Institute for governance of private and public organizations

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Policy Suggestions of

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Alternative Courses of Action

Suggestions[1] of
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The Council needs to address the key business challenges manifested in several symptoms, described in the first parts of our paper: the *short-termism* of corporate management, the *disincentives* of factoring the interests of stakeholders other than shareholders in corporate policies and decisions, the *questionable compensation practices* of corporations, most particularly in the financial sector, the *eroded public trust* in large corporations and their leadership, the *broadening role of the State* in economic affairs.

These symptoms portend of a general malaise, a discontent with an economic system perceived as flawed and unfair, which inflicts recurrent financial havoc on societies.

Yet, business has been, and should remain, a driver of innovation, a creator of wealth, a harbinger of economic freedom.

What should be done?

(Advice to policy makers and corporate leaders)

The following suggestions, which range from moderate to radical, are submitted for discussion.

[1] Drawn in part from Allaire and Firsirotu ***Black Markets and Business Blues*** (FI Press, 2009)

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They are arranged under four headings:

1. **Ownership and compensation matter!**
2. **Institutional investors must behave!**
3. **Management must behave!**
4. **Governments must set a level-playing field**

1. Ownership and compensation matter!

If one surveys how customers/buyers of the world are served nowadays, one finds a varying mixture of State-owned or controlled corporations, privately-owned businesses, partnerships, business cooperatives, exchange-listed companies with an assortment of capital structures (dual-class shares, pyramidal and cross-shareholding arrangements, controlled corporations, LLPs, exchange-listed 'limited partnerships", etc.) and, finally the widely held, exchange-listed corporation.

In this marketplace of organizational forms, the latter model has gained the largest market share in the U.S, and the U.K but a more modest, though growing, share in the rest of the world.

Even in the USA though, there are more than 400 fully *private companies* as well as 51 business *cooperatives* with yearly revenues in excess of $1 billion; and, in 2007, 11.5 % of all companies listed on the New York Stock Exchange sported a dual class of shares (including Berkshire-Hathaway, Ford, Tyson, News Corp, The New York Times and Google, although the latter is listed on NASDAQ). (Howell, 2009)

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A study by Anderson and Reeb (2003, 2004) based on the S&P500 firms (excluding utilities and financial services) over the period 1992-1999 found that *families* were present (i.e. held more than 5 % of shares) in one third of these companies and accounted for 18% of outstanding equity.

In the same vein, Villalonga and Amit (2005) conducted a large-scale study of firms which, at any time during the period 1994-2000, ranked among the Fortune 500 list of companies and qualified as a family firm because its *founder or a member of the family by either blood or marriage is an officer, a director, or the owner of at least five percent of the firm's equity*" (2005; p.35). These family firms accounted for some 36% of their Fortune 500 sample. Family shareholders owned 16% of the equity on average, with control-enhancing mechanisms (in half the cases) raising the share of vote to 33 % on average. Indeed, for 12% of these very large "family companies", the family is the largest shareholder with at least 20% of the votes

Be that as it may, of the 100 largest American commercial organizations, some 75 are widely-held public corporations; that number is 41 for Canada. Of the 70 largest German companies in 2005, but 22 were of the widely held, publicly traded sort. (Fronningen and Wijst, 2009).

For 5232 publicly listed companies in 13 Western European countries, a mere 37% operated as widely held corporations. (Faccio and Lang, 2002). A survey of 2980 publicly traded corporations in nine East Asian countries finds that "more than two-thirds are controlled by a single shareholder" (Claessens, Djankov, Lang, 2000).

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Half of the ten largest companies in the world, *on the basis of market cap,* are *government-controlled* and headquartered outside Europe and the United States. (Burgess, K. *Financial Times*, June 20, 2008).

The world's 300 largest *cooperatives* had collective revenues of some US$1.1 trillion in 2007, the equivalent of 35 median size companies of the Fortune's Global 500.

But a distressing fact must be reckoned with. A particular variant of the business corporation has played a key role in the latest financial crisis as well as earlier ones: *the one-share-one-vote publicly listed company "owned" by an array of funds (many of the activist breed with a short-term horizon), fastidiously governed by "independent" board members, managed by executives motivated by stock-price related incentives to "create shareholder value", surrounded by speculative funds playing all sorts of lucrative games with the company's shares and debt.*

Creating shareholder value has become synonymous with ever increasing *earnings per share*, even in a world of very low inflation. Corporate executives must find all possible arguments to convince financial markets that their company can achieve ever-increasing earnings per share and then make sure to deliver on this commitment.

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All the actors of the 2007-2008 financial catastrophe, with the exception of hedge funds, pension funds and a couple of rating agencies, were corporations of the model described above.

**The actors in the 2007-2008 financial tragedy:
What's common to all (or most) of them?**

Sub-Prime Originators	Lending « Banks »	Investment Banks	Sellers of Credit Default Swamp	Investors in Sub-Prime, CDO, MBS and others
Countrywide Financial HSBC Washington Mutual Wells Fargo Home Mortgage First Franklin Financial New Century Financial Etc.	Bank of America Citigroup Wachovia Merrill Lynch Fannie Mae Freddie Mac	Lehman Brothers Bear Stearns Morgan Stanley Merrill Lynch Goldman Sachs	AIG MBIA Ambac FGI Hedge Funds	Investments Banks European Banks American Banks Hedge Funds Pension Funds Credit rating agencies (Moody's, Standard & Poors) 36

Many observers[2] have noted how the extension of that model to investment banking/trading firms (Morgan Stanley, Bear Stearns, Lehman Brothers, Goldman Sachs), to the "government-sponsored" enterprises Fannie Mae and Freddie Mac and to credit rating agencies[3] (e.g. Moody's) have added momentum to a runaway financial system.

[2] Among others, Michael Lewis (2008), Henry Blodget (2008), Eric Kolchinsky (2009).

[3] One might add the proxy advisory firms to that list; ISS went public, was acquired by Risk Metrics, itself acquired recently by MSCI. A company offering advisory services on governance matters should have an ownership structure better suited to the delicate nature of its mission.

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It used to be that the widely-held public corporation could count on a degree of loyalty and stability from its shareholders. Over the last twenty or thirty years, the average share holding period has dropped to well under a year, as shown in the following graph:

It is interesting to note that the same short holding period prevailed at the time of the 1929 financial crisis. This phenomenon of a systematically shortened holding period is a global one as the following graph illustrates:

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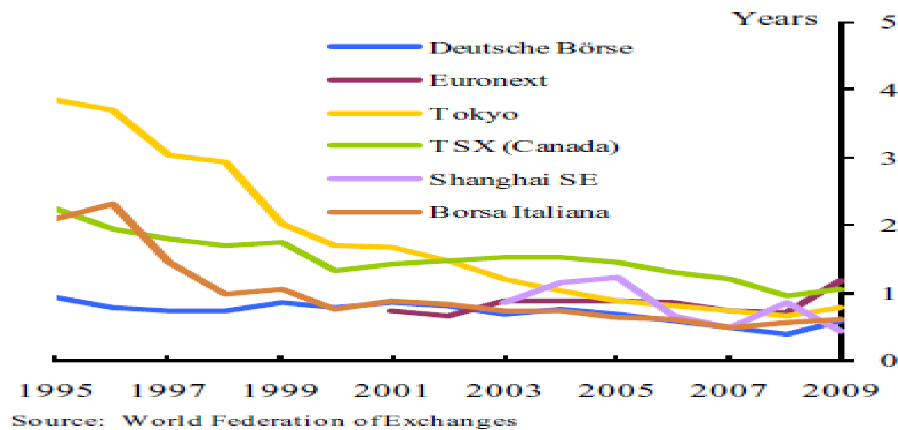

These figures capture a number of financial "innovations", which converge to make the stock market into a sort of casino and turn companies into commodities: day traders, speculative funds, the booming business of stock derivatives, short-sellers, and lately "high speed trading" (a relatively new phenomenon which may well push the average holding period down to a few months)[4].

A new reality has come to dominate the relationship between shareholders and the widely held corporation. In earlier times when shareholders were a

[4] Indeed, some 200 firms in the business of *high speed trading* represent some 50% of daily volume on American stock exchanges (and expanding quickly to other world stock markets); their average holding period for shares is ***11 seconds***; their profits were estimated in 2009 at $25 to $ 30 billion. Their defenders claim they are adding "liquidity" to the market; others argue that they are merely *front-running* the market; that would place great value on insider information about imminent large trades by institutions. Perhaps the next scandal in the making!

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stable lot who assumed the full economic risks of share ownership, a different set of conditions and circumstances prevailed:

- New shareholders were few during any period of time; stability in the shareholder base of a company was the norm;
- Limited use was made of derivative products (puts, calls and other variants) to hedge against the economic risks of owning shares;
- Short selling of shares, borrowed from *bona fide* shareholders, was rare and viewed as an aberrant practice; *naked s*hort-selling was unheard of and would have been declared illegal (that is, selling shares one does not own nor has made any arrangement to borrow said shares; obviously the naked short-seller hopes to quickly buy back the shares, before delivery of shares is due, and make a quick profit);
- Shareholders on the record date (i.e. those owning shares on that date will be entitled to vote, by proxy or attendance, at the annual meeting of shareholders) would still own their shares by the time of the annual shareholder meeting;
- The buying of votes was rare; shareholders would not sell their right to vote by loaning their shares for a short period around the record date; this practice comes under the label "record date capture";
- Shareholders did not hide their economic interest by entering into equity swaps or similar arrangements to disguise their level of equity participation in a company.

These conditions do not hold anymore. Largely because of the mushrooming of so called hedge funds and the dominant role of investment funds in corporate shareholding, all the "deviant" practices described above are now

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commonplace occurrences in developed equity markets. These practices have created a disconnect between, on the one hand, the theory underpinning the rights of shareholders and the practice of shareholder democracy, and, on the other hand, the current reality of share ownership and trading.

Hu and Black (2006a, 2006b) have carefully documented, and illustrated with several eloquent examples, the gamut of stock market operations carried out by hedge funds and like-minded investors which may result in "empty voting" (that is, holding more votes than economic ownership) or hidden ownership (that is: holding greater economic interest than is disclosed). Vote buying (or "empty voting") is not a marginal phenomenon. Hu and Black (2006a) report on a study *that examined 341 contested shareholder votes in 2005. The study found over-voting in all cases!*

Hedge funds have been particularly creative at decoupling voting rights from economic ownership but the potential costs and the risks of abuse outweigh the putative benefits from these financial acrobatics.

Martin and Partnoy (2005) argue forcefully that "*given the proliferation of financial innovation and economic and legal encumbrances, the one-share/one-vote principle no longer constitutes a uniformly efficient rule of corporate governance, if it ever did."* (p.813).

This is a remarkable conclusion since the "one-share-one-vote" principle has been hailed over the years as the *sine qua non* of good governance, the essential virtue of an efficient financial system.

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The recently released report of the ***New York Stock Exchange Commission on Corporate Governance*** (September 2010) notes:

> *"Another development in the last decade is the proliferation of derivative or synthetic securities and hedging transactions. Often these securities or transactions are employed for good economic reasons, but derivative positions are also used in connection with takeover scenarios as well as shareholder voting campaigns, whereby investors gain the ability to vote shares while effectively having no economic interest in those shares (referred to as "empty voting").*
>
> *Regulators and courts in both the U.S. and Europe have begun to scrutinize empty voting and its implications for corporations in those jurisdictions. For many years, Delaware decisions have expressed consistent concerns about transactions that create a misalignment between the voting interest and the economic interest of shares...*
>
> *More recently, in its "proxy plumbing" concept release, the SEC acknowledged that empty voting and the "decoupling" of economic and voting interests "raises practical and theoretical considerations for voting of shares."*

Any economic system built largely on the model of business ownership of the kind that became dominant in the USA over the last twenty years will be unstable and crisis-prone. Societies will greatly benefit from an economic system with a more diversified business ownership structure.

Entrepreneurs should resist or postpone the listing of their company's shares on a stock exchange, and look for other means of financing the growth of their

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company (as well as ways other than stock options to reward key talent). They may well decide that it is best for them to remain as private companies. Financial institutions, pension funds and other sources of funds should play an increased role in providing capital to finance the growth of private companies.

If they do decide to list, entrepreneurs may well opt for a corporate structure with *a dual class of shares* to reduce the ability of financial markets to exert pressures on them as well as immunize them from unwanted takeovers (as Google has done). However, the adoption of capital structures other than the ”one-share, one-vote” type should entail specific conditions: a shareholder cannot exercise absolute control with less than 20% of common equity; the class of shares with subordinate votes should elect at least a third of board members; a provision should ensure that the controlling shareholder cannot sell the control of the company without an offer with the same price being made to minority shareholders; the process of CEO succession, when a relative of the controlling shareholder is a candidate, must be fully disclosed to shareholders; a “sunset” clause may be included whereby the company reverts to a single class of shares when the founder-entrepreneur stops playing an active role in the management or governance of the company and has no family successor to take over.

The entrepreneurial business often turns eventually into a *family business*, whether publicly listed or not. Financial market ideologues tend to look askance at this form of ownership. Yet, they play a significant role in the economies of many countries and, in general, have performed remarkably

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well. The studies cited above, conducted by sceptical academics, have come to the following conclusions:

"*Contrary to our conjecture, we find family firms perform better than non-family firms…Overall, our results are inconsistent with the hypothesis that minority shareholders are adversely affected by family ownership, suggesting that family ownership is an effective organizational structure*" (Anderson and Reeb, 2003, p-1301)

"The data thus suggest that family firms are better performers than are non-family firms" (Villalonga and Amit, 2005, p11,)

Partnerships should remain partnerships and resist the siren song of becoming publicly listed corporations. There are many other ways to raise capital when and if really necessary. If they succumb, perhaps they should try to imitate the neat trick of Blackstone and KKR and become a publicly listed "limited liability partnership". It appears that such confections leave total control of the entity to managing partners and are exempted from all the governance requirements of Sarbanes-Oxley.

Business cooperatives, a form of democratic capitalism, play a very significant role in the economy of many countries[5]. "*Cooperatives are a globe-spanning phenomenon, with membership now at 800 million people— more than double the total from three decades ago. More Americans hold memberships in co-ops than hold stock in the stock market."* (M. Kelley, 2009)

[5] For instance, cooperatives ranked among the 300 largest in the world represent 20% of GDP in Finland, 14% in Switzerland and New Zealand, 13% in the Netherlands, 10% in France.

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These cooperative firms are often long-lived and bring large benefits to their society: *Rabobank* in the Netherlands, *Mondragon*, Spain's seventh largest industrial concern, the *Mouvement Desjardins*, the largest financial institution in Quebec, *John Lewis Partners,* the employee-owned UK retail chain, *Publix*, the employee-owned U.S. supermarket chain, the *Mutual of Omaha*, *HealthPartners*, the cooperative HMO in Minnesota, *Edeka Centrale AG*, the large German food retailer, *Zen-Noh* and *Zenkyoren,* the huge Japanese agricultural cooperatives offer a few examples of large, highly successful cooperatives.

Very present in the financial sector, savings and loans cooperatives have weathered the financial crisis relatively unscathed. The cooperative model should be supported, taught in business schools, and promoted as a viable and attractive model for many business sectors. A country's legal framework should be made as friendly as possible to this form of organization.

State-owned enterprises are also making a come-back, most particularly the hybrid type where the State keeps control but sells part of the company's equity to investors and lists the shares on a stock market. The governments of China, Russia, Brazil and others now control huge publicly listed companies. The combination of government control with private sector discipline, the reasoning goes, may be a winning combination. *Where and when the legal system provides adequate protection to minority shareholders*, subjecting the management of a State-controlled enterprise to the governance discipline of a

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stock-market listed company may be judicious, but that arrangement is fraught with dilemmas and prone to conflicts.

Social business is an emerging concept of company ownership. In his book *Creating a World Without Poverty: Social Business and the Future of Capitalism* (2007)*,* Mohammad Yunus defines *a social business* as a profit-making company driven by a larger mission. "It carries the energy and entrepreneurship of the private sector, raises capital through the market economy, and deals with "products, services, customers, markets, expenses, and revenues—but with the profit-maximization principle replaced by the social-benefit principle." (Marjorie Kelly*, Emerging Alternatives to the Shareholder-Centric Model,* 2009)

Recommendation 1

Societies and their governments must determine what type of ownership structure to promote and what role the State should play in economic affairs.

There is no one best way in these matters. All forms of ownership come with their specific governance challenges. The legal frameworks and governance rules and practices which seem to work well for different forms of ownership are well documented and readily available. Examples of successful companies of every type of ownership abound; they provide useful lessons and practical models for any society.

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Societies and their governments should foster varied forms of business ownership; they should not be intimidated away from other ownership models by ideology or by financially interested parties promoting the "American" model of ownership as the *alpha* and *omega* of economics. Governments should establish a fiscal and legal context favourable to business cooperatives, employees-owned enterprises, and family-owned businesses. Governments should promote, and where they have the authority, impose state-of-the-art governance principles and processes for all forms of business ownership.

But the *widely-held corporation* is here to stay! It plays a dominant role in the American and UK economic systems and a significant role in many other countries. Prodded by activist institutional shareholders and coerced by rules and regulations, listed corporations have had to raise their governance game and become a lot more transparent to shareholders and other stakeholders. That is all for the good...to a point.

A significant benefit of the exchange traded corporation (whether widely held or not) comes from the fact that much is known about their actions and decisions. These public corporations are usually responsive to effective pressure by institutional shareholders and other groups promoting "responsible" investments and behaviour. They are often proactive in taking actions that go beyond their legal obligations. Their reputation as good "corporate citizens" is important to them, to the new breed of their employees, and to some categories of clients and shareholders. That is true of

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many publicly traded companies, whether widely held or controlled by some shareholders.

Given the economic significance of widely held corporations, how can the benefits they represent be preserved whilst reducing somewhat the perverse incentives and dysfunctions of the financially driven corporation that emerged over the last twenty years.

The answer to that critical question may come from changes in three areas:

- ✓ Rewarding "loyal" shareholders;
- ✓ Broadening and clarifying the responsibilities of boards of directors;
- ✓ Cutting the Gordian knot of compensation.

Rewarding "loyal" shareholders

The mixture of shareholders and "shareswappers" as well as the trading "innovations" concocted by hedge funds (more aptly called speculative funds) are a troubling phenomenon.

In a context where new financial players intend to change the rules of the game to their advantage, long-term investors must also be concerned with the behaviour of these fellow shareholders. Driven by different motives and esoteric strategies, these new types of "shareholders" may have interests and goals that are detrimental to the long-term welfare of the company and its shareholders.

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Confronted by these changed market circumstances, rather than further increase the power of transient, fickle, even malevolent, shareholders, should we not propose measures that favour long-term shareholding and instil loyalty and commitment to the long-run goals of the corporation? *In decent societies, tourists don't vote and gamblers don't own the casino!*

Recommendation 2:

It is time to impose a minimum holding period (say one year) before a shareholder can exercise its voting rights.

That proposal seemed radical when put forward in 2006 by the IGOPP; by now, it appears tame and essential. A prestigious group of 30 executives and academics (including Bill George, a member of this Council) assembled by the ***Aspen Institute*** to propose remedies for the chronic short-termism of American corporations offered the following suggestions, among others:

- *In exchange for enhancing shareholder participation rights, consider adopting minimum holding periods or time-based vesting, along the lines of the one-year holding period required under the SEC proxy access proposal currently under review.*

Indeed, the SEC has now adopted Rule 14A-11 on proxy access, which comes into effect on November 15th 2010, whereby shareholders owning at least 3% of voting shares for a period of *at least three years*, may nominate candidates for board seats. The significant aspect of this rule is that it grants different rights to shareholders as a function of the holding period.

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The Aspen group further proposed:

- *Capital gains tax rates might be set on a descending scale based on the number of years a security is held.* (December 15th 2009)

Stable, "loyal", shareholders could also acquire other rights and privileges for holding shares for a period of time; for instance *an increased rate of dividends after a stated holding period.*

- *Implement an excise tax in ways that are designed to discourage excessive share trading and encourage longer-term share ownership.*

No doubt that a small fee levied on every stock transaction would reduce the churn of shares, virtually knocking off the high speed traders.

Recommendation 3:

Assess the advisability in different legal and social contexts of adopting other "loyalty-inducing" measures, such as those described above, as well as imposing a fee (say, one tenth of one percent) for every stock transaction

Changes of this nature require a careful examination of many aspects: legal, logistics, fiscal impact, liquidity, etc.

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However, ***the proposal of a one-year holding period before acquiring the right to vote is actionable now!*** In one fell swoop, this provision would reduce the power of transient, speculative funds to pressure management and boards of directors; it would reduce the voting power of speculators in cases of hostile takeovers.

Broadening and clarifying the responsibilities of boards of directors

To whom and for what are boards of directors accountable? The pat answer in many circles is simple and loud: *to maximize shareholder value!* But of course it is not so simple.

The afore-mentioned Commission set up by the NYSE does propound as its first principle:

> *"The board's fundamental objective should be to build long term sustainable growth in shareholder value for the corporation, and the board is accountable to shareholders for its performance in achieving this objective."*

...and then struggles with the practical complexity of the concept.

"Given these challenges, another fundamental issue considered by the Commission was the manner in which the board exercises its duties in the face of shareholders who may have competing interests and investment time horizons, an especially formidable question given the changing definition of "shareholder," and the likely continued evolution of share-ownership as technology continues to transform trading patterns". ...

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"This diversity can lead corporations responding to shareholder pressure or demands left wondering: are we responding to the interests of our shareholders generally or to the voices of the vocal minority?"...

"As the Commission considered this issue, it repeatedly returned to the principle that the fundamental objective of the board must be to help the corporation build long-term, sustainable growth in value for shareholders and, by extension, other stakeholders, and that corporate governance principles must follow from this objective. Precisely because there will be occasions when the interests among shareholders and/or among shareholders and other stakeholders differ from one another, it is important for the board's actions to be guided by this overarching objective."

*"Consistent with their fiduciary duties, boards should be free to consciously and transparently adopt policies favoring the interests of long-term owners"....*even if short-term investors hold a majority of the votes?

Actually, the wave of hostile takeovers in the 1980s has prodded some 30 U.S. states to enact laws giving boards of directors of companies incorporated in their state enhanced power to fight off any attempt at taking over their company. Among the host of measures empowering boards, one finds "other constituencies" statute *which permits a board of directors to consider, and even favour, constituencies (other than shareholders): the corporation's employees, suppliers, customers and creditors and the communities in which the corporation operates.*

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Other arrangements gave the boards of widely held U.S. companies considerable latitude to resist the pressure of activist shareholders: staggered board whereby only one third of board members are elected each year; slate voting (instead of individual majority voting); poison pills making it virtually impossible to take over a company unless the board concurred.

Under this system, the claim that boards worked in the interest of long-term "owners" of the company had some credibility. Over the last ten years, activist institutional investors (aided by proxy advisory firms) have worked hard to remove these impediments to shareholder primacy.
The NYSE Commission reports that:

"One effect of the growing influence of both institutional investors and proxy advisory firms has been the dramatic decline in public corporations' use of structural "defensive" measures. For example, in 2005, 47% of S&P 500 companies had declassified boards with annual votes for all directors; in 2006 that number grew to more than half (55%). The number of companies with poison pills shrank each year in the 2000s, and by early 2010, less than 1,000 companies had an active poison pill—the lowest number in over twenty years. As one learned commentator recognized, "stockholders of public companies are no longer passive, weak, and incapable of concerted action." Additionally, in 2006 less than 20% of the S&P 500 companies had adopted some form of majority voting; recent estimates now place that figure at over 70%, a number that can be expected to increase."

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The successes achieved by governance champions have some downside however, some counterintuitive consequences:

> *"For example, while directors are supposed to take action in the long-term interests of shareholders, the combination of the decline in classified boards and rise in majority voting requirements has resulted in directors facing increasing pressure to take actions that are primarily intended to increase stock price in the short term if the directors want to obtain the support of investors who focus on annual stock price increases. Additionally, investors who measure results by quarterly returns, as well as managements who are compensated on the basis of short-term results, can magnify the pressure on directors to maximize short-term stock price at the expense of long-term planning."* (NYSE Commission on Corporate Governance, September 2010)

Recommendation 4:

It should be clearly and legally stipulated that the board's fiduciary duty is to maximize the long-term value of the company not to maximize (short-term) shareholder value, the mantra of the past 20 years. This statement of corporate objective clarifies a number of contradictions; it is an objective that will not be achieved without a full consideration of all relevant stakeholders as no company will survive in the long run by alienating key constituencies.

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The NYSE Commission's report is clearly heading in this direction but stops short because of the various legal dispositions governing the fiduciary duties of U.S. boards of directors.

> *"The Commission also recognized that in addition to these three groups, other corporate stakeholders have critical interests in the long-term success of the corporation, including, for example, the corporation's employees who rely on the corporation to provide jobs and wages, the corporation's customers and vendors, as well as the communities in which the corporation operates and society at large, which look to the corporation to help address society's challenges, to innovate and to promote durable and sustainable economic growth."*

In a review[6] of trends in Delaware corporate jurisprudence, former Delaware Supreme Court Chief Justice E. Norman Veasey writes:

> *"[It] is important to keep in mind the precise content of this "best interests" concept — that is, to whom this duty is owed and when. Naturally, one often thinks that directors owe this duty to both the corporation and the stockholders. That formulation is harmless in most instances because of the confluence of interests, in that what is good for the corporate entity is usually derivatively good for the stockholders. There are times, of course, when the focus is directly on the interests of the stockholders. But, in general, the directors owe fiduciary duties to* ***the corporation****, not to the stockholders."*

[6] E. Norman Veasey with Christine T. Di Guglielmo, "What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments" (2005), 153 *U. Pa. L. Rev.* 1399, at p. 1431

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[Emphasis in original.] (Cited by Supreme Court of Canada in BCE v. Bond holders)

The Canadian legal framework is grounded in a concept of the corporation fully compatible with this recommendation. The text of the Canadian Business Corporation Act, supported by recent decisions of the Supreme Court of Canada, is clear:

"The fiduciary duty of the directors to the corporation originated in the common law. It is a duty to act in the best interests of the corporation. Often the interests of shareholders and stakeholders are co-extensive with the interests of the corporation. But if they conflict, the directors' duty is clear — it is to the corporation" (Supreme Court of Canada in BCE v. Bond holders)

Boards of directors must be legitimate and credible to discharge well and fully the broader responsibilities placed on them and to keep governments from interfering in the governance of public corporations.

The financial fiasco of 2008 brought about a severe loss of legitimacy for the financial industry. Governments always respond to this state of affairs. The U.S. government has moved to regulate more tightly the players. European governments want to dictate compensation policies for these firms. It is not farfetched to anticipate that governments would broaden its intervention to other sectors of the economy.

Recommendation 5:

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Boards of directors should adopt processes of nomination and election which foster legitimacy; they should adopt all policies and processes conducive to enhanced credibility of the board.

Cutting the Gordian knot of compensation

The epochal experience of the 1980s leveraged buy-out (LBO) of publicly listed companies offered seemingly persuasive evidence that the traditional forms of governance and management were "value-destroying" for shareholders. The institutional funds, by now majority shareholders of most large widely held companies, became more vocal in insisting that boards of directors promote their interests. They were very favorable to the granting of much larger financial incentives to senior management. Indeed, LBOs, it was claimed, demonstrated that the reason traditional companies did not deliver maximum value for shareholders had to do with the paltry percentage of the wealth created for shareholders that accrued to senior management. (Jensen, 1989)

The corrective was obvious: grant to senior management much larger number of stock options. Up to 1991-1992, stock options had represented a relatively small percentage of total executive compensation. By 1993, it explodes and quickly becomes the largest part of overall compensation[7]. The reasoning, superficially compelling, held that, thus motivated, senior executives would do all they could to boost the stock price. That, they did. But too often in ways

[7] For instance, in 1985, salary and bonus represented some 70% of total CEO compensation; by 2009, salary and bonus account for 13.4% of the average CEO compensation for S&P 500 companies.

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that turned out to be value-destroying in the longer term and even conducive to the demise of companies.

As any executive who benefited from the system will admit (discreetly), stock options introduce a large component of luck and a good deal of unfairness in compensation. Imagine two colleagues with the same level of responsibility, one hired in January 2009 and the other in January 2007. Both were granted stock options at the time of their hiring. One has already a nice nest egg (on paper), which makes him very nervous about losing this paper wealth, should the stock market take an inopportune dive; the other has worthless options, which may gain some value if the stock market continues to climb back from the depth of 2008. Even then, the value of this variable compensation will be much less than his/her colleague. There are ways to correct these situations but they all introduce new sources of inequity.

Linking compensation to a volatile, noisy metric subject to short-term manipulation was a tragic mistake and one that remains uncorrected. Investors of all stripes clamoring for short-term performance measured by the gyrations of stock price combined with executive compensation massively linked to these same gyrations ushered in a period of repeated corporate fiascos. That model in full bloom played a key role in generating the financial crisis of 2008.

The *casus belli* of executive compensation is well captured by the following two charts:

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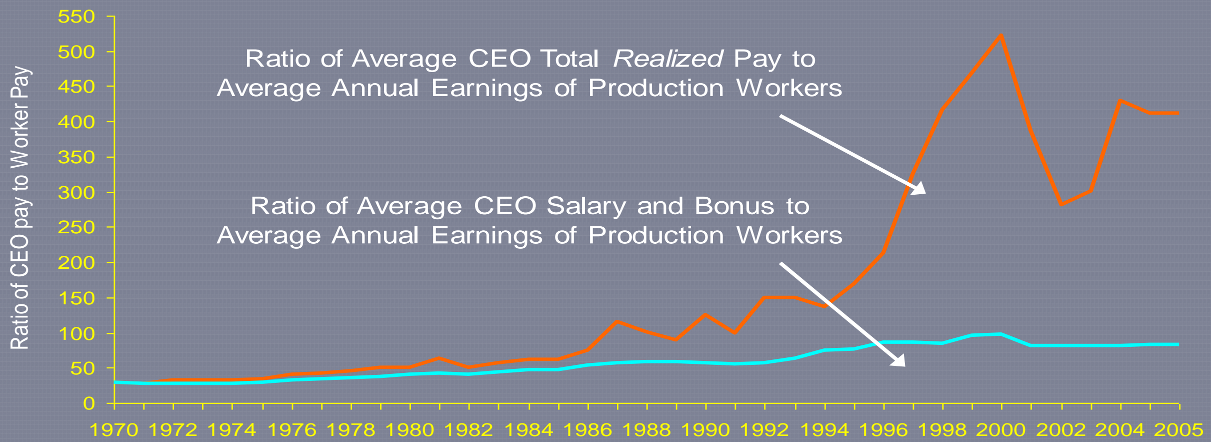
Ratio of CEO compensation to Worker's compensation (S&P 500)



Source: Murphy and Jensen 2004; updated by author

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Average Hourly Earnings and Average Weekly Earnings for the Private Industry in the U.S, 1970-2006 (1982 U.S $)

Hourly $

Weekly $

Source: U.S Bureau of Labor statistics. 2006. Obtained from Statistical Abstracts Online

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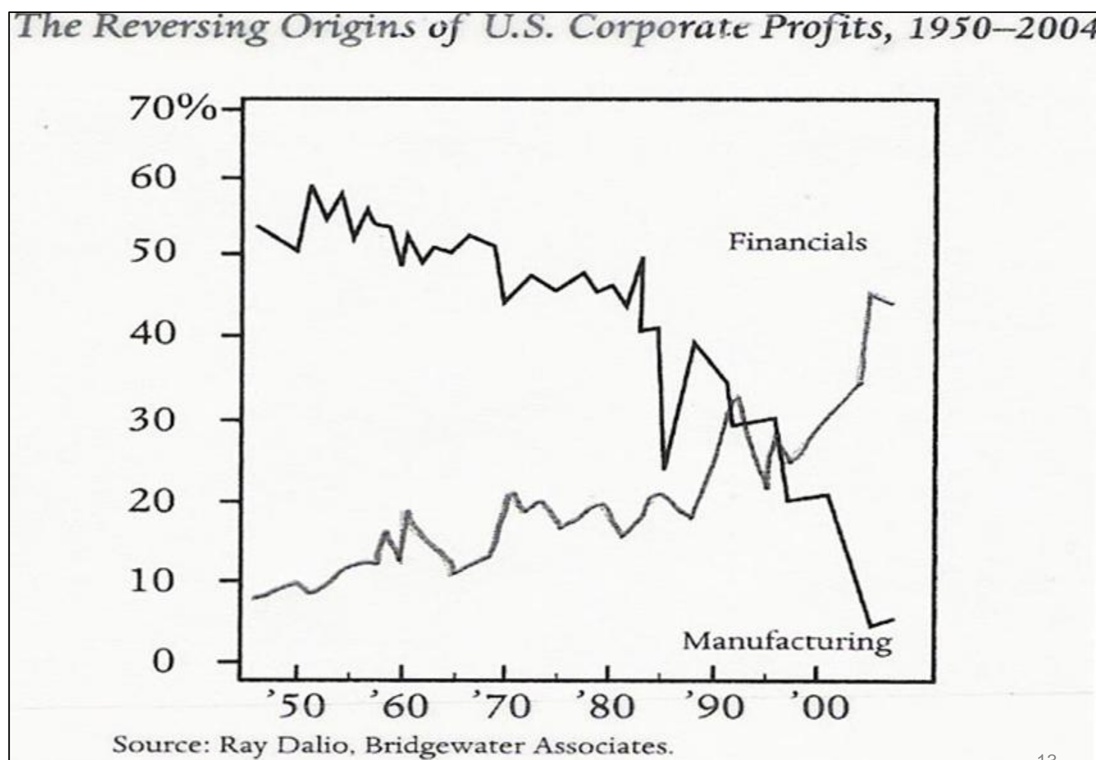
While these charts are based on American data, the phenomenon, to a varying degree, is observed in most developed countries. Differences in compensation *within* companies, at an all-time high, bring in its wake a loss of the sense of community, of *all being in the same boat*, of loyalty and reciprocal trust between senior management and rank and file employees.

In the broader society, soaring income inequality coupled with stagnation of average wages and salaries create a negative perception of business corporations among the general public. This dim view of corporations takes sustenance in facts such as the statistic that 42,000 factories were closed in the USA since 2001 and 32% of manufacturing jobs have been lost since 2000. (Lounsbury, 2010) The next graph offers a striking image of the results.



[13]

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Some proportionate number and a similar trend apply to most other developed countries.

Clearly, as the chart above on the ratio of CEO compensation shows, stock options and other stock-related compensation are the main cause of the compensation problem[8]. Try as we have to refine, calibrate, index, performance-link these compensation systems, the results remain unsatisfactory. It is time to cut the Gordian knot of a compensation system largely based on stock options, a system that prevails only since the 1990s and has wreaked havoc on many companies.

Recommendation 6:

All tax benefits (personal and corporate) which favor stock options as a means of compensation should be eliminated.

Depending on tax jurisdictions, the tax benefits granted to stock options are very generous and make this form of compensation irresistible. It is difficult to justify the special tax treatment of what is basically a form of compensation and should be subjected to the same tax treatment as other forms of compensation.

[8] Of course, the most egregious compensation happens outside of listed companies. The 25 best paid hedge fund managers earned in 2009 a total of U.S. $25.3 billion with $350 million the minimum earnings to get on this list. The collective pay-check of these 25 managers was larger than the Gross Domestic Product of 75 countries on the World Bank's list of 178 countries... ***and more than three times the total compensation of all CEOs of the S&P 500 companies*** (themselves under heavy fire for their "excessive" pay packages!). (Allaire, 2010)

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Recommendation 7:

A more radical recommendation would be to eliminate all stock options as a form of compensation.

At the very least, stock-related incentives should play a decreasing role in the overall compensation of senior management. Great companies were built and innovative firms were created in the past without the crutch of stock options. Companies will not revert to the days when CEOs earned 25 times the average earning of their employees. However, compensation should be linked to *quantitative and qualitative* indicators which drive the economic performance of the company, which **increase *the long-term value of the company.***

The competence of management at factoring in its operations the concerns of society at large and the expectations of key constituencies should be reflected in the compensation system of corporate leaders. The success and survival of the corporation hinges on first rate performance on this score. Call this enlightened self-interest, but it works.

Societies differ in their acceptance and tolerance of income inequalities. Industrial sectors differ as to what is an acceptable ratio between what is paid the average employee and what the top executives get in compensation. For these reasons, governments should not try to set some arbitrary forms and levels of compensation, at this time. That is the duty of boards of directors.

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Many boards have failed to do an adequate job. As a result, institutional shareholders want a "say-on-pay" and governments, under popular pressure, have a hitch to get involved. If boards continue to perform as they have in the past, they will be removed from the setting of executive compensation.

Recommendation 8:

The board of directors of a publicly listed corporation should set a cap on the ratio of the CEO's total compensation to that of the median earnings within the firm.

In setting this ratio, the board should be sensitive to the social, cultural and industrial circumstances within which the company operates. Of course to reach this maximum ratio, the company must have performed exceptionally as measured by valid economic indicators. The bonus earned each year should be "deposited" in a bonus bank and a third of the amount in the "bank" paid annually.

Of course, it will be argued that unless all companies proceed hand in hand to implement these changes, those who do will lose key executives to those who don't. It is perhaps more accurate to state that companies might lose their most mercenary managers, but that is a benefit not a cost.

2. Institutional investors must behave!

Institutional investors, most particularly pension funds, mutual funds and endowment funds, bear some significant responsibility for the financial chaos

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of the last decade. Pension funds of the OECD countries managed some US$ 23.3 trillion in 2009, with some $ 4 trillion allocated to “alternative investments”, which means hedge funds, private equity funds, infrastructure funds, real estate and so on.

Public pension funds manage some US$8 trillion Given that most state and local government’s shaky budgets and large unfunded liabilities, public pension funds seek to maximize their returns so as to reduce the financial burden on their members and sponsors. Private pension funds face the same challenges.

Thus, public and private pension funds have been substantial providers of capital to hedge funds and speculative funds of all sorts to carry on their trade. The next two graphs illustrate the importance of pension funds for Blackstone and KKR, two large private equity/hedge funds, now publicly listed.

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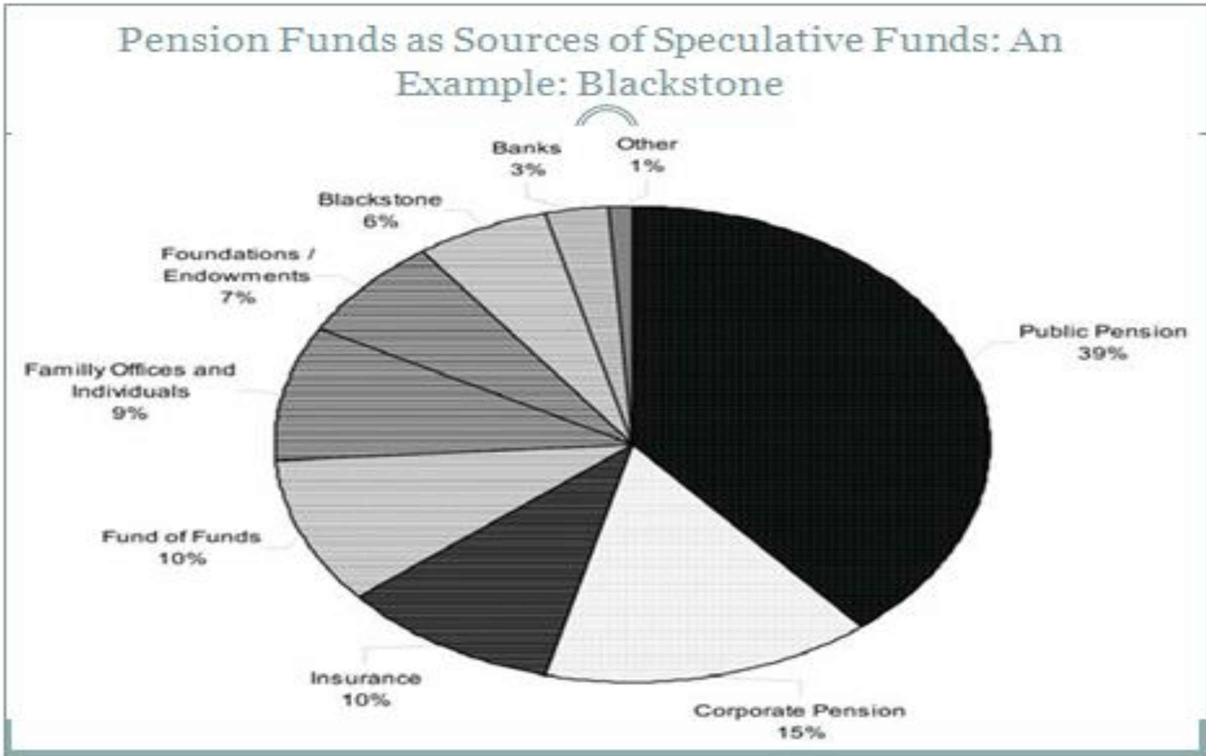
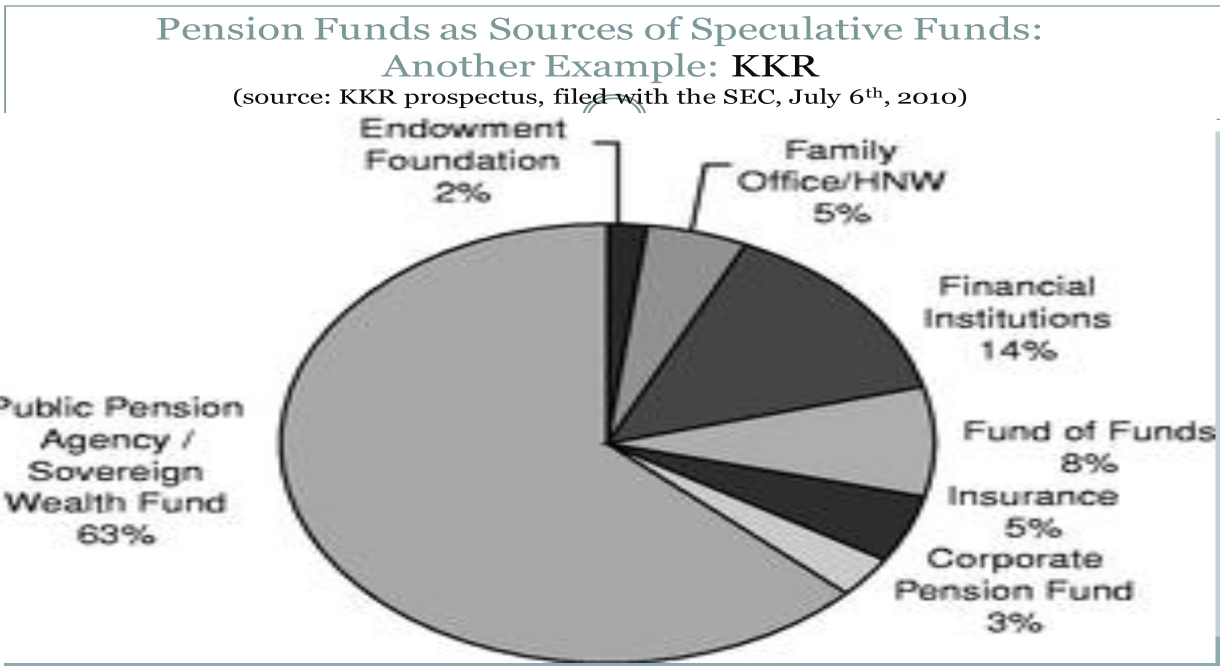


Source: Blackstone prospectus, filed with the SEC, June 2007



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Global Agenda Council- World Economic Forum

The scary part is the prognosis that public pension funds may be allocating some 20% of their assets to *hedge funds* over the next ten years, or some $ 1.6 trillion (on the basis of 2009 assets), a truly frightening prospect. (D. A. Steinbrugge, April 2010)

All this money playing all sorts of games with commodities, company stocks, corporate and country debt, all these speculative funds vying with each other for new tricks to make money, would make the 2005-2008 financial extravaganzas seem negligible by comparison.

Furthermore, in spite of their long-lived obligations, pension funds are assessed yearly (or more often), their performance compared to their peers and measured against indices. As a result, they have become fairly short-term investors.

Finally, because of their huge portfolio of stocks, they are the main lenders of shares to *short sellers*.

It is somewhat incongruous for institutions managing the funds of public-sector employees, of rank-and-file workers to play such roles in empowering speculative funds, the very type of funds that push and prod companies to take actions inimical to workers.

Recommendation 9:

- ***Public pension funds should be restricted as to the percentage of their assets they allocate to alternative investments; more***

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effectively, public pension funds should not be allowed to hire fund managers who demand more than 3% in fixed and variable compensation for their services.

- ***Public pension funds should not lend the shares of their portfolios for short-selling purposes.***

- ***Public pension funds should think long and hard about their role as investors, their policies on share holding period, their contribution to the capital needs of firms of different ownership models within their society, their expectations from listed companies.***

One may object to the first recommendation that it will reduce the returns of the funds; that may be true in the short term but, given the sums of money in play, it would be surprising if a new breed of funds did not appear to service well the pension funds; whatever return may be lost (and overall it is a small percentage), it is well worth it *for the benefit of taming somewhat the speculative funds by starving them of funds*.

Refusing to lend their shares to short sellers will also deprive pension funds of a small but significant income; but it will help curtailing the vexing problem of "empty voting", a consequence largely of short selling activity. Furthermore, the pension funds, by withdrawing from this business, will reduce considerably the supply of shares and thus increase the "rent" that short sellers will have to pay. Their activities will be less remunerative and result in less short selling activity.

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Pension funds and other institutional investors have contributed mightily to the perverse economic system that evolved over the last twenty years. Their quest for short-term performance that "beats the indices" or their peers' performance has exacerbated negative trends and dysfunctions. They must be held to account.

3. Management must behave!

Managers and leaders of large corporations, particularly those of the widely held sort, have become suspended in a web of pernicious motivations and unyielding pressures. It is a web that they have, in part, spun themselves, but, in large part, it has emerged from the collective changes described in this paper.

Short-fused activist funds threaten to take initiatives at the first signal of wavering stock price; short sellers and other speculators bet on the company's misfortunes and broadcast their sombre views to one and all; boards of directors formerly a buffer between management and shareholders are now intimidated by activist shareholders and proxy advisory firms; executives with "paper" wealth are anxious to cash in some of these riches, well aware that their wealth may vanish overnight if the stock market, in general, or their company's stock, in particular, were to experience a major drop in price.

Management has become accustomed to huge, open-ended compensation. The practice, promoted and given credibility by compensation consultants,

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of determining what is the market value of management talent on the basis of a set of reference companies, has done wonders for executive compensation, but it is a sham. All these companies are advised by the same small set of compensation consultants, pushing up all compensations, well aware this is an unstated condition for retaining their services.

Senior executives, understandably in the current context, want to maximize their wealth in the short term, knowing full well that if they disappoint in any way, they will be out of a job in a flash. A sort of blackmail occurs whereby successful executives imply to the board that they might leave if their compensation package is not fully satisfactory.

It was thought that the quantum of executive compensation, fully publicized in the media, may trigger some *shame factor* and lead to less egregious compensation. But for the audience that counts for executives, large compensation is a badge of honour, a sign of merit, a trigger of "bonus envy" among peers. As John Stewart Mill wrote: "*Men do not desire to be rich but to be richer than other men*"
Through all this, management is expected to manage for "the long term" and to behave ethically in all circumstances. Indeed, *what is surprising is that, in spite of these incentives and pressure, many executives did behave ethically and with a sharp sense of their social responsibilities.*

But *ethics is "the resistance of values under pressure". Everyone, except saints and heroes, has a breaking point*. We must spin a new social and economic web, *which is what the earlier recommendations are proposing.*

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Management will behave differently and predictably if the incentives are changed and the pressures are channelled differently.

But it may not even then. Bad habits die hard. The deal here comes as follows: actions by institutional shareholders, governments, and boards of directors will bring about a different business context, one that allows management to plan and decide with a longer-term perspective and a due consideration of relevant stakeholders.

It will give management more stability and employment security. It will stifle somewhat the dictatorship of ever-increasing earnings per share. But management bears a great responsibility for making this happen. Collectively, they yield great power and have access to huge resources. THE SYSTEM HAS NOT BECOME WHAT IT IS WITHOUT MANAGEMENT COOPERATING ENTHUSIASTICALLY AND GAINFULLY WITH OTHER PARTIES.

Recommendation 10:

Management will demand compensation that will foster and protect trust and a sense of fairness within and around their company. Under this new set of circumstances, ethical behaviour and socially conscious decisions, already manifest in many corporations, will become, should become, the norm. Management will be an active participant in the shaping of a new corporate order.

If this does not come to pass, then beware! More radical solutions will be promoted and enacted by actors with a less benign view of corporations.

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Managers as a class should not let a few greedy ones destroy the system for all.

4. Governments must set a level-playing field

For many of the recommendations sketched above, governments have to play a key role. In some areas, cooperation and coordination between and among countries (say, the G20) would be essential. That is particularly so for the regulation of financial markets, for the reining in of financial derivatives (subjects not addressed in this document).

Globalization notwithstanding, national governments retain considerable power and latitude to intervene forcefully and positively in economic affairs. Canada, living in the shadow of the United States, has shaped a financial, business and social system significantly different from the American system and more attuned to the tradition and mores of Canadians.

Governments should not stand idly aside as the industrial structure of the country is devastated by the off-shoring of large swaths of business operations, from manufacturing to engineering and telemarketing. Nor should they stand by as foreign companies take over their natural resources and their key companies.

Recommendation 11:

Governments should impose the principle of reciprocity in their international dealings; this principle could be called "elementary fairness".

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For instance, companies domiciled in a given country should not be able to acquire firms in another country if the latter firms would not be allowed to do so in that given country. Governments should set different standards for acquisitions of companies operating in the in the natural resources sector or the financial sector.

The difference in social and environmental costs between the "exporting" and "importing" countries should be factored in some form of tariff applicable to all competing products.

Countries should not freely "import" jobs and "export unemployment" by playing tricks with their currency.

National **c**ompanies sending abroad part of their operations should be held accountable for some of the cost of retraining employees made redundant by this move.

Champions of "free trade" will foam at the mouth in protest. But the concept of free trade has actually been warped into a large-scale, devastating move abroad by domestic companies to push up share prices and push down consumer prices on the back of workers.

Conclusions

The recommendations proposed here, taken as whole, would change radically and fundamentally, and for the better, the way our economic and

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financial systems work. All economic agents are called upon to do their part:

National governments should:

- Foster varied forms of business ownership;
- Promote, and where they have the authority, impose state-of-the-art governance principles and processes appropriate to different forms of business ownership;
- Modify, if necessary, their corporate business laws:
    1. *To state unequivocally that the fiduciary responsibility of the board of directors is **to the corporation**, not to shareholders or other stakeholders;*
    2. *to permit a different treatment of shareholders on the basis of their unequal share holding period;*

- Consider the fiscal impact of modulating capital gain tax as a function of the holding period of shares;
- Eliminate the favourable tax treatment of stock options;
- Consider banning stock options as a means of management compensation; one may argue that some degree of international coordination would be required here because of the high degree of geographical mobility for managers and executives; this concern may be legitimate for some business sectors (finance, for example) but not as a general rule; also, under the proposal put forward here, total compensation can still be quite generous though in a different form;
- Consider imposing a tax or fee on every stock transaction; this measure would require a high degree of coordination among the counties hosting the major stock markets;

- Regulate the pension funds under their jurisdiction to restrict or eliminate their investments in speculative funds as well as their stock lending activities;
- Impose the principle of reciprocity in their international dealings

Most of these measures may be implemented by a given national government.

Institutional Investors should:

- Restrict the percentage of their assets allocated to alternative investments; more effectively, public pension funds should not be allowed to hire fund managers who demand more than 3% in fixed and variable compensation for their services.
- Not lend the shares of their portfolios for short-selling purposes.
- Think long and hard about their role as investors, their policies on share holding period, their contribution to the capital needs of firms of different ownership models within their society, their expectations from listed companies.

Boards of directors should:

- Make clear that they see their role as fostering the long-term interests of the corporation;
- Adopt every legally feasible measure to increase the stability of shareholders and the holding period of shares; lobby governments to adopt legal and fiscal measure to support a more a stable “ownership” base; push for a one-year holding period before a shareholder can exercise the right to vote;

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- Boards of directors should adopt processes of nomination and election which foster their legitimacy; they should adopt all policies and processes conducive to enhanced credibility of the board;
- Adopt the governance practices best suited to the ownership form of the business they are charged with governing;
- Change compensation practices; eliminate stock options, or at the very least reduce the percentage of total compensation which comes from stock-price related incentives;
- Set a maximum ratio of executive compensation to the median earnings within the company, taking full account of the norms and values of the surrounding society and the specific character of the industry;
- Define with the senior management team performance objectives that take into account the softer (but more difficult) side of the business as well as the broader social and ecological impact of the corporation.

Corporate leaders should:

- Support, and advocate for, the type of changes proposed here;
- Take the initiative of discussing with their board how to implement measures to bring about a more stable shareholder base;
- Work with their board on setting compensation in a way that preserves essential values of trust and fairness within the company, and a broad view of the corporation's responsibility within society;
- Instil in their company the value of social stewardship and a keen sense of "we are all in the same boat".

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The policy recommendations proposed here may bring about the kind of economic system in which "vanguard corporations", described by Rosabeth Moss Kanter will mushroom, the kind that "is good for communities, that employees want, and the public approves"[9].

We must seed the conditions, *the terms of inducements,* in which "authentic leaders" will blossom, the kind of leaders about whom Bill George wrote so eloquently..."*leaders who build organizations, mobilize their employees to provide superior service, and create long-term value for shareholders...guided by qualities of the heart, by passion and compassion...*"[10]

No doubt that some of these policy suggestions would generate great resistance and be met with scepticism or fatalism; but may we convey the simple truth that "*the status quo in slightly modified form with a pinch of regulations and a drop of oversight added to the mix*" will not do, and would ensure economic pain and social unrest in a near future.

[9] Kanter, Rosabeth M., ***Supercorp***, Crown Business, 2009.
[10] George, Bill, ***Authentic Leadership***, Jossey-Bass, 2003.

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