March 2004

RBC Letter

The current issue of RBC Letter is dedicated to the memory of Robert Stewart, who was one of only two editors of the modern letter. Mr. Stewart, who passed away on Dec. 28, 2003, began this issue of the letter and others have supplemented his work.

Back to the Basics of Corporate Democracy

One of the great historic flashes of inspiration struck in mid-Victorian England, when Lord Bramwell, an Exchequer judge and former banker, had an elegant solution for the issue of limiting liability for a business corporation. By simply adding the word "Limited" to the names of joint stock companies, shareholders of a business corporation would be liable for its debts only to the extent of their investment in it. It was an idea whose time seemed to have come; and with the proviso of making this "limited liability" clear to potential investors, the concept became British law in 1862.

By shifting ultimate financial obligation from the individual investor to the corporation itself, limited liability provoked an explosion of economic energy. Vast sums of dormant capital and credit were put to work, generating wealth and employment. Adopted in every country that had free capital markets, limited liability gave rise to two of the most important institutions of modern times – the large business corporation and the public stock market. Splitting the capital into small affordable units spread the rewards of business investment widely by making the market accessible to people of moderate incomes, at the same time allowing them to diversify their risks. With the later invention of investment trusts and stock-based mutual and pension funds, many millions of citizens were brought into the market indirectly. (In Canada, for example, it is thought that as much as half the population has an equity interest in at least one of the chartered banks.) Corporations for their part gained access to unprecedented capital resources. Limited liability made the Canadian Pacific Railway possible – while building other railways from China to Peru. Bramwell had joked that the word "limited" should be inscribed on his tombstone: it could equally well be said that if you wish to see his monument, look around you.

As always, there is another side to the story. Like all business relationships, the limited liability corporation requires a climate of trust to deliver its full potential. Recent events, notably in the United States, have shown how completely that trust can be misplaced. A series of resounding corporate scandals, Enron foremost among them, have made stock values collapse or disappear. Thousands of employees have lost their jobs and often their pensions too. Revelations of fraud, deception and outright robbery by senior management have frightened small investors and disgusted the public, while galvanizing governments into belated displays of severity with corporate wrongdoing. Not least significant, demands that such scandals be prevented in future have placed the issue of good corporate governance high on the public policy agenda in the U.S., Canada and Europe. In particular the role of corporate boards of directors – too often revealed by scandal to have been inattentive at best or complicit at worst in the misdeeds of management – has come in for highly critical scrutiny.

The founders of the limited liability corporation were cautious revolutionaries. In designing the new investment vehicle they drew on two long-standing traditions. First came the business partnership, which since the Babylonians at least had made a partner's share of control and reward directly proportional to his investment. One share, one vote and one dividend. Ten shares, ten votes and ten dividends. This is an equitable distribution of rewards, hence the word "equity" for investment in common shares. Next, the legislators adapted the political idea of representation, with its roots in the European Middle Ages. Just as all the commoners of England could not easily be assembled in one place and therefore elected members to represent them in Parliament, so the widely scattered shareholders of the unlimited corporations that had existed since the early 1600s had elected boards of directors with powers to manage the assets of the company. Limited liability companies also had boards, but with a highly significant change. Early boards had been expected to manage the corporation as well as represent the shareholders. In the new "Limited" companies, boards were expected to appoint managers but not to do the managing themselves. Rather they supervised the managers to ensure that the best interests of the shareholders were safeguarded and advanced. Directors could be managers, and managers directors, but in principle the two entities were distinct – and the passage of time has made the distinction of steadily greater importance.

In the words of the early 20th century jurist Edward Manson, a board's powers were "in the nature of a trust, and the directors must exercise them with a single eye to the benefit of the company." Directors were bound by a set of rules. They could not accept monetary gifts from suppliers, favour family or friends in the allocation of shares or divert the company's funds to any purpose not defined by its articles of association. Above all, directors had to protect the company's capital against dilution.

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In the absence of profits, capital could not be used to buy the company's own shares or to pay dividends. In practical terms this meant that the directors had to take due care that the company's financial statements gave a true picture of its condition and to retain independent auditors to certify the accuracy of the company's books.

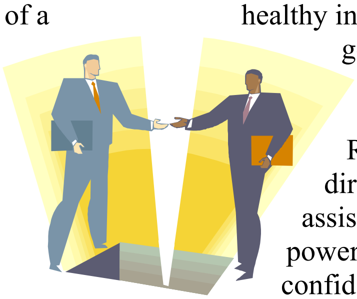
The courts could enforce these rules, but courts have been reluctant to second-guess directors because they felt that directors were in the best position to act in the best interests of the company and shareholders. However, human ingenuity, human greed and human laziness make a formidable team and all of them soon targeted the immense new wealth created by limited liability companies. As the decades passed, it became increasingly clear in virtually every jurisdiction that the annual meeting was a woefully inadequate safeguard against wrongdoing by managers, directors and auditors, especially if any of them were in collusion with the others. Public demand for closer government regulation of corporations to defend the interests of shareholders grew, and became loudest in times of economic hardship or, as today, after resounding corporate scandals. Governments listened to these demands. A massive body of statutes, regulations and precedents governs corporations today in every jurisdiction. Complying with this body of law has become a major corporate activity in itself, and interpreting it the province of professionals.

Yet the view that no amount of regulation can ever replace trust as the foundation of corporate life has not gone away. In a recent speech calling for better corporate governance in Canada the president of the Canadian Council of Chief Executives, Thomas d'Aquino, said: "We called for more vigorous enforcement and tougher penalties of breaches of the law, more comprehensive disclosure of insider trading, and a critical review of CEO compensation practices, especially in terms of pay for performance." So far his listeners might have thought that the speaker favoured more corporate regulation, but d'Aquino went on to say: "More broadly, we affirmed our belief that the key to good governance is more a matter of values than of law, and that a fundamental responsibility of the chief executive is to live by those values." This is a fairly explicit appeal to Canadian investors to trust our corporate leadership to put things right, along with a stricter application by regulators of the existing rules.

Unfortunately the recent scandals have left many, if not most, investors in Canada and elsewhere with grave doubts about the values of the country's chief executives. Simply saying "trust us" is unlikely to change their minds. It is a matter of common observation, after all, that people who deserve trust do not usually have to ask for it.

All the same, the advocates of a trust-based system have powerful arguments on their side. Regulation is a blunt instrument. It is much more effective in punishing breaches of the law than in preventing their happening in the first place. It is almost always costly to administer; and while the costs are certain, it would be difficult to place a firm estimate on the benefits. The law of unintended consequences seems to operate with particular force in a highly regulated environment; each regulatory solution is all too often a new problem. And it is undeniable that regulation, intended to stamp out wrongdoing, has itself often generated highly sophisticated wrongdoing, on occasion by the regulators themselves.

Perhaps the crux of the issue is that the "trust vs. regulation" debate has been framed in the wrong terms. Trust and regulation are not polar opposites but both essential and complementary components of a healthy investment climate. The goal of regulation is not to replace trust but to strengthen it. Regulation should give directors and their assistants, the auditors, the powers, the information, the confidence, and perhaps most important, the climate of opinion in the business world they need to do the job they received in 1862. It should assure investors that malfeasance will be detected early in the game and when detected, punished appropriately and without interminable delay. Finally, the best regulations are always those which mathematicians would call the most elegant – those that are a rapier rather than a sledgehammer, achieving the most with a minimum of words and a minimum of bureaucracy.



The debate on the role of regulation mirrors another important issue: the perception of regulators' effectiveness.

The 17th century French writer, La Rochefoucauld, once observed: "In the misfortunes of our best friends there is always something that does not displease us." This was certainly the unwarranted reaction to the recent corporate scandals in the U.S. in some quarters outside that country, including Canada. To be sure, Canada has had its fair share of high profile scandal, though perhaps not on the scale or scope of those in the U.S. With this in mind, Canadians cannot afford the luxury of thinking their standards are adequate. Indeed, Canadians must continuously find ways to ensure their standards are beyond reproach: The important point is not whether Canadians believe their standards are high, but whether the international capital markets think so too.

Canada has been a massive importer of capital throughout its history as an industrialized country. While Canada now generates large amounts of capital internally – and invests significant amounts of it abroad – Canadians are still heavily dependent on capital imports to maintain their standard of living and an adequate rate of economic growth. In today's world this means that Canadian companies are competing for a limited amount of capital with scores of other capital markets around the world. That in turn means that Canadian companies have to convince investors abroad that the quality of the country's corporate governance matches or exceeds that of other nations. The Canadian regulatory system must be state of the art, and the quality of companies' boards of directors second to none.

The U.S. authorities have responded to the wave of scandals with the Sarbanes-Oxley Act of 2002 (known as SOX or Sarbox) and new listing rules on the New York Stock Exchange (NYSE). CEOs and chief financial officers must personally vouch for the accuracy of financial statements, ruling out the defense of ignorance that has been used in past investigations of fraudulent disclosure. The responsibility of audit committees of boards for managing the relationship with auditors and the whole financial governance of a company has been tightened. And the NYSE now requires more board independence and more independent directors, reducing real, perceived and potential conflicts of interest.

The SOX reforms have now become the widely watched standard for corporate governance regulation around the world. The Ontario Securities Commission (OSC), by default Canada's most important market regulator, has sought to adopt many features of SOX to the Canadian markets in a way that is effective without being overly constraining. The OSC has made it mandatory for boards of corporations listed on the Toronto Stock Exchange to have audit committees comprised only of independent directors. As in the U.S., CEOs and CFOs are required to certify that financial statements filed with the OSC fairly represent their company's financial condition. These measures are the minimum needed to let investors around the world know that Canada is keeping pace with the changes in the U.S.

Improving the quality of boards is a more complex and subtle business. A recent study at the Clarkson Centre for Corporate Effectiveness in the University of Toronto's Rotman School of Management suggests that the 214 leading publicly traded Canadian firms have made impressive improvements but that several governance risks remain which will harm Canada's ability to attract capital. The study found that Canadian companies today have many more independent directors and many more directors who do not sit on multiple boards than they did even two or three years ago. Many more companies have split the roles of CEO and chairman of the board, resolving what is a key concern for investors. Boards and board committees are becoming more active, more informed, and more independent of management – and more of them are evaluating their own performance as boards and as individuals.

This is an encouraging story, but a significant number of companies – including some of the largest – have yet to take these steps. Overall, the most effective change for reassuring investors is significant stock ownership by directors, but almost half the companies studied did not meet investors' expectations in this area. Nonetheless there is reason to be optimistic on this front. A recent study by McKinsey & Company of more than 200 institutional investors – managing an awe-inspiring US$3.25 trillion in assets – found that three quarters of them said that board practices were as important as financial performance in evaluating companies for investment. In other words, good board quality is worth money. Other studies have shown that companies with good board practices and good response to shareholders tend to be more profitable than "corporate dictatorships" where only one opinion counts. Virtue does not have to be its own reward in corporate governance, and this fact will sooner or later move corporate mountains. Canadians, by investing in companies known for excellence in governance, can help move those mountains sooner and thereby benefit both themselves and their country.

. . . .

It has been memorably and truly said that the price of liberty is eternal vigilance. The same seems likely to be true of effective corporate governance. Neither Canada nor any other jurisdiction will ever attain a fortunate state in which they can sit back and enjoy the benefits of a perfectly regulated market. Unscrupulous people can always take advantage of a situation and give reason to be watchful: Human ingenuity, human greed and human laziness are as active as ever, and the restless, ever-changing dynamism of the capitalist system will continue to give them many opportunities for separating the unwary from their lawful property. Vigilance is the price to be paid for the prosperity unleashed by those Victorian legislators more than 140 years ago. If Canadians can keep the quality of their capital markets as good, or better, than any others on earth-- if men and women are able and willing to give full value on boards of directors – the rewards will be great. "Limited" by name, the modern corporation is anything but limited in its potential for shaping the twenty-first century.

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