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MANAGING BOOKS / IDEAS

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Black Markets...

And Business Blues

By Yvan Allaire

and Mihaela Firsirotu,

FI Press, 300 pages, $29.95

Yvan Allaire and Mihaela Firsirotu aren't the kind of people you would expect to find railing against the dangers of modern capitalism and proposing a major overhaul. Mr. Allaire is an emeritus professor of management and former senior executive of Bombardier Inc., while Ms. Firsirotu is a respected professor of business strategy at Universite du Quebec a Montreal.

But in a just-published book they despair that, while the financial crisis should have been a eureka moment leading to major changes in our capitalist system, it will likely just fade away without a fundamental assessment of its causes and what reforms those demand. Influential players will seek to preserve the status quo in a slightly modified form, with a pinch of regulation and a drop of oversight added to the mix. "Until more fundamental changes are implemented, our societies will continue to operate under the dominion of financial operators who will find ways and means to circumvent regulations or use them to foster their interests," they write in Black Markets...and Business Blues.

They note that, since the 1980s, we have seen a transformation in three distinct but related markets:

Products and services

Privatization, deregulation, free-trade agreements, globalization and new information and communications technologies have combined to make markets for products and services increasingly competitive, efficient and unforgiving.

Talent

Many companies abandoned their commitment to job security and exclusive promotion from within, and a talent market emerged, which included a "winner-take-all" mentality among star executives, and a striking divorce between the interests of rank-and-file employees and those of corporate leadership.

Financial

With a flood of money into financial markets from surging pension funds and baby boomers' retirement savings came relentless financial innovations, growing mutual funds and the emergence of hedge funds, private equity funds and returns-focused money managers. The result, they say, has been a tectonic shift from managerial capitalism, in which managers were dominant, to financial capitalism - or, perhaps more accurately, casino capitalism - with a new activism by shareholders to maximize the short-term value of their investment. Loyalty is gone. "The corporation is now seen as a convenient, fluid arrangement of people and assets whose sole purpose is to maximize shareholder value and, in the process, the wealth of executives," they observe.

Their penetrating chapters on the recent financial crisis are set against that backdrop. At one point, they ask readers to imagine themselves as Richard Fuld, the former and unlamented CEO of bankrupt Lehman Brothers, and see how his fall was inevitable - how he had virtually no choice but to join other investment banks in their risky investment strategies, given the demands of shareholders for ever-escalating returns and the gargantuan rewards he personally would receive for fulfilling those expectations. "You were a limited man with unlimited greed and energy, perfectly suited to the job of financial operator," they say of Mr. Fuld. "You played by the compelling rules of financial markets. You lost!"

They stress it was impossible for any one financial institution to stop the game of investing in mortgage derivatives once it had started. That could have happened only if all the players decided to hold hands and stop playing at the same time - a fantasy scenario.

Only government and regulatory authorities could have prevented the debacle, they say. And now, they want governments to move in with some stiff rules, and companies to see the light and make some reforms themselves, to give us a new capitalism in which there is a greater focus on realistic long-term returns than on unrealistic short-term returns. They propose:

Narrower ownership

Governments promote policies favourable to other forms of corporate ownership than the current, widely dispersed shareholders model. That includes publicly listed companies with a dual class of shareholders, where the founders have greater sway through the shares they hold and are less likely to take reckless risks. As well, they cite favourably private partnerships, which used to be the norm for the big investment banks and again where the fear of losing their personal stake kept executives more restrained; co-operatives; and state-owned companies. They also believe governments should encourage inducements for shareholder loyalty and/or constrained ownership rights in publicly listed corporations, to dampen the push for unrealistic shareholder returns. And they like private companies in which large funds would be stakeholders, since those are presumably more educated and cautious. None are perfect, they acknowledge, "however, none of these alternative forms of ownership can match the dismal record of fiascos of widely held publicly listed corporations" and "none have brought the international financial system near collapse."

Restrict voting rights

Just as we wouldn't let anybody who happens to be in the country on election day vote - there are citizenship requirements - companies should not be letting anybody who just bought stock have immediate influence. They want governments to change the relevant business acts so that any shareholder's right to vote in a publicly listed company be subjected to a one-year holding period. And when a tender offer is made for a publicly listed company, only shareholders with a right to vote on the day the offer is made public could vote on it, unless the board of directors decided to lift the one-year holding period.

Vary tax rates

Vary capital gains tax rates according to the length of time the asset was owned by the individual, again encouraging a long-term approach.

Linked compensation

Ban compensation in the form of stock options, restricted shares and the like, since we have now seen it is a a source of many shenanigans, to link variable compensation of executives directly to the stock price. Any variable compensation should be linked to true measures of economic performance that influence a company's long-run value.

Director appointments

Companies must appoint directors with an independence of mind and sufficient credibility to hold the post, which means an intimate knowledge of the organization and the time and energy to oversee management. As well, when a family or pension fund has a significant stake in a company, that group should be given board members proportionate to their economic interests in the company.

Simplified structures

Companies need to be simplified in structure to be be properly governed. "No company should be more complex than what its board can govern effectively."

Pension fund investments

To prevent pension funds from investing in speculative hedge funds and private equity funds, it should be mandated that no pension fund can invest in an outside fund that demands more than 2 per cent of the pension fund's investment in total compensation for the outside fund's services.

Those are challenging recommendations, and this is a challenging book. Although the authors are passing over familiar turf, their astute analysis, with its many unexpected insights and their take-no-prisoners tone, holds the reader's interest.

There is a series of recent books on how we got into the current financial mess, but the advantage of this one is that it's set out in an overall philosophical, economic and historical context and isn't willing to settle for more of the same in the future.

Travaux Nommés : Black Markets... and Business Blues: The Man-made Crisis of 2007-2009 and the Road to a New Capitalism (Nonfiction work) Book reviews

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