Institute for governance
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Good versus Bad Capitalism: a Call for a Governance Revolution

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(Extracted in part from ***Black markets and Business Blues*** *(FI Press, 2009) and* ***A Capitalism of Owners*** *(IGOPP, 2012), both co-authored with professor Mihaela Firsirotu)*

Toward Value-Creating Governance™

Summary

This paper examines a number of inter-related questions, which portend a different kind of corporate governance than the accumulation and refinement of fiduciary responsibilities heaped upon boards over the last twenty years.

- **Is short-termism in corporate management a truly serious problem? If so, why has it come about?**

A pernicious combination of factors may well bring about a short-term perspective in corporate management: 1. Financial players threatening actions against management if it does not deliver increased share price; 2. Boards of directors intimidated by activist hedge funds and proxy advisors; 3. Warped incentive systems prodding and "bribing" management to take actions to boost short-term stock price.

- **Are activist investors and hedge funds really short-term players whose actions have a negative impact on corporations in the longer term?**

According to Cremers, Pareek, and Sautner ["Stock Duration and Misvaluation", SSRN No.2190437, December 2012], the average share holding period of institutional investors has barely changed since 1985; it hovers between 1.2 and 1.5 years.

Remarkably, some have concluded from these results that institutional investors are not short-term holders! Since when holding shares for 1.5 years turns one into a long-term holder? These results actually show that the trend to shorter holding period has been in place since the 1980's. By 1985, the average holding period had already dropped to some 1.5 years; the further drop (to under one year) may be the product of speed traders and others; but there is no doubt that shares were held for a much longer period of time before the first wave (since the 1920s) of short-term "investors" appeared in the 1980s.

- **Do boards really need to be better insulated from the actions of "activist" investors as well as from unwanted takeovers?**

Canada is very different from the U.S. in matters of corporate ownership and board empowerment. The three "bêtes noires" of U.S. activist institutional funds and proxy advisors are non-issues in Canada:

1. Splitting the roles of Chair and CEO (Only 41% of S&P 500 companies have separate Chair and CEO position and in many cases that chair person is not an independent member but the former CEO; fully 85% of Canadian companies have divided the roles of Chair and CEO, an important principle in situations of conflicts with shareholders);

2. Eliminating staggered boards and electing all members every year. A third of the S&P 500 companies still have staggered boards (that is, only a third of members of staggered boards are up for election each year); staggered boards are practically non-existent in Canada;

3. Curtailing the role and duration of poison pills as a defense mechanism against takeovers; these attempts have been largely unsuccessful in the U.S., particularly in States which grant very specific and extensive powers to the board of directors in situations of attempted takeover; none of these defenses are available to Canadian companies as a result of decrees by the securities commissions.

The result is that Canadian boards are less empowered than the board of any run-of-the mill American corporation. American activists would hail Canada as the *Promised Land* for shareholder rights.

- **Who owns the publicly listed corporations?**

Society at large may rightfully claim that it has a stake in companies operating in its midst, a stake just as important as that of shareholders (Brennan, 2005). No doubt that a fickle, volatile, ever-changing shareholding base provides arguments for a different concept of "who owns the company".

The basic assumption underlying "corporate democracy", the one-share-one vote mantra, has become questionable. In a world of "empty voting", total return swaps, record date capture, speed-trading, transient share flippers, arbitrageurs, speculators and game players, the question arises: are any and all shareholders the legitimate owners of publicly traded corporations?

In all decent societies, "***Tourists don't vote***!" and "***Gamblers don't own the casino!"***

Every democracy imposes a minimum period of time before a newcomer acquires the full rights of citizenship, particularly the right to vote. Corporate democracy likewise should call for a modicum of commitment from a shareholder before he or she can influence the destiny of the corporation, for example a one-year holding period.

The long-run welfare of societies and the economic vigour of industrial companies are more important than the spurious lure of "shareholder value" and the freedom to practice financial sleights-of-hand

Introduction

The theme of this conference could well have been "Good Capitalism versus Bad Capitalism" because short-termism and unchecked activities of speculative funds are emblematic of "bad capitalism", of the kind we must get rid.

John Gray writes in ***False Dawn*** that "*In a global free market, there is a variation on Gresham's law: bad capitalism tends to drive out good capitalism".*

Bad capitalism is finance-driven capitalism; it is capitalism without true owners, a capitalism in which corporate leaders, motivated by the carrot of lavish incentives and the stick of humiliating replacement, are singularly focused on generating short-term value for shareholders. It is a system where financial operators reap immense riches from activities of no social value.

What sort of capitalistic system produces 25 hedge (read "speculative") fund managers who earn **five times** the total pay of all the CEOs of the 500 largest American companies, themselves often upbraided for their *excessive* compensation?

What sort of capitalism would reward a fund manager with an $8 billion pay check for a single year's speculations and gambles with other people's money? A middle class citizen earning an honest $50,000 a year would have been working since the *Middle Palaeolithic period* some 160,000 years to get to that figure.

No doubt, forceful actions could, and should, be taken to counteract the pernicious nature of "financial capitalism", but we must first answer convincingly three related questions:

- Is short-termism in corporate management a truly serious problem? If so, why has it come about?
- Are activist investors and hedge funds really short-term players whose actions have a negative impact on corporations in the longer term?
- Do boards really need to be better insulated from the actions of "activist" investors as well as from unwanted takeovers?

My answer to these three questions is a resounding "YES"; but that will not suffice. Let's examine each one of these questions in turn.

Is short-termism in corporate management a truly serious problem? If so, why has it come about?

A pernicious combination of factors may well bring about a short-term perspective in corporate management: 1. Financial players threatening actions against management if it does not deliver increased share price; 2. Boards of directors intimidated by activist hedge funds and proxy advisors; 3. Warped incentive systems prodding and "bribing" management to take actions to boost short-term stock price.

There is ample evidence of these forces at play.

- Anyone who has participated in, or listened to, the quarterly conference calls with analysts has to be struck by the unreal focus of these people on the short-term, on the earnings per share of the next quarter and the current year. We should not underestimate the impact on the psyche of executives from the quarterly prodding and second-guessing going on in these sessions. If or when executives have to come to them with a less than stellar performance, all hell breaks loose. This charade is truly intimidating, particularly in companies with no controlling shareholder.

- All senior managers know the cost and pain of coming up short on expected quarterly earnings-per-share.

  Let's look at a concrete example. Mrs. Indra Nooyi, the CEO of Pepsico, an insightful, enlightened executive, made it clear when she became CEO in 2006 that she would try to take Pepsi from snack food to health food, from sweet and fattening colas to fruit juices, and from shareholder value to sustainable enterprise; she stated at the time that she wanted *to give Wall Street what it wants but also, the planet what it needs.* Achieving these goals may be essential to keep the company prosperous over the long term.

  Well, as long as share price moves up (or at least does better than relevant stock indices) and earnings per share keep growing, the CEO is free to expound on social issues and make any claim she/he wants about how socially responsible the company has become. “Investors” and analysts tend to believe that this posturing and speechifying by the CEO are all part of a good public relations campaign. The moment of truth comes when the stock falters, earnings disappoint. Does the CEO really believe this stuff?

For Ms. Nooyi, that moment came on July 21st, 2011. At the conference call with financial analysts about its second quarter results, Pepsi had to revise downward its “guidance” for 2011 earnings per share (EPS) growth from 10% to “high single digit”.

The stock price tumbled in the days following the conference call. For an announced shortfall, compared to previous guidance, of some 2 cents a share, *or around $30 million in yearly earnings,* the market value of the company dropped by some $7 billion (or 233 times the shortfall in expected profit for 2011 and some 14% of its total market cap)! And the financial press and blogs alighted with calls for her replacement.

She got the message. She dropped the “health focus” and zeroed in exclusively on margin improvements, cutting costs and market share. Now she’s all about giving Wall Street what it wants and quickly; the planet will have to take care of itself. Pepsico’s stock price is back up and doing better than Coca-Cola’s Her job is secure. Whether that is good for the long-term success of Pepsico is a question for another day!

But what was the position of the board of directors of Pepsico? Obviously, they did not comfort Ms. Nooyi’s course of actions. The board did not act as a buffer and certainly did not advise the CEO to tell all these agitated analysts and fund managers to go fly a kite. Why?

Because board members are themselves afraid to come under attack, to be singled out, by activist hedge funds and proxy advisory firms. Giving the “market” and proxy advisors what they want *now* becomes the safe course of action for boards of directors.

- The influence of proxy advisers on corporate governance is troubling. Too many, boards of directors, to ensure favorable recommendations from proxy advisers, are taking pre-emptive steps to ensure that their policies on governance and executive pay will not trigger a negative score when fed into the proxy advisers' standardized algorithm. "*For example, some such [*proxy advisor] *firms have policies that recommend a vote against a director in the annual director election if during the previous year the director voted in favor of certain corporate actions, leading some boards to ask before approving certain actions, "What are the proxy advisory firms' policies on this action?" (*New York Stock Exchange Commission on Corporate Governance, September 23, 2010).

That is going on across the whole landscape of exchange-listed corporations, which, in the U.S., are gradually stripped of defense mechanisms against this sort of "investor" behavior.

- Ask CFOs whether they would postpone profitable investments in order to meet the quarterly earnings targets. Well, a survey of 400 financial executives of U.S. companies found that they would indeed "*give up positive NPV projects to meet short-term earnings benchmarks*..." The researchers write: "*In the end, many of our results are disturbing. A majority of these CFO's admit they would sacrifice long-term economic value to hit a target or to smooth short-term earnings*" (Graham, Harvey and Rajgopal, 2005).
- Ponder what sorts of incentives are really built in executive compensation packages. Examine what metrics *are proposed by proxy advisors* and others to give a "good-governance" seal of approval to executive compensation. Subtly or not so subtly, and despite claims to the contrary, they all drive management to a short-term focus (Unless you happen to define three years as long term). Claims to have linked compensation to long-term performance are largely spurious. Giving executives a yearly dose of stock options and restricted shares, no matter that they vest only sometime in the future or on the basis of some sort of future performance, means that, *this year and next year*, some past grants are coming to maturity; therefore, whatever the performance hurdle or the stock price set some years ago, the results *this year and next year* will determine how much an executive will reap from these prior incentives.

Are activist investors and hedge funds really short-term players whose actions may well have a negative impact on corporations in the longer term?

The fact that some corporate management may succumb to short-termism does not necessarily imply that institutional investors, activists or otherwise, are also short-term in their actions and their strategies.

A few facts:

- Publicly traded companies are now “owned” by institutional investors, pension funds, mutual funds and others. In the U.S. over 70% of the shares of the 1000 largest companies are in the hands of institutional investors; in Canada, the prevalence of controlling shareholders and dual class of shares create a different profile of company ownership.

- All institutional investors have become “activist shareholders”; their public accountability for yearly (and, in some cases, quarterly) results has raised their sensitivity to the short-term performance of the stocks in their portfolio. Theirs is a “soft” activism, however, made up of insistence on various governance measures, on incentive systems that link pay to performance, and so forth. That approach is to be contrasted to the “hard” activism of hedge funds with their willingness to be confrontational, to carry out proxy fights, to demand changes in strategy and leadership of the targeted companies.

- But what about the notion that shareholders hold on to their shares for a much shorter period of time nowadays, that the stock market is made up largely of share flippers? There is no doubt that the rate of turnover of shares has increased tremendously over the years. Some American data suggest that turnover has now reached over 300%; that is, the annual volume of share transactions divided by the total number of shares outstanding is over three times. Of course, speed traders and other forms of programmed trading explain a large part of this increase in volume. The question remains: do investors hold on to their shares for a shorter period of time than before. Some academic researchers have produced empirical data that, in their view, answer this question negatively.

As shown in the following figure (Figure 1), the average share holding period of institutional investors has barely changed since 1985; it hovers between 1.2 and 1.5 years.

Figure 1

Year	Bank Stock Duration	Investment Company Stock Duration	Pension Funds Stock Duration	Others Stock Duration
1985	1,23	1,11	0,85	1,75
1986	1,23	1,05	1,06	1,60
1987	1,36	1,10	0,75	1,53
1988	1,57	1,20	0,92	1,98
1989	1,71	1,19	1,34	1,52
1990	1,67	1,26	1,68	2,18
1991	1,65	1,25	1,90	1,52
1992	1,64	1,25	2,09	1,44
1993	1,53	1,27	2,15	1,81
1994	1,42	1,30	1,97	1,63
1995	1,41	1,29	1,80	1,71
1996	1,19	1,15	1,90	2,10
1997	1,30	1,13	1,63	1,70
1998	1,30	1,16	1,68	1,69
1999	1,39	1,15	1,50	1,15
2000	1,37	1,15	1,48	0,82
2001	1,37	1,20	1,50	0,67
2002	1,41	1,24	1,58	0,82
2003	1,49	1,27	1,74	0,86
2004	1,64	1,33	1,97	0,65
2005	1,73	1,36	2,17	0,79
2006	1,76	1,36	2,28	0,93
2007	1,78	1,39	2,31	1,01
2008	1,80	1,43	2,10	1,18
2009	1,60	1,34	1,96	1,22
2010	1,62	1,41	2,00	1,23
Total	1,50	1,23	1,72	1,00
Change (1985-2010)	32%	27%	134%	-30%

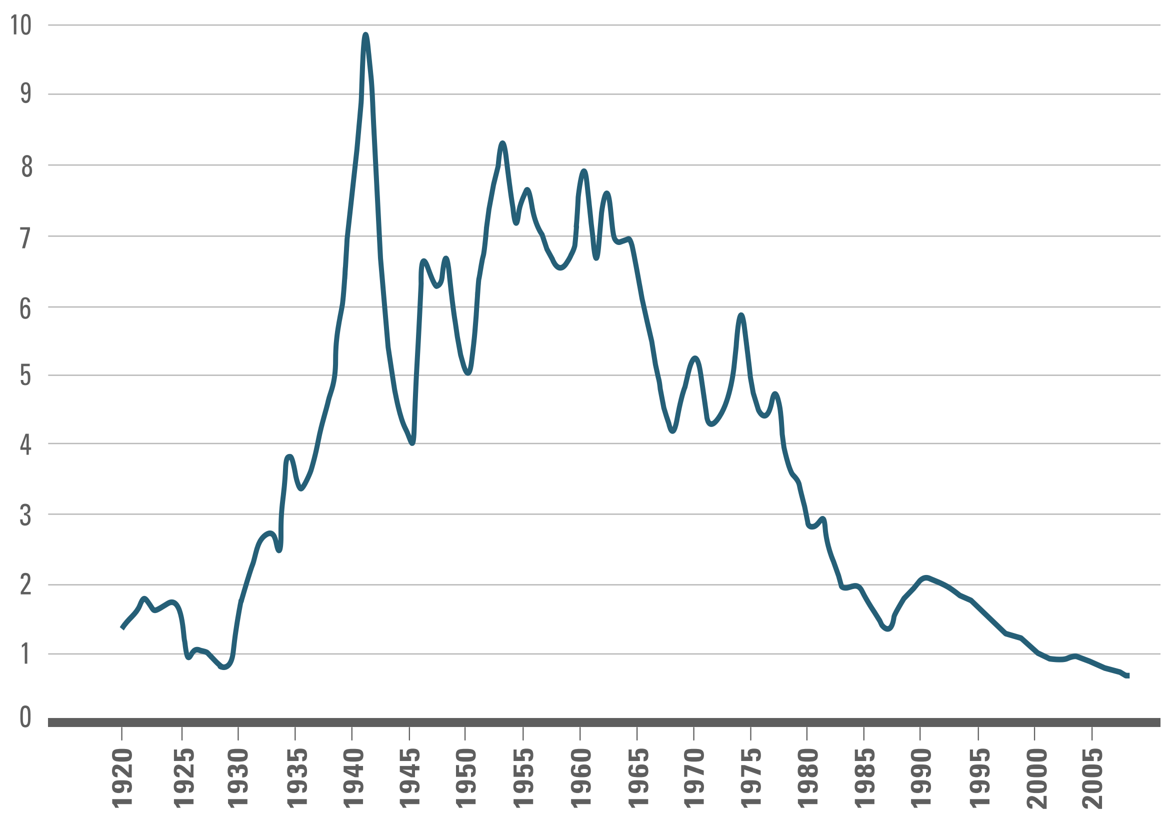
(Source: Cremers, Pareek, and Sautner "Stock Duration and Misvaluation", SSRN No.2190437, December 2012)

Remarkably, some have concluded from these results that institutional investors are not short-term holders! Since when holding shares for 1.5 years turns one into a long-term holder? These results actually show that the trend to shorter holding period has been in place since the 1980's. The following figure makes this phenomenon clear.

Figure 2

Average stock holding period - NYSE 1920-2008

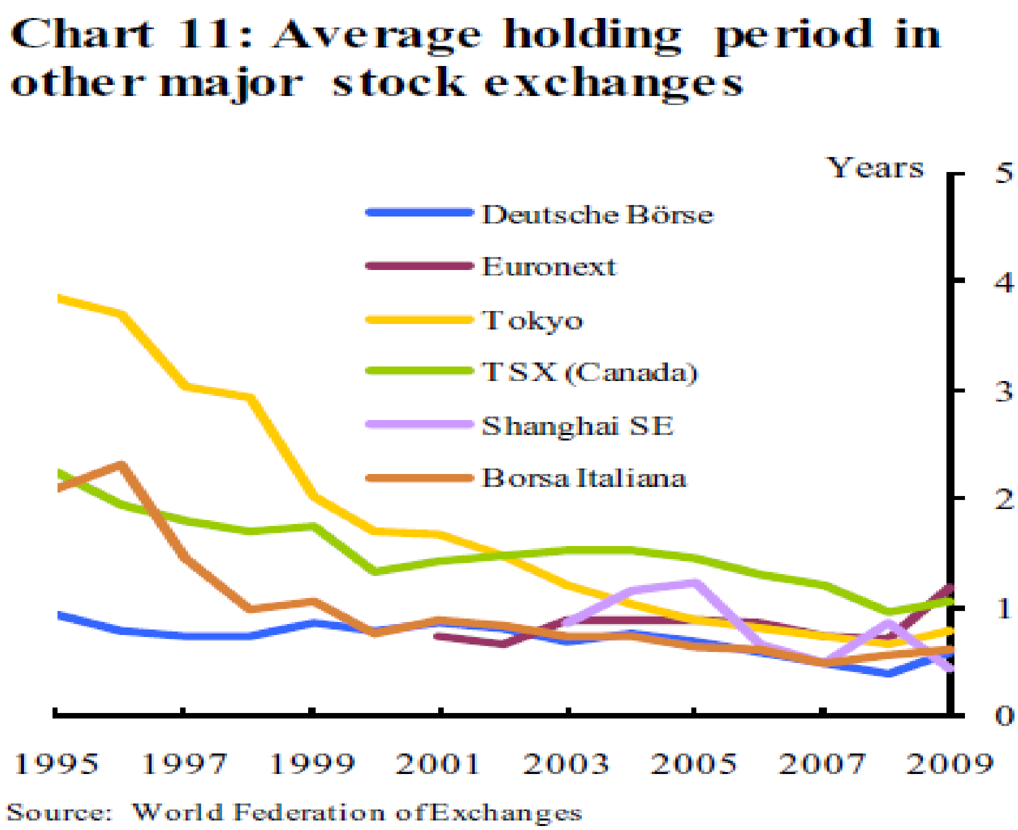
SOURCE: SG GLOBAL STRATEGY RESEARCH



By 1985, the average holding period had already dropped to some 1.5 years; the further drop (to under one year) may be the product of speed traders and others; but there is no doubt that shares were held for a much longer period of time before the first wave (since the 1920s) of short-term “investors” appeared in the 1980s.

The phenomenon is a worldwide one as shown by Figure 3 charting the average holding period of several stock exchanges.

Figure 3



But what about hedge funds: are their investment strategies short-term and do they foster a short-term orientation in corporate management?

One would think that the nature and size of their compensation (*annual* cash compensation based on a percentage (usually 20% or more) of the return of the fund) would tend to induce a short-term view of performance. Either monetary compensation can warp motivations or it cannot. If corporate executives are believed to be influenced in their actions and decisions by their compensation packages, then the same logic should apply, *a fortiori*, to hedge fund managers.

Numerous academic studies have been conducted to try to answer the question of the impact of activist hedge funds. Yet again, *Academia is enlightening but not decisive.* In fact, it is sharply divided between supporters and critics of hedge funds.

However, some this research activity does help to answer some questions:

- **What do activist hedge funds want?**

- *Selling the company, going private* (33% to 36% of cases)
- *Unbundling* **-** selling "under-performing" divisions, assets, etc. (18% to 32% of cases)
- *Disgorging cash* - special dividends, share buy-back, debt restructuring (20% to 36% of cases)
- *Changing governance, strategy and/or management* (30% to 45% of cases)
- *Pursue growth strategies* (1 to 2% of cases)

(Source: Adapted from Bratton, 2006 / Brav et al., 2007)

All these moves, if implemented, will likely boost stock price in the short-term. One could also argue that, for example, selling "under-performing" divisions or "changing strategy and leadership" could bring lasting benefits to the company but only if the hedge funds made the right call; given their lack of management and operational expertise, one may be skeptical about their long-term wisdom.

Does the price increase from the actions of hedge funds represent true economic value creation?

The debate is raging within academia on that topic. Some studies purport to demonstrate a lasting positive effect on the productivity of the firms targeted (Brav, Jiang, and Kim, April 2013). However, the increase in stock price may be largely accounted for, not by true wealth creation, but by transfer of wealth to shareholders from bondholders and from employees. (Klein and Zur, 2010; Hu and Li, 2010, Brav *et al*., 2010).

For instance, Brav *et al.*, who otherwise support the thesis that hedge funds have a positive influence, write:

Overall, results suggest that target firm workers do not share in the improvements associated with hedge fund activism. They experience a decrease in work hours and a *stagnation in wages, while their productivity improves significantly. Moreover, the relative decrease in wages compared to the improvement in labor productivity suggests that wealth is* ***transferred from workers to (equity) investors****, which may account for part of the positive abnormal return at the announcement of hedge fund interventions.* (Emphasis added)

("The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Industry Concentration", April 2013)

Another group of researchers finds clear evidence of **a transfer of wealth from bondholders to shareholders:**

Further, they [hedge funds] *do not improve the accounting performances of firms in the year after the initial purchase – in fact, EPS, ROA, and ROE decline in the fiscal year after the activism. Instead, they appear to extract cash from the firm through increasing the debt capacity of the target firm and paying themselves higher dividends….the activist campaign suggests that hedge fund managers achieve their goals by posing a credible threat of engaging the target in a costly proxy solicitation contest.*

…we find that hedge fund activism significantly reduces bondholders' wealth. [A result] *inversely related to subsequent changes in cash and assets (loss of collateral effects) and directly to changes in total debt. Confrontational campaigns and the acquisition of at least one seat on the target's board elicit more negative bond returns. We also find an expropriation of wealth from the bondholder to the shareholder.*

("The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders", Klein and Zur (2010))

By the way, some of these researchers also claim that activist hedge funds are not short-term investors because they hold their positions for more than a year on average and sometimes for almost two years! Again, holding periods of one or two years qualify an investor as long-term!

Are financial markets so myopic that they do not factor in the current price the long-term negative impact, if any, of hedge funds' short-term actions?

Finally, a last argument is put forward to sustain the argument that hedge funds cannot benefit from short-term action which might have a deleterious impact on stock price in the longer term: "efficient" financial markets would see through such moves and would factor longer term effects into short-term prices, therefore depriving hedge funds of their short-term gains. Warren Buffett has stated: "*if markets were efficient, I would be a beggar in the street with a tin cup*".

Bebchuk (2013) circles warily around this argument, well aware that the 2008 financial debacle has all but discredited the notion of efficient markets. He merely claims that financial markets cannot be totally myopic.

However, the examples of actions and decisions which have boosted stock prices in the short-term only to turn out to have disastrous effects in the longer term are too numerous and obvious to give any credence to this argument. Why did investors, in 2007, ***not*** factor in the stock prices of Lehman, AIG, and others the longer term impact of their highly risky business models?

The most generous conclusion one may reach from these empirical studies has to be that "activist" hedge funds create some short-term wealth for shareholders (and immense riches for themselves), in a minority of cases bring some lasting benefits to companies, but largely they succeed through wealth transfer (from debt holders and employees) rather than wealth creation.

A governance revolution?

Perhaps the real lesson to be drawn from the actions of activist speculative (or so called hedge) funds may be that corporate governance needs to undergo some fundamental questioning, a revolution perhaps. The last time this has occurred was in the 1980s with a wave of leveraged buy-outs (LBO). The LBO funds claimed that the governance of publicly listed companies was weak, complacent and incompetent at setting the kind of incentive system that would drive high performance. Only by privatizing the companies could the right kind of value-creating governance be put in place.

Ten years ago, Professor Mihaela Firsirotu and I wrote a piece for the C.D. Howe Institute titled *Changing the Nature of Governance to Create Value* (No. 189, November 2003). We argued that the fiduciary type of corporate governance, the obsessive refinements of guidelines and rules, was fast approaching the point of diminishing, if not negative, return.

We proposed a different kind of governance: value-creating governance. We made the point that there might be lessons to be learned from the kind of governance put in place by LBO/ private equity funds in the companies they privatized.

Yet, we concluded our piece for the C.D. Howe Institute on a somewhat pessimistic note. There are four critical differences between private equity funds driving the management of a privatized company and the board of directors of a stock-exchange listed corporation:

1. The board members of the privatized company, often made up of general partners of the fund, are compensated at a level and in a manner hardly conceivable for board members of a publicly listed company.

2. Board members of the newly privatized company must not be "independent" and rarely are; a majority of board members of publicly listed companies must be "independent".

3. The boards of listed corporations must discharge fully all their fiduciary and legal responsibilities; that component of governance grabs a good portion of the time available to board members; privatized companies have none of these hassles and can concentrate on strategy, cash flow management, etc.

4. The board of a privatized company will call directly on outside consulting firms to assess the company, its competitors and so forth, and the external consultants will report directly to the board. Now imagine that the board of a publicly listed company were to inform management that it intends to hire some firm to audit the company's strategy and benchmark its performance. That would not fly well and would certainly create severe tensions between the board and management. Management would claim that the board is straying away from its governance role; it would contend that the company regularly gets this sort of studies and reports regularly to the board on their results, etc.

Eventually, popular outcry led to political actions to clip the wings of the LBO revolution. But their actions have had a lasting influence on corporate governance, most spectacularly in the form and level of executive compensation. We owe to this period the emergence of large chunks of stock options as a means of motivating executives to work exclusively for shareholders.

Once again, it may be that "activist" hedge funds are enriching themselves on the back of a governance failure; we have tightened, refined and expanded the fiduciary aspects of corporate governance over the last 10 years. Most observers would agree that the continued fine tuning of fiduciary governance will result in sharply diminishing returns.

But we have not solved the basic quandary of governance: the asymmetry of information, knowledge and time invested between the governors and the governed, between the board of directors and management. What has happened recently at Canadian Pacific and SNC Lavallin, *both companies with stellar governance scores*, underlines the fact that fiduciary governance, no matter how well executed, will too often fall short.

Until forms of governance are designed to cope with this fundamental issue, boards will be prone to surprises, kept in the dark about various goings-on in the company, insufficiently informed to push hard on management for lasting high performance. In the current form of governance, corporate directors are somewhat akin to skaters making intricate arabesques on a frozen lake but unaware of the teeming life going on underneath.

Do boards really need to be better insulated from the actions of "activist" investors as well as from unwanted takeovers?

This question brings a different response in the Canadian context than it does in the U.S. context of corporate ownership and board empowerment. First, as shown in Table 1, the largest 100 Canadian companies (on the basis of revenues) exhibit a diverse ownership structure:

Table 1

Ownership and Control of the 100 Largest Commercial Enterprises in Canada (on the basis of revenues) (*Excluding subsidiaries of foreign companies*) « Control » means that a single, non financial, shareholder (or a group of related shareholders) holds more than a third of voting rights (Data sourced from the FP 1000 (2012) and the Globe and mail Report on Business)		
	Canada	
Industries with legal constraint on control: - By any shareholder	9	
- By a foreign shareholder	5	
Widely held companies	***36***	
Controlled through a dual class of shares	16	
Controlled through a single class of shares	7	
State-owned companies	15	
Cooperatives and Mutuals	6	
Private companies	5	
Other	1	

All but 36 of the 100 largest Canadian companies are immune to takeovers as well as to the financial chicanery of hedge funds. No doubt that a society will benefit from an ownership structure that makes their large commercial businesses immune to short-term incentives and the assorted games of activist funds of all sorts.

By contrast, of the 100 largest American business organizations (on the basis of revenues), some 75 are widely held; but in many cases, these widely held companies have put in place (or the State of their incorporation has put in place) very effective measures to insulate the company against takeovers.

Indeed, since the Leveraged-Buy-Out (LBO) extravaganza of the 1980s, legislative actions in some 30 U.S states in the Land of Free Markets have enhanced the power of the board to resist unwanted takeovers and assorted hostile manoeuvres against the company. These legislations vary from state to state but they all aim at shifting the balance of power to the board of directors.

There is no equivalent in Canada. Once a company is put in play, protective measures are few and of short duration; they are basically designed to give the board the time to shop around for a better offer.

Second, the three "bêtes noires" of U.S. activist institutional funds and proxy advisors are non-issues in Canada:

1. Splitting the roles of Chair and CEO (Only 41% of S&P 500 companies have separate Chair and CEO position and in many cases that chair person is not an independent member but the former CEO; fully 85% of Canadian companies have divided the roles of Chair and CEO, an important principle in situations of conflicts with shareholders);

2. Eliminating staggered boards and electing all members every year. A third of the S&P 500 companies still have staggered boards (that is, only a third of members of staggered boards are up for election each year); staggered boards are practically non-existent in Canada;

3. Curtailing the role and duration of poison pills as a defense mechanism against takeovers; these attempts have been largely unsuccessful in the U.S., particularly in States which grant very specific and extensive powers to the board of directors in situations of attempted takeover; none of these defenses are available to Canadian companies as a result of decrees by the securities commissions.

The result is that Canadian boards are less empowered than the board of any run-of-the mill American corporation. *American activists would hail Canada as the Promised Land for shareholder rights*.

But the battle that rages on in the U.S. will have an echo in Canada although the two contexts are totally different. For instance, Professor Lucian Bebchuk of Harvard University has been writing about "*The myth that insulating boards serves long-term value*" (Forthcoming, Columbia Law Review, 2013), wherein he claims *to debunk[s] the view that insulating corporate boards serves long-term value*.

A somewhat beleaguered opponent of all forms of board empowerment, he singles out "staggered boards" as a prime target of his vituperations. *Although this is a non-*

issue in Canada, the musings of Bebchuk and others will leak into Canada and will be (have been) well reported.

Yet, for widely held Canadian corporations, boards of directors are among the least empowered in the developed world.

Thirdly, the Canadian context offers another distinctive characteristic: boards of directors, according to the Canadian Business Corporation Act as well as two important decisions of the Supreme Court of Canada, are responsible for the long-term interest of the corporation and must, in their decisions, take into consideration all stakeholders, not only shareholders.

In making his case against board "insulation", Bebchuk (2013) writes:

"I should stress that my focus in this paper is on board insulation as an instrument for serving the interests of long-term shareholders.

Board insulation has also been supported as an instrument of protecting the interests of stakeholders such as employees. Such claims are beyond the scope of this paper".

The legal responsibility of Canadian boards to evaluate the impact of a takeover on several constituencies should be protected by appropriately empowering boards of directors to discharge their responsibility.

Not only are there several stakeholders with large interest at stakes whenever a company is threatened by a takeover but there are also divergent groups of shareholders with potentially divergent interests. Within days of a takeover offer becoming public, the abnormal trading volume indicates that 30% to 40% of the shares have now moved into the hands of new types of shareholders.

Of course, as a result of this market demand, the stock price rises to a level close to the offering price. Any fund which has moved into the stock at that time has to be betting that the transaction will close at the offering price or at a higher price. The worst outcome would be for the transaction to abort and the stock price to return to its former level, inflicting large losses on any fund that moved in during the days after the announcement of a takeover bid. Arbitrage funds and some hedge funds specialize in these betting games.

These new “shareholders” should **not** be granted the full rights of a long-term shareholder; they should **not** have the right to vote on whether the company should be sold or a poison pill should stay in place! The whole point of their existence is to get these companies sold out at the best price and as quickly as possible. That’s how they make their money.

Changing the game of takeovers in Canada

In 2007, the federal government in response to public outcry at the takeovers in short succession of Alcan, Falconbridge, Inco and others, set up the Competition Review Panel. In its report, the Panel recommended that:

- Securities commissions should repeal National Policy 62-202 *(The policy that stripped boards of directors of all authority in takeover situations).*
- Securities commissions should cease to regulate conduct by boards in relation to shareholder rights plans (“poison pills”).
- Substantive oversight of directors’ duties in mergers and acquisitions matters should be provided by the courts.
- The Ontario Securities Commission should provide leadership to the Canadian Securities Administrators in making the above changes, and initiate action if collective action is not taken before the end of 2008.

Nothing happened until recently. The Canadian securities commissions have now undertaken a process to review and modify the rules they set some 20 years ago whereby boards of directors were basically stripped of all authority and turned into sales agents seeking the highest bidder for the company.

The Ontario Securities Commission seems prepared to take but a timid, ineffective, step. Allowing a poison pill (or shareholder rights measure) to be extended as long as shareholders vote for the proposal will not change anything. As explained above, by the time such a vote would be held, a large proportion of the “shareholders” would be new comers who are intent on selling the company.

By contrast the *Autorité de marchés financier* (AMF), Québec’s securities commission, has made proposals that would align the Canadian takeover regime with Canadian laws and with the rulings of the Supreme Court of Canada. It would bring the takeover process close to the standard of Delaware where most American large corporations are incorporated.

"*The primary objective of the AMF Proposal is to restore regulatory balance between bidders and target boards and update the policy framework of our take-over bid regime to reflect the current legal and economic environment and market practices respecting unsolicited take-over bids.*"

In essence, the AMF proposal would empower boards to take into account the long-term interest of the corporation and of its stakeholders. Securities commissions would not intervene unless issues of abusive behaviour or conflicts of interest arose. As in the U.S. (where the SEC plays no role in takeovers), the bidder or shareholders who felt mistreated by the board of directors could call upon the courts to review the matter.

It is in the interest of Canada that the AMF proposal be adopted by all Canadian securities commissions.

The most fundamental issue for widely held corporations everywhere has become: "who owns the publicly listed corporations"?

Society at large may rightfully claim that it has a stake in companies operating in its midst, a stake just as important as that of shareholders (Brennan, 2005). No doubt that a fickle, volatile, ever-changing shareholding base provides arguments for a different concept of "who owns the company".

The basic assumption underlying "corporate democracy", the one-share-one vote mantra, has become questionable. In a world of "empty voting", total return swaps, record date capture, speed-trading, transient share flippers, arbitrageurs, speculators and game players, the question arises: are any and all shareholders the legitimate owners of publicly traded corporations?

In all decent societies, "*Tourists don't vote*!" and "*Gamblers don't own the casino*!"

In the current stock market context, the practice of granting the full and immediate rights of corporate citizenship, including the right to vote, to shareholders immediately upon their appearance in the rostrum of shareholders, does not make sense anymore.

The democratic equivalent to this practice would consist of granting the right to vote to anyone who happens to be in the country on Election Day (recent immigrants, tourists, business travelers, etc.).

Every democracy imposes a minimum period of time before a newcomer acquires the full rights of citizenship, particularly the right to vote. Corporate democracy likewise should call for a modicum of commitment from a shareholder before he or she can influence the destiny of the corporation, for example a one-year holding period.

Conclusions and recommendations

Short-termism and activism on the part of institutional investors are here to stay. A cost/benefit analysis of this phenomenon would probably show benefits for investors and fund managers with the costs borne by workers, debt holders, long-term investors and the society at large.

But, short-termism by investors does not have to translate into short-termism in the management of corporations, which is destructive and should be fought vigorously. Several measures would likely moderate this overall trend:

1. The ownership make-up of the large business organizations in a society will determine the level of vulnerability of its economy to the actions of "activists" of all sorts. The Canadian make-up shows (See Table 1 above) that only 36 of the 100 largest companies in Canada (on the basis of revenues) are vulnerable to proxy fights, activist hedge fund demands and outright attempts at takeover; whenever a company is controlled by a shareholder (or related shareholders), the vultures stay away. Of course, cooperatives, State-owned corporations, privately owned firms are not even on the radar of these activists. Societies should adopt policies, fiscal and otherwise, that foster this variety of ownership.
2. Dual class of shares, with strong protection of the rights of minority shareholders, should be viewed positively in a context where stable and sizeable shareholders provide companies with the proper time horizon and a quality of governance that is comparable to that of private-equity funds; this ownership structure should be supported rather than frowned upon by

institutional investors. This form of ownership combines the discipline of markets, the transparency of publicly listed corporations, and a relative imperviousness to short-term pressures and dictates of financial markets.

3. We need to review and change the forms of executive compensation that are widely used in corporations and the role these pay systems play in fostering greed and short-termism in corporations. IGOPP adopted a policy position on this issue, which stated:

"*We are convinced that a modicum of social trust, loyalty and reciprocity must be re-built in publicly traded companies, and that management must manage for the long-term benefit of the corporation and its varied stakeholders. We are also convinced that this will not happen without fundamental changes in the compensation models currently in use in most companies:*

- ✓ *Step away resolutely from the notion that a large percentage of senior management's compensation should be at risk to satisfy the demands of investors, proxy advisers and sundry governance raters. Compensation is not actually at performance risk but at the whim of uncontrollable events and macro-economic circumstances. Their compensation being at risk (or, more accurately, dependent on their good or bad luck), senior management then requests protective contractual clauses and very generous pension terms.*
- ✓ *A reasonable bonus linked to well-selected performance indicators is an effective and tangible way to motivate management, one which has become too perfunctory in the current overall pay packages of executives.*
- ✓ *Reduce or, preferably, eliminate stock options from the compensation program.*
- ✓ *Restricted shares programs should have a vesting period reflecting the investment cycle of the company and should range between five-to-ten years. These restricted shares should have to be earned by meeting performance hurdles of the qualitative and quantitative sorts. Restricted shares should not be granted on an annual basis; it might be advisable to grant such shares at significant points in a senior manager's career at the company (e.g. when joining the company at a senior level, at the time of significant promotions or at multi-year intervals).*

(***Pay for Value: Cutting the Gordian Knot of Executive Compensation***; Yvan Allaire, IGOPP, Policy Position No. 5, March 2012)

4. It is time to impose a minimum period (say one year) before a shareholder can exercise its voting rights. This practice would call for an affirmative statement by shareholders that they have held their shares continuously for a period of at least one year as of the record date.

5. Canadians should support the proposals of the *Autorité des marchés financiers* to enhance the powers of the board of directors in situations of unsolicited takeover attempts; these proposals, broader and more vigorous than what is proposed by the Ontario Securities Commission, would align the securities commissions with Canadian law and bring Canada on a par with moderate American States in matters of board empowerment.

6. The best, most exemplary corporate governance has fallen short in several recent instances. Fiduciary governance has reached its point of diminishing returns. We must move from a strictly fiduciary type of governance to a "value-creating" governance; this latter form of corporate governance will call for unusual arrangements, different selection criteria for board members, enhanced compensation of board members, and so on; we are in the process of working out the how's and what's of this revolution in governance; we believe that it is essential for the welfare of capitalist societies that we cope with the challenge of establishing a "value-creating" governance in widely held corporations. Otherwise, this type of corporation may well become extinct.

Finally, I should stress the immense role that institutional investors, public pension funds in particular, may, must, play in several critical areas. These funds bear a singular responsibility:

- They are the largest providers of money to hedge funds and private equity funds; whatever costs to society at large come about as a result of the actions of these financial players, institutional investors are partly responsible. Without the large sums of money coming from pension funds and endowments, these activist funds would be small, negligible entities. Pension funds cannot hide, and tacitly support, activist hedge funds without getting some of the mud on them;

- These institutional investors are fairly determined to tame and discipline management compensation programs, to tie compensation to performance, presumably, of the long-term sort; yet, the compensation of their own senior management often comes short of the high standard they want to impose on corporations; the link between their compensation scheme and the long-term performance of the fund is as tenuous and opaque as it is in publicly listed corporations.

- Institutional investors will be very influential in the debate going on about the proper regime for takeovers in Canada. These funds, the public pension funds in particular, should put the overall interest of the Canadian economy and society ahead of their short-term interest; the open season on Canadian companies that is abetted by the current regime will prove, sooner or later, untenable; those responsible for maintaining any longer this unhealthy regime will be held accountable.

- These funds are major clients of proxy advisors; they should use this leverage to discipline these influential and troubling new comers to corporate governance; IGOPP has published a policy paper urging institutional investors to take action:

  "Large institutional investors, as clients of proxy advisory services, should demand that they be given full information on their business model: part-time vs. full-time employees, location of employees, extent of work performed in foreign countries, training of employees, proficiency of the staff, the ways the advisory service copes with the logistics of having to formulate opinions and recommendations on thousands of proposals within a very short time period.

  As clients of these advisors, they must, henceforth, demand explicit statements of conflicts of interest whenever these advisors are involved in M&A transactions, proxy contests or other litigious matters. They should insist that proxy advisors disclose at the time of their recommendation whether the advisor has, currently or within the recent past, been engaged by any participant in the relevant M&A transaction or proxy contest, whether any of the interested parties subscribe to the proxy advisory firm's services, and the aggregate fees paid by the interested parties to the proxy advisory firms.

> *Finally, institutional investors should state their disagreement with some of the proposed guidelines of proxy advisors. Certainly they should make clear that they do not consider the ISS proposed guidelines on executive compensation appropriate or useful and that they will not give any weight to voting recommendations based on these metrics. There's a key role here for the Canadian Coalition for Good Governance. It has the credibility and the legitimacy to counter the unhealthy influence of proxy advisors on executive compensation.*

(***The Troubling Case of Proxy Advisors***, Yvan Allaire, Policy Paper No. 6, IGOPP, March 2013)

Howls of calumny, chagrined outrage and dire forecasts of terminal tampering with efficient markets are bound to greet these proposals. So be it. The long-run welfare of societies and the economic vigor of industrial companies are more important than the spurious lure of "shareholder value" and the freedom to practice financial sleights-of-hand.

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