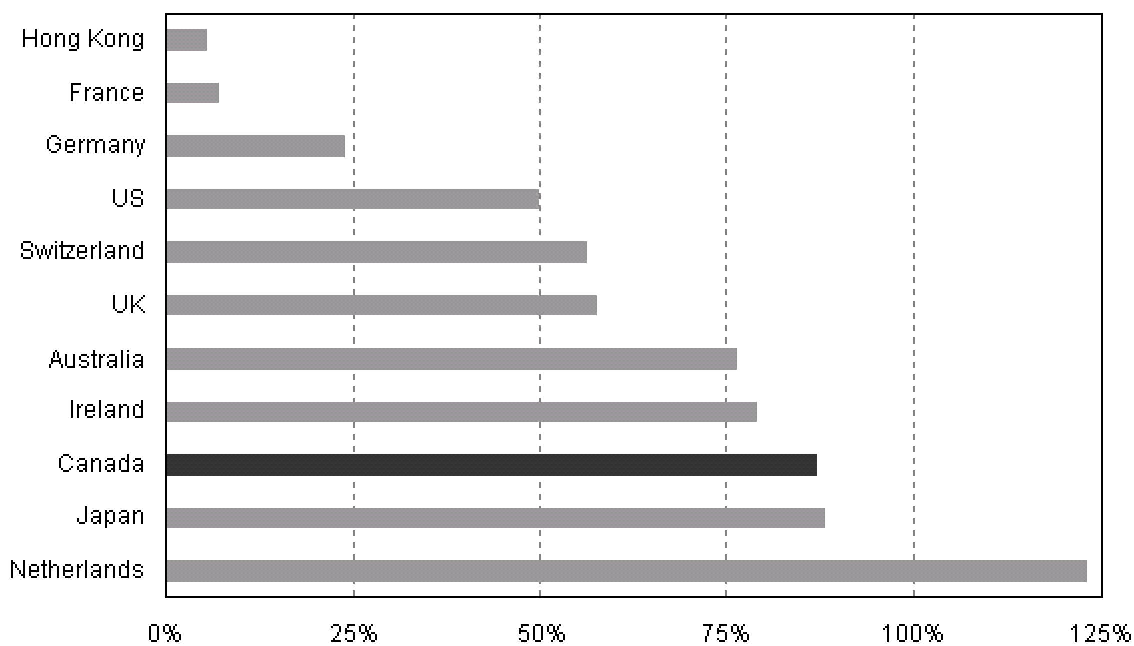
B. Unemployment Rates, in Percent, of Canada, the United States, and the United Kingdom



Source: Data in Panel A are from the World Bank's WDI database; those in Panel B are from the OECD.

Of course, these metrics too can be challenged. Shareholders also have jobs and earn wages from their employer. Workers are also shareholders via their pension funds and savings. Pension funds now account for a huge fraction of the total savings of the Canadian economy. In fact, Figure 4 shows that workers' pension funds are actually larger in Canada than in the United States or United Kingdom, relative to the size of the economy. Workers, like other shareholders, may well see shareholder value maximization, constrained by the laws of Canada and the ethical standards of Canadians, as a decreasingly radical idea. If anything, aging Canadian workers ought to be increasingly concerned about pension fund portfolio values.

FIGURE 4
Canadian Pension Funds Compared



Pension fund assets as fraction of total stock market capitalization for selected developed economies. *Source:* Pension assets are from Watson Wyatt and various secondary sources, as reported in the FEI *Canada Accounting & Finance Review*, February 2006. Market capitalizations are from the World Bank's World Development Indicators database.

The list of possible performance metrics is endless, and almost anything is admissible. For example, value-destroying firms may truly be extremely well run and entirely worth their shareholders' quiet respect. Jesus teaches that "love of money is the root of all evil," and perhaps Canadians appreciate the freedom from evil brought by low productivity, anaemic wealth creation, low wages, and high unemployment. But such saintliness seems implausible in the land of the Winnipeg General Strike.

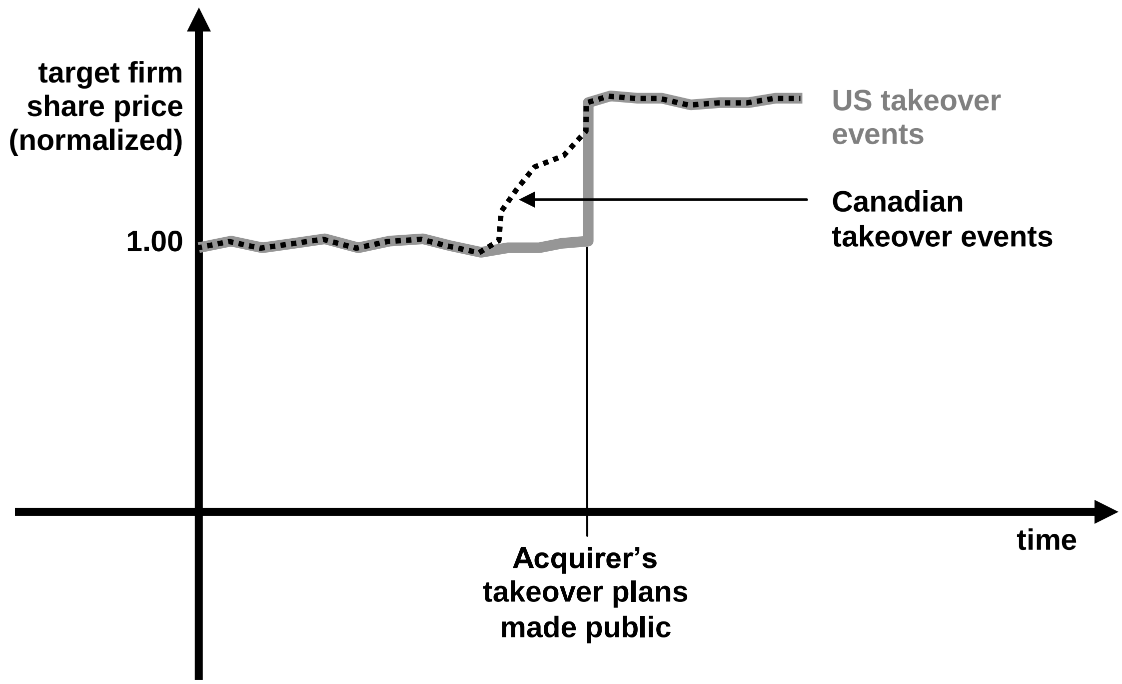
It's Nice to Be an Insider in Canada

In the 1980s, studies by Eckbo (1986; 1988) raised eyebrows by contrasting stock price movements around corporate takeovers in Canada versus in the United States. The solid grey line in Figure 5 epitomizes the well-known pattern in the United States (Westin, Mitchell, and Mulherin 2004), tracing out how the target firm's share price moves relatively little until the bidder makes a public announcement that a takeover is in the offing, whereupon the target firm's stock price shoots up – often by 30 percent or more within minutes.

The economics behind this price increase are complicated, but in many cases boil down to the acquirer firm's top mangers being expected to operate the target firm more efficiently, or at least less inefficiently.[1] Except in leveraged buyouts in the 1980s and 1990s, this efficiency gain does not seem detrimental to workers – acquired firms do not fire workers or cut wages relative to otherwise similar firms that remain independent (Shleifer and Summers 2000; Westin, Mitchell, and Mulherin 2004). Overall, the empirical evidence shows that shareholders do better, and workers no worse, if firms are more vulnerable to takeovers.

[1] For a full explanation of the economics, theory and evidence, supporting this view, see Westin, Mitchell, and Mulherin (2004).

FIGURE 5
Corporate Takeovers in Canada and the United States



Upon the news that it may be a takeover target, a firm's share price rises markedly. In the United States this increase occurs in the minutes or hours immediately following the announcement. In Canada the target price generally begins rising sooner. *Source:* Graphical summary of findings in Bris (2005); Eckbo (1986; 1988); Jensen and Ruback (1983).

For our purposes, the key revelation is that the target firm's share price holds steady and then shoots up once investors learn that a control change is in the works. This contrasts markedly with the dotted black line that traces out a stylized Canadian corporate takeover. Here the target's share price slowly levitates upward during the two to three months before the takeover is announced and then moves relatively little when the plans are made public. Eckbo (1986, 1988) interprets this as evidence of more energetic and lucrative insider trading in Canada.

Remarkably, a recent study (Bris 2005) shows little change in two decades. In fact, after comparing statistically meaningful samples of takeovers on each of the world's active stock exchanges, he reports that Canada permits the most lucrative insider trading in any developed economy. American courts routinely prosecute top corporate insiders for trading on inside information, and even jail the occasional home decorating guru like Martha Stewart. But Canada, with insider trading laws that read much like those in the United States, did not see its first genuine criminal conviction for insider trading until 2010.[2]

After I mentioned this anomaly in a seminar for senior Canadian business leaders, one explained why it was good for the country. First, he clarified, if shareholders really didn't like it, they could sanction the corporate insiders at the next shareholders meeting. Second, he continued, since Canadian top corporate insiders make a bit extra on the side by trading in their firm's stocks, they accept lower salaries. Neither point, unfortunately, can be tested. Canadian top corporate executives, unlike their American peers, have not faced firm requirements to disclose their insider trades until 2010, and still need not make public their individual compensation packages.

Limits on Shareholder Democracy in Canada

Shareholder democracy in Canada is free of staggered boards – one of its major constraints in the United States. Staggered boards let shareholders elect a third of the board to a three year term each year, and have gained popularity with US corporate insiders seeking to limit the power of outside shareholders. By forcing dissidents to wait two years to replace a majority of the board and three years to replace it entirely, staggered boards effectively entrench insiders to an extent sufficient to significantly depress shareholder value in the affected firms (Bebchuk and Cohen 2008).

[2] See In The Matter of the Securities Act, R.S.O. 1990, C. S.5, As Amended v. Stanko Joseph Grmovsek and Gil I. Cornblum, 2009). A mining company executive was previously convicted of insider trading as a lesser charge to fraud and, upon appeal, sentenced to 6 months and fined C$1 M (In the Matter of the Securities Act R.S.O. 1990 c. S 5, as amended v. Glenn Harvey Harper, 2004) in connection with a mining stock fraud, whose principal perpetrators remain unknown (Sergeant 2006, p. 64).

In Canada, staggered boards are ineffective because federal and provincial corporations laws let shareholders demand emergency meetings at any time, at which all directors can be replaced; and these provisions trump any charter amendment to the contrary. This enhances the power of shareholders against hired managers. However, if the managers please controlling shareholders, outsider shareholders can be ignored in many cases. A far greater proportion of major firms have controlling shareholders in Canada than in either the United States or United Kingdom, so unhindered shareholder power to hire and fire the board might properly be translated as unhindered power for the controlling shareholder to appoint the board.

This has implications for the Canadian economy because previous work shows that firms with entrenched controlling shareholders underperform (Morck, Shleifer and Vishny 1988; McConnell and Servaes 1990: Morck, Stangeland and Yeung 2000) and that economies in which most large firms have controlling shareholders underperform (Morck and Yeung 2004; Morck, Weinstein and Yeung 2005; Fogel 2007).

Shareholder value is especially compromised where the controlling shareholder commands a dominant block of votes without actually owning a proportionate fraction of the firm's shares (Smith and Amoako-Adu 1995; Gompers, Ishi and Metrick 2010). This happens in two ways in Canada.

First, a number of Canadian firms have used so-called dual class shares (Amoako-Adu and Smith 1995, 2001) to magnify insider shareholders' voting power until it eclipses that of outsider shareholder.[3] The firm sells one class of shares, usually called *restricted voting shares*, to the general public. These shares might give their owners one vote per share at the firm's shareholder meeting. The firm simultaneously provides its insiders with a different class of

[3] Dual class shares also exist in the United States and elsewhere. However, they were prohibited on the New York Stock Exchange for many decades, and so fell out of favour among firms desiring a "blue chip" reputation. See Gompers, Ishii, and Metrick (2010).

shares, usually *called superior voting shares*, which give their owners many votes per share. This practice means that even if the majority of a company's shareholders dislike the company's top insiders, they can lack the voting power to do anything about it. Insiders increasingly disproportionate voting in dual class firms has attracted criticism, and pressure to unify their equity into a single class (Smith and Amoako-Adu 2001).

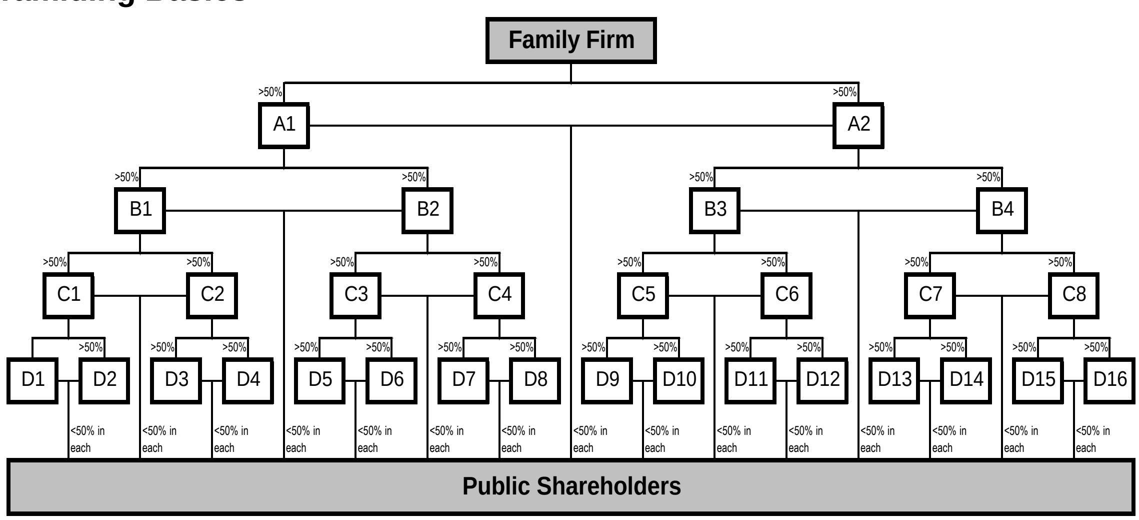
Such a case played out in 2010, Ontario courts and regulators let Magna controlling shareholder Frank Stronach cash in his superior voting shares at a 1,800% premium after 57% shareholder vote to allow it, despite the vocal objections of pensions funds with stock in the firm. The problem with a simple vote on such an issue is that, even if insiders cannot vote, they frame the question: the issue was not to eliminate the insiders' superior voting rights or not, but to eliminate them with a huge payment to the insiders or retain disproportionate insider control for the foreseeable future. We cannot know how shareholders might have voted given a third option, such as the removal of the insiders'' superior voting rights at a premium set by a disinterested third party.

Second, many Canadian firms without dual class shares still have controlling shareholders, typically very wealthy and well-connected, old-moneyed families. These families sometimes command an effective majority through direct ownership of a large voting block, but often employ a practice called *pyramiding*, to enhance their voting power.

Figure 6 explains how pyramiding magnifies substantial fortunes into control over large groups of seemingly distinct corporations that, together, are worth vastly more. A wealthy individual or family controls enough stock to dominate the shareholder meeting of one listed firm – that at the apex in the figure. This firm, in turn, controls equity blocks sufficient to dominate the shareholder meetings of a second tier of listed firms. These, in turn, each hold control blocks in listed firms in a third tier. As many tiers can be added as the apex firm's controlling shareholder desires, and each additional tier exponentially increases the corporate assets that shareholder controls. Pyramiding thus creates artificial controlling shareholders in firms that are really primarily capitalized by outside shareholders such as pension funds and small investors.

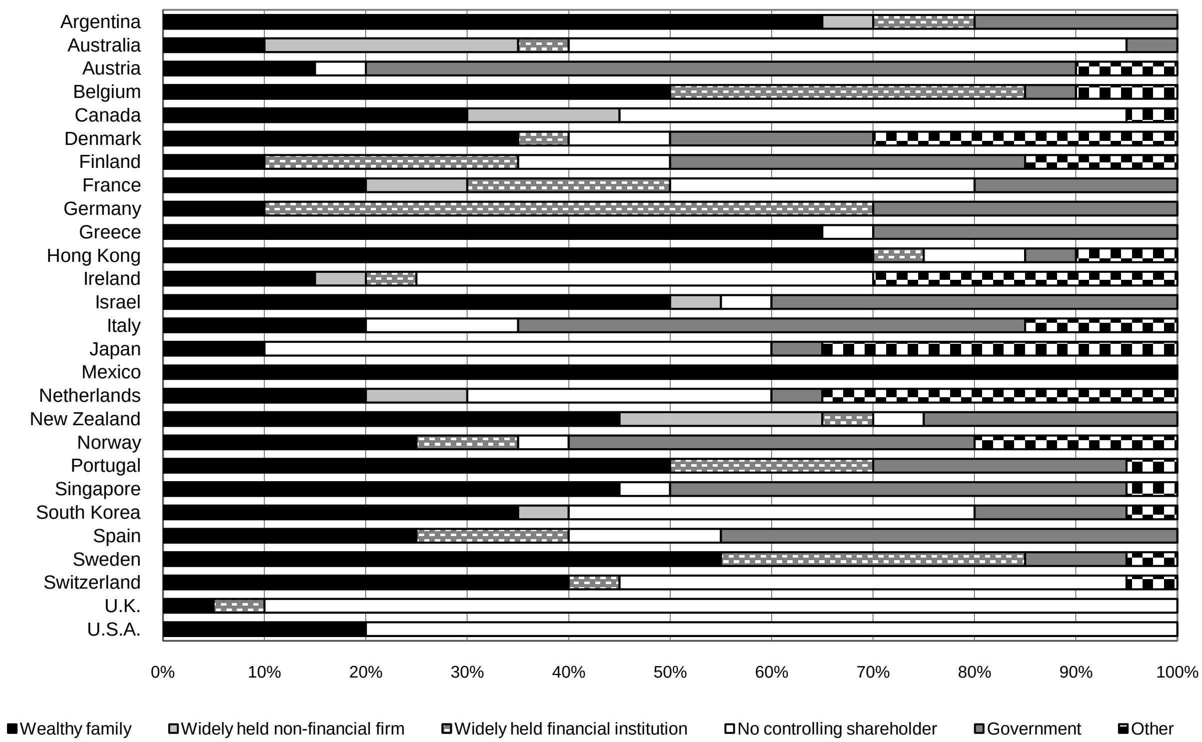
Pyramidal groups of this form are the structures that let small cliques of oligarchic families control the economies of many countries in Latin America, Asia, and continental Europe – especially Eastern Europe and Russia. This practice is essentially unknown in both the United States and United Kingdom, but widespread in Canada and throughout Asia, Latin America, and continental Europe (La Porta et al. 1998).

FIGURE 6
Pyramiding Basics



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

FIGURE 7
Controlling Shareholders around the World



The type of ultimate controlling shareholder, if one is present, in the 20 largest listed corporations in each country as of 1996. Control is inferred from a 10 percent voting block. Ultimate "controlling shareholder" means the person at the end of any chain of corporate controlling shareholders. The prevalence of controlling shareholder in Japan is probably understated because the stakes of equity holders who act together are not aggregated. Figures for Germany include proxy voting rights held by universal banks. *Source*: Baums (1996); La Porta et al. (1998).

Canada's Place in the World

Figure 6 shows that controlling shareholders are far more predominant among large Canadian firms than in either the United States or United Kingdom. Canada looks instead much like an Asian, Latin American, or continental European country in terms of the concentration of economic power evident.

Pyramiding is little known in the United States because the Depression era president Franklin Delano Roosevelt ended the practice as part of his New Deal. In a series of tax reforms, he applied double taxation to inter-corporate dividends. This made large pyramidal structures, in which dividends flow from firm to firm to firm, radically tax-disadvantaged. He also provided capital-gains tax incentives for firms either to absorb or spin off listed subsidiaries. To reinforce these tax sticks and carrots, he also pushed through the Public Utilities Holding Companies Act, which proscribed large pyramids from controlling firms in industries designated as "public utilities." Finally, his *Investment Companies Act* of 1940 subjected firms whose assets are mainly shares in other firms to the rules governing investment funds. The last was perhaps overkill, because pyramiding had largely disappeared from the United States by the late 1930s.[4] Still, Roosevelt's attack on America's robber barons, as the apex firms' controlling shareholders were then known, was politically popular – and was never reversed by subsequent administrations, including those of Ronald Reagan and the two Bushes.

Pyramiding disappeared from the United Kingdom after that country's pension funds successfully lobbied the London Stock Exchange to impose a *takeover rule* in 1968. That rule, later codified, required any listed firms' controlling shareholders to own either less than 30 percent of a firm's shares or all of them.[5] But Canada's Depression-era leaders showed no interest in emulating Roosevelt's drive to democratize business; and Prime Minister Trudeau, in power when the LSE rule came into effect, proposed no such thing for Canada.

Högfeldt (2005) argues that Sweden's left-leaning politicians embraced pyramiding because it simplified "business-government cooperation." A Social Democrat prime minister need only phone a few business family patriarchs to cement a deal with "big business." Perhaps Trudeau reached a similar conclusion, or perhaps nationalists in his circle persuaded him that entrusting the business sector to wealthy Canadian oligarchs was preferable to risking foreign

[4] For a detailed history of this legislation and its impact on the shareholdings structures of American businesses, see Morck (2005).
[5] This sequence of reforms is outlined in Franks, Mayer, and Rossi. (2005). Note that widely disbursed ownership was commonplace in Britain before this reform as well, though the reform clearly was intended to solidify shareholder democracy by ensuring that listed firms remain widely held.

takeovers. Or, the increased government interventionism of the Trudeau era and subsequent governments might have induced businesses to invest more in lobbying the government (Sawatsky, 1987), and large business groups controlled be old-moneyed and well-connected families might have been more effective lobbyers, and hence became favoured players. These suggestions are speculative, and a real answer awaits further research.

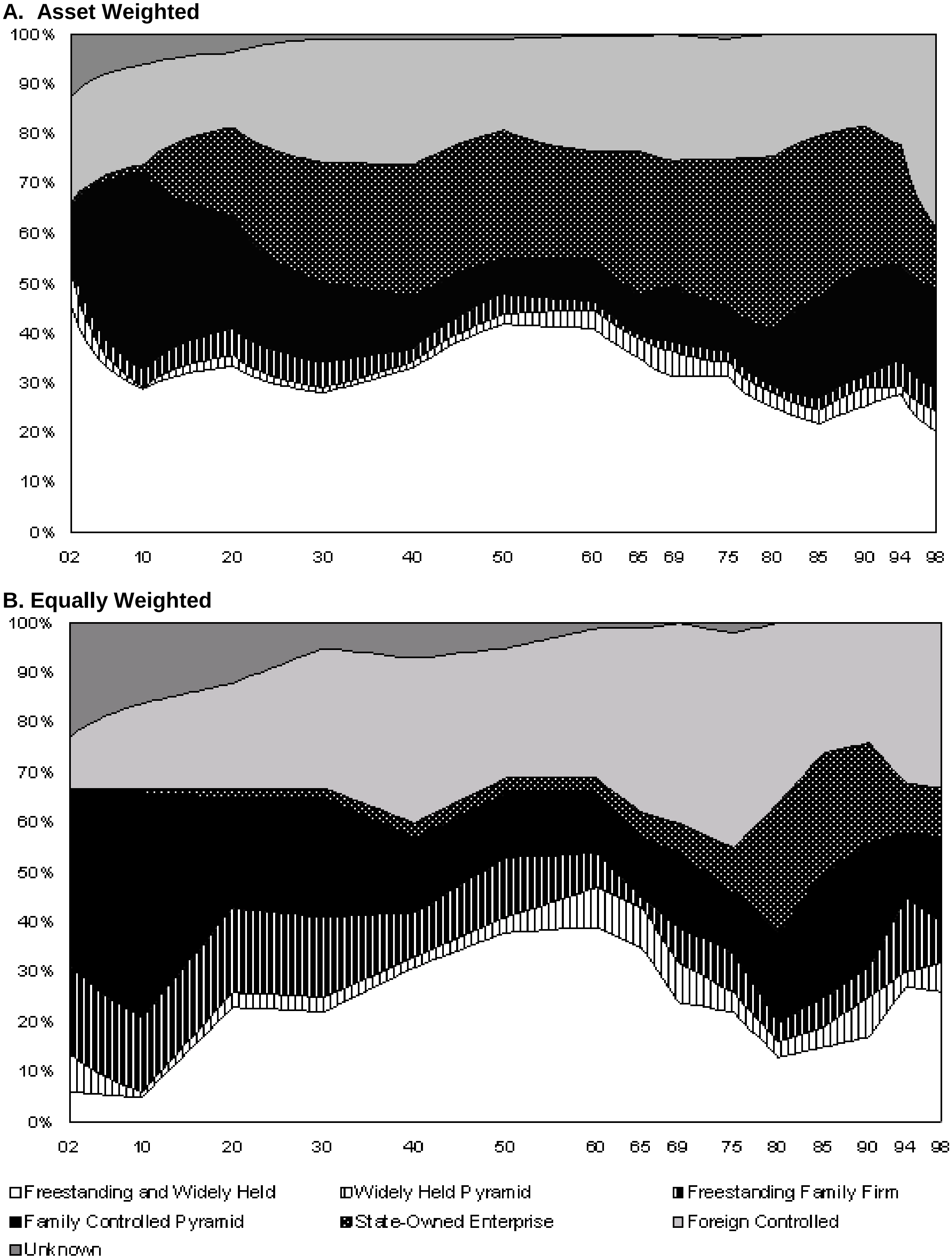
Regardless, a remarkable upsurge in pyramiding corresponds roughly to Trudeau's leadership of the Liberal Party. Figure 8 classifies Canada's 100 largest companies, ranked by assets, according to who controls them, first decade by decade and then at five-year intervals, through the twentieth century. The figure shows a steady drop in family-controlled pyramidal groups until Trudeau assumed leadership of the Liberal Party and government, whereupon a sudden resurgence occurs.[6] This persists until the 1980s, when Trudeau relinquished power.

[6] Figures 9 and 10 are from Tian (2006), and are based on issues of *Statistics Canada's Directory of Inter-Corporate Ownership*, *Canadian Annual Financial Review*, and *Financial Post Corporate Securities* and the *Financial Post* cards data. For the first half of the century, control is constructed from family and corporate histories plus general histories of Canadian business, including Armstrong (1986, 1987), Armstrong and Nelles (1986), Bliss (1986), Francis (1986), Khemani, Shapiro, and Stanbury (1988), Marchildon (1990), Maule (1966), Myers (1914), Newman (1975, 1981, 1991, 1998), Naylor (1975), Reynolds (1940), and Taylor and Baskerville (1986).

FIGURE 8

The Changing Control of Large Firms through the Twentieth Century

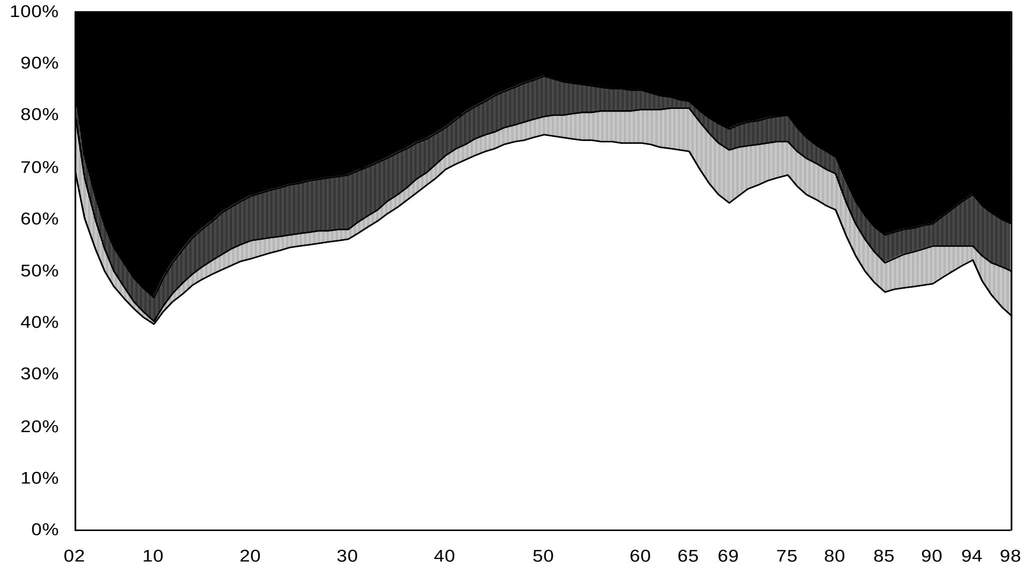
The Importance of Different Categories of Controlling Shareholders in Top 100 Firms, 1902–1998, Weighted by Total Assets (Panel A) and Equally (Panel B).



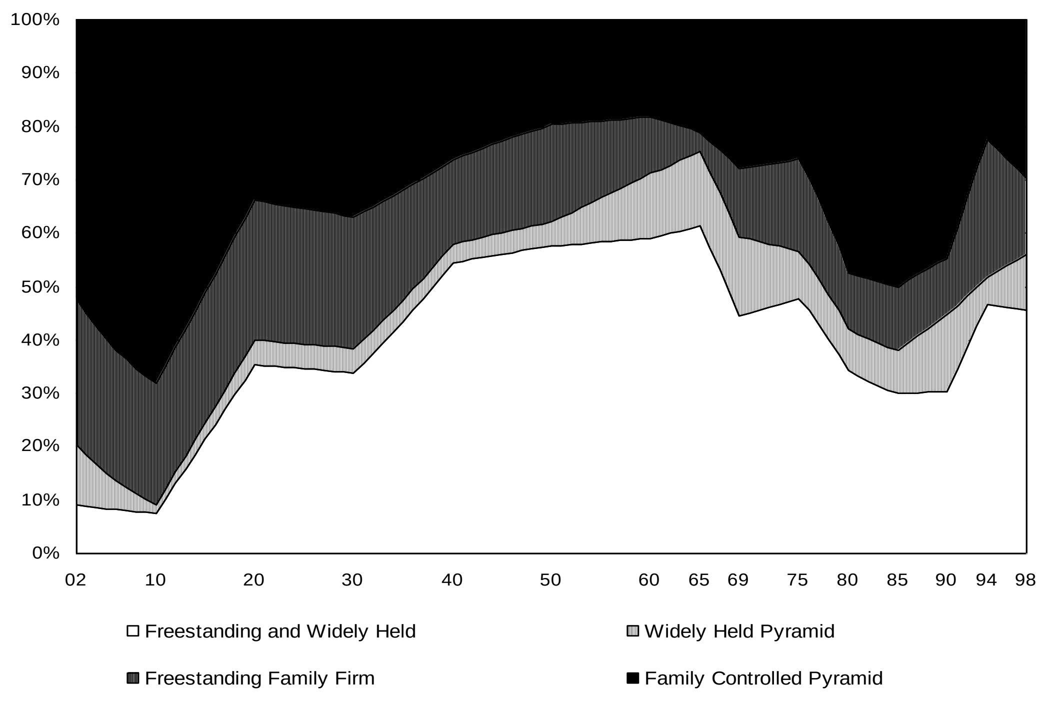
Source: Morck et al. (2005).

FIGURE 9
The Changing Control of Domestically Controlled Private-Sector Firms
The Importance of Different Categories of Controlling Shareholders in Top 100 Firms, 1902– 1998, Weighted by Total Assets and by Number of Firms

A. Asset Weighted



B. Equally Weighted



Note: State-owned enterprises, multinational subsidiaries, and firms whose control is unclear are excluded. *Source:* Morck et al. (2005).

In Canada, other categories – pyramids with widely held firms at the apex and freestanding family controlled firms – are relatively minor in terms of assets. However, government and foreign controlled firms are major classes. Figure 9 therefore removes foreign controlled firms and state-owned enterprises to better reveal the composition of the domestically controlled private sector. The figure shows that, in terms of changes to this pattern, the twentieth century might easily have been omitted. By its end, family-controlled pyramiding was roughly as prevalent as at the century's beginning. A greater importance of concentrated economic power relative to United States or United Kingdom is perhaps unsurprising, given Canada's tolerance of dual class shares, controlling shareholders, and pyramiding, and even the occasional company with a corporate charter that lets a controlling family appoint half the directors, veto shareholder proposals, and the like. But the time pattern in the figures, however, is both surprising and disturbing.

The turn of the 21st century brought an abatement in the prominence of large pyramidal business groups. Several large new firms without dual class shares of tiers of listed subsidiaries – Research in Motion, EnCana, and Potash Corporation of Saskatchewan. If this trend holds up, Canadian corporate democracy may come nearer its potential. However, both dual class shares and pyramiding persist; and nothing at present precludes their resurgence.

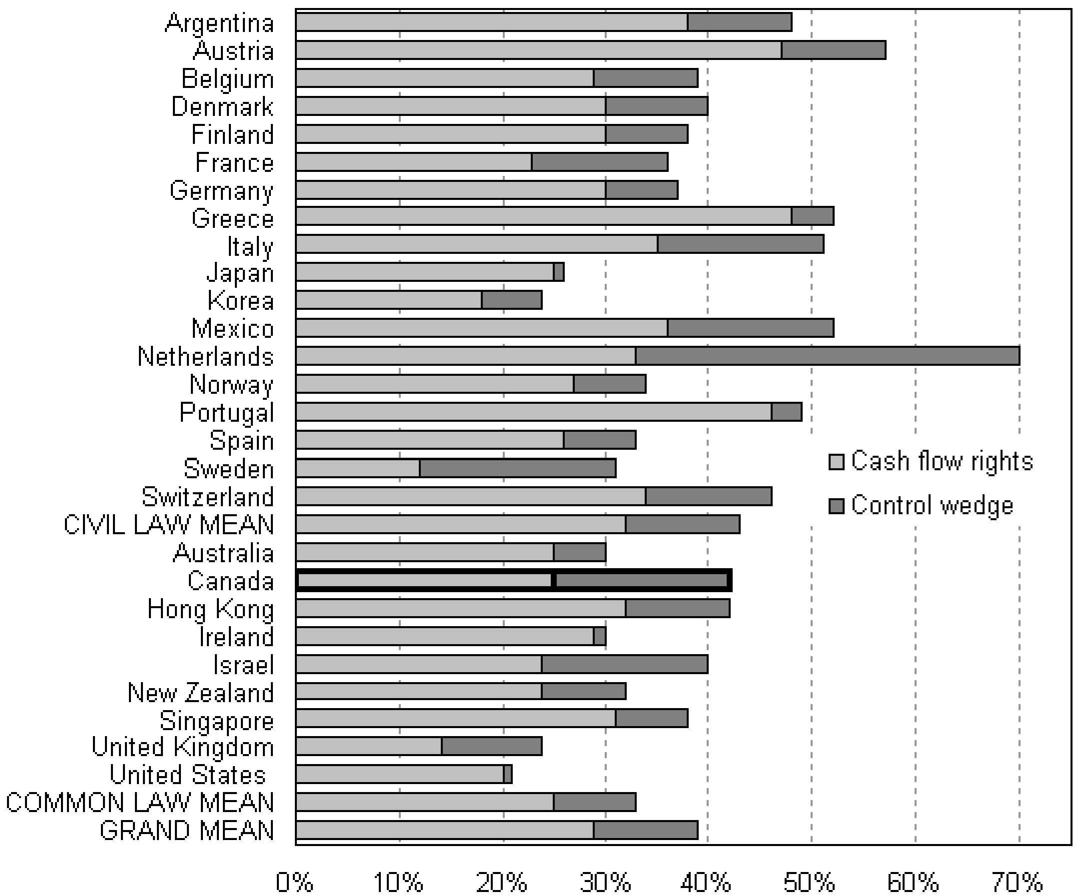
More democratic corporate governance holds promise because it correlates not just with better firm performance (Gompers Ishii, and Metrick 2003; Bebchuk and Cohen 2008), but also with better economy-level performance. Figure 10, from La Porta et al. (1999), uses the 20 largest listed companies in each major market economy worldwide to gauge the health of its shareholder democracy as of 1996. The length of each bar is the mean voting stake of the controlling shareholder. The lighter part of the bars is the controlling shareholder's mean actual stock ownership. The larger the difference, or *control wedge*, the worse the state of shareholder democracy. La Porta et al. (1997; 2000; 2002) find weak shareholder democracy, measured in various ways, including that displayed in the figure, to correlate with stunted financial systems, depressed shareholder value, and a dearth of start-up firms.

The figure shows shareholder democracy in Canada markedly weaker than in any other Common Law country because of the pyramiding and dual class shares then prominent. While Canada scores well on other metrics, such as the laws on the books giving shareholders legal rights against managers (La Porta et al. 1997), this creates a strong circumstantial case that weak shareholder democracy underlies Canada's long weakened economic performance.

In today's global economy, Canada must compete for the savings of Canadians and foreigners alike. Countries whose stocks give investors a rawer deal lose savings to countries whose stocks offer better terms. Labour versus capital conflicts are ebbing, as workers discover the importance of shareholder wealth creation to their pension funds and their quality of life in retirement.

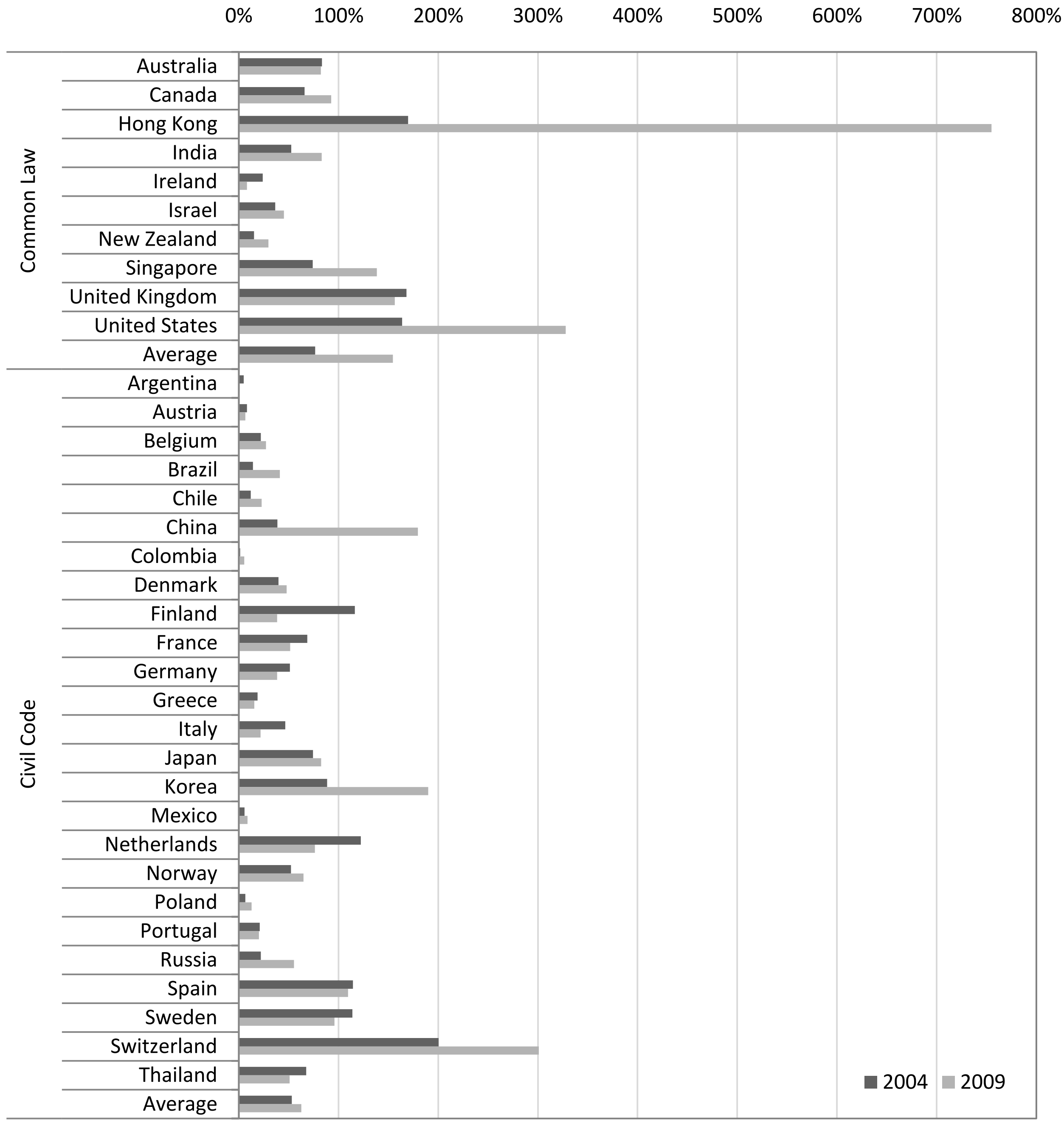
Canada's economy survived the Panic of 2008 in better shape than many others, including America, and this is most likely due to its relatively conservative stance on banking deregulation (Ratnovski and Huang 2009). It would be nice to credit improved corporate governance across the board for this resilience, but this would be unwarranted. Figures 11 and 12 reveal relatively subdued trading activity and a relatively unimpressive total market capitalization in comparison to the averages across common law countries; though Canada looks good next to most Civil Code countries. .

FIGURE 10
Control Blocks in Canada and Other Countries



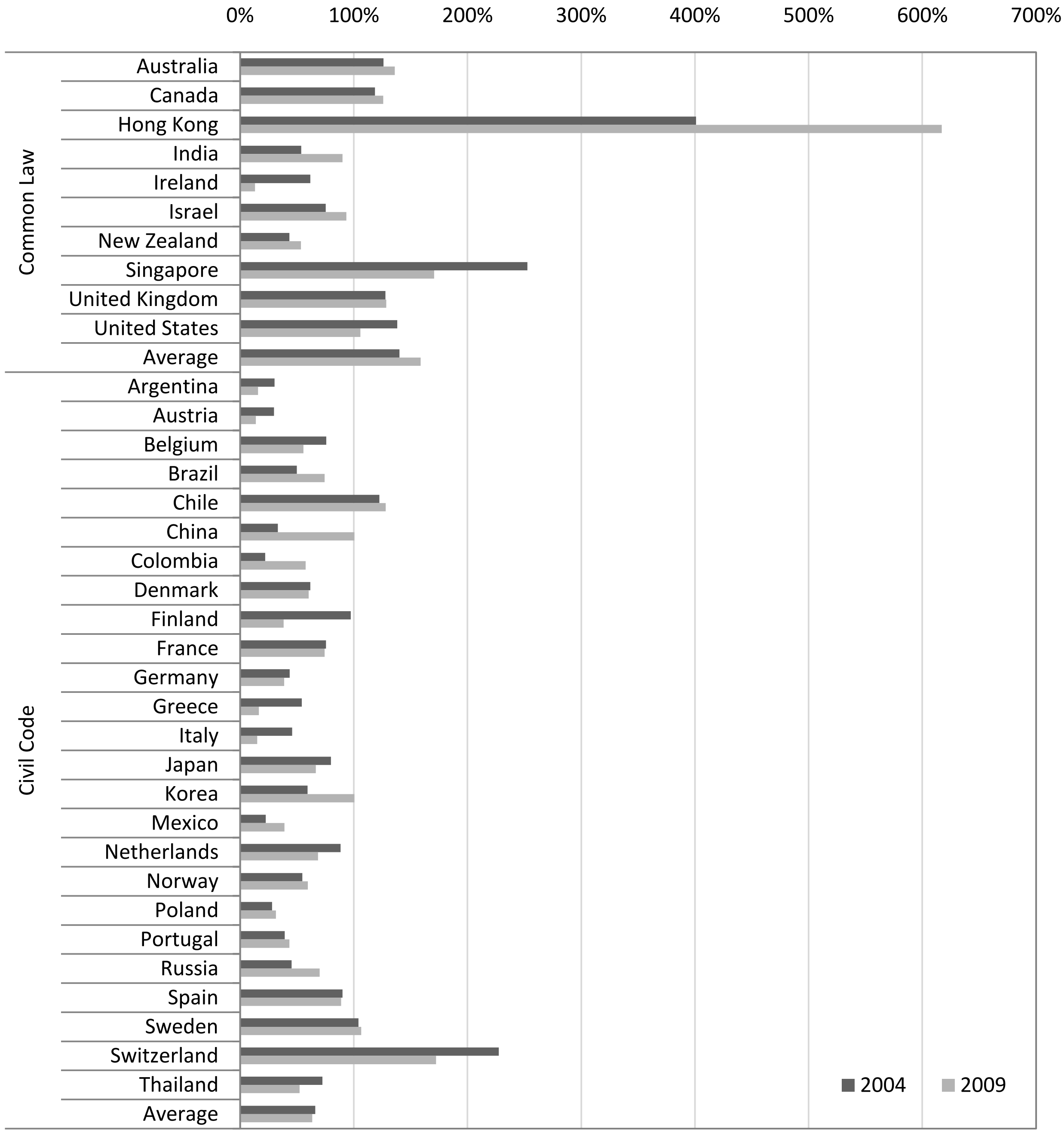
The total length of each bar is the size of the average voting control block in the top 20 listed firms, ranked by market capitalization, in each country. The light grey segment of each bar is the average actual ownership stake of the controlling shareholder. The darker grey segment is the average control wedge: the average excess of that shareholder's voting power over his or her ownership stake, and is due either to super-voting shares or pyramiding. *Source*: La Porta et al. (1999).

FIGURE 11
Stock Market Activity: Shares Traded as Fraction of GDP (2004 and 2009 Data)



Source: World Development Indicators database, World Bank, 2010.

FIGURE 12
Stock Market Size: Market Capitalization as Fraction of GDP (2004 and 2009)



Source: World Development Indicators database, World Bank, 2010.

What Is a Liberal Democracy to Do?

Canada is now establishing a federal securities regulator. This long overdue application of federal power may well foster a larger and more active financial system. But the social purpose of the financial system is not to be large and active, but to allocate the nation's savings to the highest value uses. This section lays out a spectrum of policy alternatives paths federal securities regulation might follow, along with their likely costs and benefits to the economy.

Larger and more active stock markets correlate with faster and more sustained economic growth (King and Levine (1993; Gompers and Lerner 1986, 2006; Levine 1997; Jovanovic and Rousseau 2001, 2002, 2003) and others. Sophisticated financial systems appear to augment economy growth primarily by letting new firms list and tap the nation's savings (Schumpeter, 1911; Djankov et al. 2002), not by catering to old firms' insiders (Fogel et al. 2008). Rajan and Zingales (2003) go further, presenting evidence of entrenched elites in the mid 20th century actively undermining local stock markets to block the rise of competitors and lock in a favourable (to them) status quo. Indeed, they directly link stunted stock markets to cozy clubby corporate governance and a dearth of dynamic start-ups.

A federal securities regulator will have to contend with a set of uniquely Canadian problems: a long tradition of incestuous private-public partnership, a deep social democratic vein, and an oddly leftist nationalism. (Nationalists lie to the right in most countries.) These problems complicate economic regulation in general, but are likely to be especially salient to federal securities regulation.

The incest problem is protected by institutional inertia. Corporate insiders have long grown used to the idea that securities regulators exist to protect them from impertinent shareholders. Provincial regulators traditionally courted the insiders of listed firms; presumably fearing they might move their listings elsewhere. This misapprehends the link between large, dynamic financial markets and economy prosperity, which is through the readier capitalization of innovative new firms. A regulator that sought to please as yet unknown potential entrants, rather than extant listed firms, would realign stock markets towards fuelling growth.

A federal regulator is in a position to make a new start, but will encounter entrenched lobbies that press for a continuation of the traditional model. This is already evident in the "compromises" that provincial securities regulation will continue in parallel with the new federal system and that firms may choose their regulators. This will fail if it becomes a race to the bottom, with each regulator outbidding the other in allowing worse insider excesses. However, it could succeed if federal regulation becomes a stamp of blue chip quality. Firms that list under federal regulation might then command valuation premiums by engendering greater shareholder trust. But for such a stamp is to be meaningful, firms must not be able to switch regulators. Shareholders will not pay more for federally regulated equity if insiders can opportunistically switch to an accommodating provincial regulator and then legally loot their firms.

The second problem, Canada's social democratic bent, pervades politics, the civil service and the courts. Social democracy is not per se a problem, for the modern welfare state has delivered unprecedented human development (Morck and Yeung 2010). But well-intended attempts to view capital markets through social democratic prisms can have unintended consequences. A good example is the *Canada Business Corporations Act*, which provides an *oppression remedy* that lets public shareholders pierce through chains of holding companies to sue controlling shareholders. Although few such suits succeed, this is precisely the sort of rights outside investors need in an economy dominated by controlling shareholders – in theory. In practice, the country's social democratic tradition intervenes in the guise of the Supreme Court's interpretation of this Act. In 2004, the Supreme Court ruled to "accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of."[7]

This sounds progressive and enlightened, but actually provides corporate insiders de facto cover to advance their own interests at every turn, for virtually any decision advances someone's interests. By opportunistically selecting an appropriate interest group for each decision, insiders have free rein to do as they will. Subsequent rulings have not undone this, and remedial action by regulators or lawmakers is overdue. Federal securities regulators will be well positioned to correct this.

The government is charged with regulating labour, the environment, and so on. That is why we have labour law, environmental law, and other legislation. These bodies of law ought to provide directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment binding constraints on what corporate insiders may and may not do. But to grant them freedom to harm labour as long as this benefits the environment, or to harm shareholders as long as this benefits some other interest group, subordinates public policy to a private elite of corporate officers, directors, and controlling shareholders so as to undermine both social and shareholder democracy.

A third problem a federal securities regulator will confront is nationalism. This awoke in 2010, when the federal government, energetically prodded by the Premier of Saskatchewan, blocked an Australian takeover bid for Potash Corporation of Saskatchewan. Potash neglected to replace its poison pill with an enduringly effective takeover defence, such as a voting cap, and so sought refuge in patriotism. While some politicians glowed in national colours, those of more

[7] Peoples Department Stores Inc. (Trustee of) v. Wise, 2004 SCC 68, [2004] 3 S.C.R. 461 §42.

liberal economic persuasion were left red-faced. The episode's aftermath may well be an antitakeover defence in federal securities regulations that prevents future such embarrassment.

The idea that some takeovers ought not to happen is hard to dispute (Morck et al. 1990), and some sort of filter is easy to justify. However, an economically sensible filter – one that passes governance-improving takeovers and blocks empire-building ones – is very hard to design. The Potash system of case-by-case political lobbying to block takeovers on vague" national interest" grounds, is surely the worst of all options, for it subjects corporate officers and directors' careers to political influence. Much empirical evidence links politicized corporate governance to dramatically inefficient resource allocation (Faccio 2006; Faccio et al. 2006; Krueger 1974; Haber 2000, 2002; Haber et al. 2003; Högfeldt 2005; Shleifer and Vishny 1999; and many others).

Federal securities regulators will have to contend with all three of these Canadian quandaries. This must be done with adept finesse if a more efficient financial system is to emerge. A path must be found that accepts the political power of incumbent corporate insiders, the proximity of a social democratic vein to the political mainstream, and the enduring strength of nationalist rhetoric as cover for special interests.

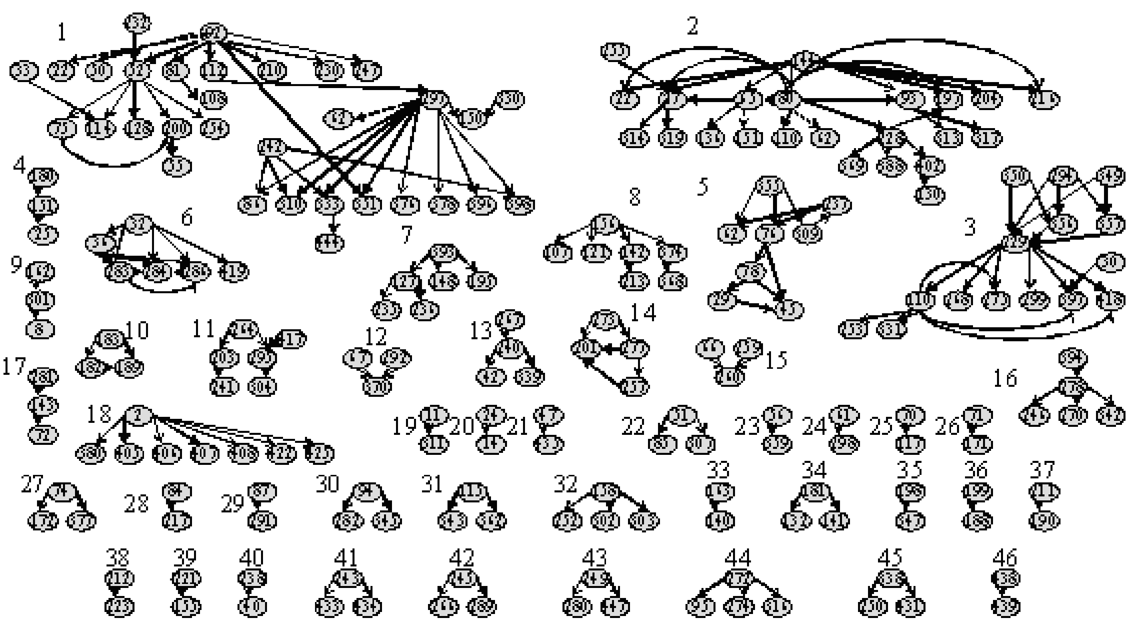
One possible path is the American one. Federal securities regulators could permit American takeover defences – poison pills, staggered boards, and antitakeover laws. These would shelter corporate insiders from shareholder pressure in ways that cannot attract too much criticism from the United States; while providing boards with weapons to stop foreign takeovers. Some U.S. state anti-takeover laws even evoke the Supreme Court's stakeholder balancing act as a legal defence corporate officers and directors may use to fend off shareholder lawsuits.

However, the American system is damned at home for leaving underperforming corporate insiders in charge too long (Shleifer and Vishny 1997; Gompers et al. 2003; Bebchuk and Cohen 2005). Such criticisms, bolstered by the failure of US financial institutions in the Panic of 2008, discredit this model. Federal securities regulators would court instant reputational damage by emulating it.

Another option is Western Europe, where pyramiding, dual class shares, and powerful business families limit shareholder democracy. But this model too suffers from its history. Sweden suffered a dramatic financial collapse in the early 1990s, and European productivity lags that in the US too. Where the European system arguably works best, other mechanisms – intrusive bankers, expansive labour laws, and interventionist bureaucrats – drastically limit controlling shareholders' discretion (Botero et al. 2004; Roe 1996). Canada's banks are already vulnerable to charges of oligopoly, and granting them the governance powers entrusted to German banks (Fohlin 2005) is surely politically infeasible. Redrafting labour rights along European lines would also run aground on provincial jurisdiction. State intervention in business works better in some countries than others, and Canada historically falls among the others (Arbour 1993; Borins and Brown 1986). Private public partnership is perhaps more synonymous to corruption in Canadian English and French (Bliss 1986; Cameron 1995) because the sweeping disclosure that holds Scandinavian government and business to account (Amore 2010; Campbell 2008, Holmen et al 2007; Thomsen and Rose 2004) would be unacceptable to Canadians. In short, the European model is probably not viable for federal securities regulators because of the absence of complementary institutions that check corporate insiders in the wealthier parts of Europe.

The most dangerous path is a superficial emulation of Northern Europe without its checks and balances, for this led Latin America to a tenaciously oligarchic capitalism punctuated by brief episodes of populism.[8] Extensive pyramiding entrusts the governance of the greater parts of their large business sectors to mere handfuls of elite families, who are all but unaccountable under pervasively weak labour laws, disclosure rules, and public sector corruption.

FIGURE 13
A Corporate Governance Map of Chile



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

Figure 13 illustrates one of Latin America's most economically democratic economies, that of Chile. Each numbered circle is a listed company, and the lines demarcate equity control blocks. The figure shows most listed Chilean firms controlled by one of a handful of wealthy

[8] See Haber (2000; 2002); Haber, Razo, and Maurer (2003).

families. In Ecuador, an extreme case even by the standards of that continent, one huge pyramid entrusts the governance of virtually the entire big business sector to one family, the Naboa dynasty.

Roosevelt attacked “robber baron” in 1930s America by taxing and otherwise restyricting pyramiding. William Lyon Mackenzie King, Canada’s prime minister at the time, saw no great problem with robber barons. Indeed, the Rockefellers endowed Harvard’s Canada Program in his name.

This form of capitalism, however, is the least successful at generating widespread prosperity (Rajan and Zingales 2003). The concentration of power it promotes is associated with corruption (Fogel 2006), and inherited corporate control is no formula for corporate success – in Canada (Morck, Stangeland, and Yeung 2000; Smith and Amoako-Adu 1999) or elsewhere (Fogel 2006; Bennedsen et al. 2007; Pérez-González 2006).[9] Yet this system is often enthusiastically favoured by capitalists and their heirs. Shareholder democracy, and other ways of restraining robber barons, therefore matter because they prevent the capitalist class from undermining capitalism (Rajan and Zingales 2003).

A final choice open to Canada’s federal securities regulators is the British path. Following 1930s America in taxing augmented corporate control and explicitly limiting pyramiding in key industries would require legislation that would run up against powerful special interests.[10] But emulating Britain’s 1960s reforms to its takeover rules might well be within the powers of a national securities regulator 1960s.

[9] Expressing a minority view, Khanna and Palepu (2000) argue that such concentrated economic power usefully compensate for dysfunctional markets in developing economies; that is they are a ‘second best’ solution necessitated by a weak business environment. As evidence, they point out that firms controlled by more powerful business families perform better in Chile and India. Morck and Yeung (2004) argue that this likely reflects political influence rather than genuine value creation. Khanna and Palepu (2005) disagree.
[10] Bailey (1982) shows that Canadian tax rules previously discouraged dual class shares. They could readily be changed to do so again.

Given the rise of Canadian pension funds in Figure 5, and the role of British pension funds in that country's 1960s reforms (Franks, Mayer, and Rossi. 2005), the British trajectory is perhaps a better bet. Federally regulated firms might therefore be subjected to "all or nothing" takeover regulation – acquirers must buy 100% or stay away. While diluted versions of this sort of rule, such as the Ontario requirement that acquirers buying control blocks extend their offers proportionately to public shareholders, merely encumber acquirers; the full blooded British version is consistent with an active market for corporate control in the UK (Franks et al. 2005) and with a genuine democratic accountability of corporate insiders (Faccio and Ameziane 2000; Cheffins 2009).

A key issue here is the independence of pension funds' boards of trustees. In the US, most pension funds are controlled by business corporations, and such effects are only associated with public sector pension funds, whose trustees are more accountable to their beneficiaries (Pound 1988, 1991; Gordon and Pound 1993). Corporate pension fund trustees are, in contrast, appointed by corporate CEOs and subject to a different dynamic: one firms' pension fund may support another's entrenched insiders in anticipation of a quid pro quo (Pound 1988). Most British pension funds are trade based: they cover all workers in a given trade and are thus more responsible to workers and less under the thumbs of corporate insiders (Faccio and Ameziane, 2000). Canadian pension funds are a mixture, and if the British model of shareholder democracy is to prevail successfully, would have to be rendered more like British pension funds.

This route might also accommodate a takeover defence with fewer downsides than the poison pills and staggered boards of the US or the entrenched business families of Europe and Latin America. Canada's banks are currently protected from takeovers by voting caps, which prevent any shareholder from acquiring more than a given fraction of their shares. This effectively immunizes firms from takeovers. However, voting caps need not protect managers from shareholder democracy if institutional shareholders can coordinate voting to oust underperforming CEOs, as they appear to do in the UK (Black and Coffee 1994).

Federal securities regulation might thus accommodate nationalists, and salve self-interested corporate insiders too, by permitting voting caps as a takeover defence as long as institutional investors were also empowered sufficiently. For example, if institutional investors could readily nominate and campaign for opposition slates of directors, voting caps would lose much of their force. Takeovers can go awry, but the threat of dismissal by a raider is too useful a stick against slothful managers to be discarded. One option might be to let a potential raider convene a shareholder meeting upon reaching the voting cap, whereat a majority of disinterested shareholders could vote to repeal or maintain the cap.

This, or something akin to it, addresses the three pressures likely to sway federal regulators: Social democracy is accommodated by empowering employees and retirees via independent and democratic pension funds. A hat is tipped to nationalism by letting workers' and retirees' representatives vet takeovers, including those by foreigners. The self-interest of entrenched corporate insiders is salved with voting caps, but not so much as to wholly lose the market discipline hostile takeovers provide. As in Britain, mandatory 100% bids once a certain threshold – say 20% - is crossed could prevent pyramiding and the governance problems associated with entrenched insiders running narrowly held firms. This would also continue the trend towards less pyramiding and fewer dual class equity structures by leaving listed firms widely held and fully subject to shareholder democracy. Were this course pursued, listed firms would end up democratically governed and controlled firms would end up private.

Of course, pension funds themselves can be misgoverned, so enhanced democracy there too might be considered. Many corporate pension funds are controlled by chief financial officers, not employees; and are run as organs of the sponsoring corporation (Lakonishok et al. 1991; 1992). Many public sector pension funds are run by political appointees with their own agendas (Romano 1993a). Clearly, real shareholder democracy would empower the ultimate owners of the shares: workers and retirees. For shareholder democracy to capture the center ground of Canadian politics, democratic accountability of institutional investor management to beneficiaries would have to be part of the picture, though both extremes of the political spectrum might equally dislike this.

Weiler (1990) argues persuasively that granting labour stronger rights is good for the economy and the general welfare. His most cogent arguments support workers rights to organize and a level playing field upon which organized labour and management negotiate. With labour unions in decline, pension funds might provide another route to both sorts of labour empowerment. Workers could organize by electing pension fund trustees, and influence major economic decisions by commanding votes at genuinely democratic shareholder meetings. Perhaps in the twenty-first century "capital-labour dispute" will even come to mean a shareholder meeting wherein investors and pension funds combine forces to dispute the policies of top corporate insiders.

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