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Jeffrey G. MacIntosh
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Abstract
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Keywords
Institutional investors; Individual investors; Capital market–Law and legislation; Canada

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THE ROLE OF INSTITUTIONAL AND RETAIL INVESTORS IN CANADIAN CAPITAL MARKETS

BY JEFFREY G. MACINTOSH

In recent years, the growth of the institutional portfolio (i.e., funds managed by mutual funds, insurance companies, banks, trust and loan companies, etc.) has been truly astonishing. In this article, Professor MacIntosh argues that this growth has important implications for the manner in which Canadian capital markets are regulated. In particular, institutional shareholders tend to be better monitors of corporate managers than retail shareholders. Institutional monitoring has been impeded by a number of features of the regulatory landscape. Professor MacIntosh makes a number of recommendations for changes to corporate and securities laws.

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I. INTRODUCTION

This paper is about the changing balance between “retail” and “institutional” investors in Canadian securities markets. Retail investors are individuals who invest for their own account in securities markets either through full-service or discount brokers. Institutional investors include banks, trust companies, pension funds, insurance companies, mutual funds, endowments, and the like. Both retail and institutional investors trade in primary and secondary securities markets, and both play a role in funnelling the savings of Canadians into “real” investment opportunities—for example, the trucks, buildings, mines, patents, and other tangible and intangible capital that form the backbone of the economy. However, in the past four decades, there has been a dramatic change in the balance of retail and institutional investors in Canadian markets. In particular, the aggregate market power of institutional investors has increased dramatically as more and more dollars saved by Canadians have been placed with institutional investors rather than
being invested directly in securities markets.\textsuperscript{1} The largest of these financial intermediaries, such as the Caisse de Dépôt et Placement du Québec and the Ontario Municipal Employees Retirement Fund, invest funds that run to the tens of billions of dollars.\textsuperscript{2} Importantly, the growth in the institutional share of the market has been accompanied by growth in the proportion of fund portfolios invested in equities.\textsuperscript{3} The result is that institutional funds have become in the aggregate the largest shareholders (or at least the largest non-controlling shareholders) in many Canadian corporations.\textsuperscript{4}


\textsuperscript{2} As of the end of 1991, the Caisse de Dépôt et Placement du Québec had approximately $41 billion of assets under administration, the Ontario Teachers’ Pension Plan had about $25 billion, and the Ontario Municipal Employees Retirement System (OMERS) had approximately $15 billion. See Benefits Canada, 1991.

\textsuperscript{3} Between 1980 and 1989, the percentage of equity held in trusted pension fund portfolios increased from 20.4 per cent to 28.0 per cent (Statistics Canada, Cat. 74-201). See also E. Roseman, “Top 40 listing holds surprises” \textit{The [Toronto] Globe and Mail} (23 November 1992) B5 (reporting average equity holdings for 1992 of 50 per cent). The pattern has been similar in the U.S.; see Brancato, \textit{supra} note 1 at 17-18 (pension funds increased the percentage of assets allocated to equities from 6 per cent in 1950 to 40 per cent in 1989).

\textsuperscript{4} Again, the U.S. experience is similar. See Brancato, \textit{ibid.} at 18-21 ("in 1989, [institutions] held 50 per cent of the equity of Business Week’s top fifty corporations ranked by stock market value"); \textit{ibid.} at 18).
In this paper, I argue that the comparative growth of the institutional sector has profound implications for the structure of corporate and securities law in Canada. One way in which this will occur is through the impact of institutionalization on market efficiency. The degree of market efficiency or inefficiency is the most important empirical datum for constructing a set of rules for the regulation of corporate conduct. Corporate regulation aims at ensuring that shareholders, and to a lesser extent creditors, are not systematically taken advantage of when they invest in corporate securities. Where securities markets are informationally efficient, however, all known risks are priced and securities markets are a "fair game" in which, on average, investors earn what they expect to earn. This creates a strong incentive for corporate issuers both to disclose all cost-justified information and to design the corporate "contract" so as to minimize the cost of capital. In such a world, the arguments in favour of both merit regulation and mandatory disclosure of information are much weaker than in a market that is not informationally efficient. I argue in this paper that the growing dominance of institutional traders in securities markets is likely to enhance informational efficiency, and thus reduce the amount of regulation that is needed.

Given that securities regulation is often geared to protecting the relatively unsophisticated retail investor, such investors are likely to be the primary beneficiaries of enhanced market efficiency. In an efficient market, the market price at any given time is the best estimate of the intrinsic worth of a particular security. An informationally efficient market is thus the best protection for relatively unskilled retail investors, since even a strategy of selecting securities at random (for example, by throwing darts at a pin-up of the Toronto Stock Exchange (TSE) 300) is likely to yield on average the "required" risk-adjusted rate of return. Indeed, a major thrust of this paper is that retail investors free ride on the self-protective efforts of institutional investors, since the latter are the marginal investors whose buying and selling activities determine share prices and make securities markets informationally efficient.

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6 Ibid.

7 The required rate of return is that rate of return that will induce an investor to invest in a particular security, given its risk and the availability of alternative investments. See, for example, S.A. Ross & R.W. Westerfield, Corporate Finance (St. Louis: Times Mirror/Mosby College Publishing, 1988) at 302-317.

8 See Parts VIII and XI, below.
A second way in which market institutionalization will reduce the need for mandatory regulation of corporate capital markets is by enhancing the efficiency of corporate monitoring. The "rational apathy" of retail investors that results from insufficient resources and incentives to monitor corporate managements is well known. The concentration of economic power, expertise, and incentives in the hands of institutional investors is a means of overcoming collective action problems and ensuring that both corporate managers and controlling shareholders are well monitored. The law, however, has interfered in a number of ways with the role that institutional shareholders might play in corporate monitoring. I suggest a number of recommendations for legal reform.

Throughout this paper, reference will be made to "first market" and "second market" companies. The first market consists of large public corporations with significant public floats and significant institutional shareholdings. Both primary and secondary trading markets for the securities of these firms are closely followed by both securities analysts and the financial press, and are likely to operate with a high degree of efficiency. The "second market" consists of smaller public corporations, which typically have slim public floats and few or no institutional shareholders. These markets are more likely to depart from a condition of rigorous informational efficiency. While the line between first and second market companies may not always be crystal clear, the distinction nonetheless serves a useful function in highlighting differences that are important in formulating appropriate rules for the governance of corporate conduct.

The paper is roughly divided into four segments. Parts II to IV examine the role of institutional investors in corporate governance. Parts V to VIII examine the effect of market institutionalization on market efficiency, as well as related regulatory issues. Parts IX and X examine some issues related to the internationalization of securities markets, while Part XI looks at financial innovation in securities markets and the development of new tools for managing risk.

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9 See, for example, Black, supra note 1 at 526-529.

10 There is a high degree of correlation between the size of institutional holdings and the amount of attention devoted to the company by financial analysts. See A. Arbel, S. Carvell & P. Strebel, "Giraffes, Institutions and Neglected Firms" (1983) Fin. Analysts J. 57 at 60.

11 Large public corporations with slim public floats are included in the first market, since they are likely to have institutional shareholders and a good following amongst investment analysts.

12 A higher proportion of investors in small firms will be uninformed "noise" traders. For this reason, at least episodic divergences between price and value are more likely to occur. See Parts V(C), V(D), below.
II. THE ENLARGED ROLE OF THE INSTITUTIONAL INVESTOR AND CORPORATE GOVERNANCE: REMOVING LEGAL IMPEDIMENTS TO INSTITUTIONAL ACTIVISM

Since institutional investors have lower coordination costs than retail shareholders, more resources at their command and, as a result of their relatively large shareholdings, much better incentives to monitor management, their presence greatly improves the monitoring of both corporate managers and controlling shareholders. As a number of recent cases illustrate, dissatisfied institutional investors are often in a position to alter management's intended course of action by privately or publicly expressing their dissatisfaction with management (often in conjunction with other institutional investors), voting against management, threatening to exercise their dissent rights, suing to

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13 See Black, supra note 1 at 587-588, arguing that the incentive of institutional shareholders to monitor is exponentially greater than that of retail shareholders because both the monetary reward from monitoring and likelihood of casting a pivotal vote increase with share ownership, although see also infra note 242.

14 Institutional shareholders, for example, convinced Southam to water down shark repellent proposals prior to the shareholder vote on the proposals. See A. Robinson, “Caisse opposes voting power changes” The Globe and Mail (27 July 1985) B1; and B. Jorgensen, “Southam rule set to protect shareholders” The Globe and Mail (9 August 1985) B1. The Southam affair was a watershed for institutional involvement in corporate governance, despite the fact that Southam was eventually able to forestall a rumoured takeover by negotiating a share swap with Torstar. See H. Enchin, “Southam, Torstar agree to share swap” The Globe and Mail (27 August 1985) B1. See also W.M. Mackenzie, “Donohue Goes Dual Class” (1993) 5:1 Corp. Gov. Rev. 2 (discussing changes in Donohue's dual class recapitalization plan induced by institutional investor protests).

15 For example, the proposed reorganization of Crownx (involving the issuance of non-voting shares) was abandoned after institutional investors, led by the CN Pension Fund, voted down the proposal on a majority of the minority vote. See K. Howlett, “CN stalls Crownx reorganization” The Globe and Mail (10 April 1986) B4; M. Mittelstaedt, “Chalk one up for CN pension fund” The Globe and Mail (12 April 1986) B2; K. Howlett, “Crownx drops controversial share plan” The Globe and Mail (17 April 1986) B5. A much higher percentage of institutional investors than retail investors voted against the scheme. See D. Best, “Minority rules at Crownx” The Financial Post (19 April 1986) 4.

16 For example, a threatened dissent by the Caisse de Dépôt et Placement du Québec appears to have been instrumental in causing Southam management to water down proposed shark repellent amendments. See H. Enchin, “Southam vote is postponed” The Globe and Mail (3 August 1985) B1. A similar threat by the Caisse also appears to have caused the management of Lac Minerals to water down shark repellent proposals. See E. Simon, “The Week in Business” Canadian Press Newstext (2 August 1985) (QL).
enjoin the transaction,\textsuperscript{17} or, in rare cases, by mounting or participating in a proxy battle against management.\textsuperscript{18}

A growing body of empirical literature suggests that concentrated ownership is likely to enhance firm value.\textsuperscript{19} For example, a number of studies have shown that firm value increases when managerial ownership increases\textsuperscript{20} or when the firm has a controlling shareholder.\textsuperscript{21}

There is also evidence that the concentration of share ownership results

\textsuperscript{17} Institutional investors were instrumental in pushing the Canadian Tire case forward. See Re Canadian Tire Corporation Ltd. (1987), 10 O.S.C.B. 857, aff'd 35 B.L.R. 117, 59 O.R. (2d) 79 (H.C.), leave to appeal refused 35 B.L.R. xx (Ont.C.A.). OMERS has also recently sued Xerox Canada in connection with a freezeout of public shareholders. See Xerox Canada Inc. v. Ontario Municipal Employees Retirement System 4924/90 [1991] O.J. No. 455 (QL), Ontario H.C. (per Austin J.). The Caisse de Dépôt et Placement du Québec, the province of Quebec's public pension fund manager, began an oppression action in connection with Inco's adoption of a poison pill, although the suit has apparently not been pursued. Institutional shareholders also commenced an (unsuccessful) action to upset the settlement of an action by the Director of the Canadian Business Corporations Act, R.S.C. 1985, c. C-44 [hereinafter CBCA], against Southam and Torstar. See Sparding v. Southam Inc. (1988), 66 O.R. (2d) 225 (H.C.).

\textsuperscript{18} The Sheritt Gordon case appears to be the only case in Canada in which dissident institutional shareholders were successful in unseating management. See "Sheritt" Canadian Press Newstext (19 September 1990) (QL). Gordon Capital Corp., an investment banker, undertook a brief proxy battle with Memotec management that ended in a settlement in which management agreed to replace two management board nominees with independent directors. Gordon was supported by the two largest public pension funds in Canada, the Caisse de Dépôt et Placement du Québec, which owned 12.5 per cent of Memotec, and OMERS, which owned 10.8 per cent. It was also supported by BCE Inc., which owned 31.5 per cent, although BCE was prohibited by federal law from voting for directors other than its four nominees. See "Memotec fight" Canadian Press Newstext (10 May 1991) (QL); "Memotec," Canadian Press Newstext (16 May 1991) (QL). With respect to institutional engagement in proxy battles in the U.S., see, for example, K. Van Nuys, "Corporate Governance through the Proxy Process: Evidence from the 1989 Honeywell Proxy Solicitation" in J. Fin. Econ. [forthcoming].


\textsuperscript{20} See, for example, R. Morck, A. Shleifer & R.W. Vishny, "Management Ownership and Market Valuation" (1988) 20 J. Fin. Econ. 293 (showing, however, a drop in value in the 5 per cent to 25 per cent mid-range, apparently owing to the fact that in this range the negative effect of managerial entrenchment outweighs the increasing alignment of manager/shareholder interests that results from enhanced managerial ownership). See generally W. McEachern, Managerial Control and Performance (Lexington, Mass.: Lexington Books, 1975) 55; E. Herman, Corporate Control, Corporate Power (Cambridge: Cambridge University Press, 1981) at 111-12 and note 110; although see J.J. McConnell & H. Servaes, "Additional Evidence on Equity Ownership and Corporate Value" (1990) 27 J. Fin. Econ. 595 (finding a reduction in firm value for insider ownership in excess of 40-50 per cent).

in better alignment of managerial decision making with shareholder interests.\textsuperscript{22} Leveraged and management buyouts, which tend to concentrate ownership interests in the hands of both managers and institutional investors, also result in increased firm value.\textsuperscript{23} More directly on point, there are a growing number of studies that show that heightened institutional ownership has a positive effect on share prices\textsuperscript{24} and corporate performance,\textsuperscript{25} and tends to lead to better corporate decision-making.\textsuperscript{26} Indeed, it has been argued that the (allegedly) superior performance of Japanese and German industry in recent history is in part a product of market and legal structures that allow for more effective oversight by institutional monitors.\textsuperscript{27} In addition, there is evidence that institutional investors are more likely than retail investors to vote against wealth-reducing management initiatives such as anti-

\textsuperscript{22} Black, supra note 19 at 919.


\textsuperscript{24} K.H. Wruck, "Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings" (1989) 23 J. Fin. Econ. 3 (indicating, however, that over the range of 5 to 25 percent ownership, firm value decreased, as in the study by Moreck et al., supra note 20); S.H. Szewczyk & R. Varma, "Raising Capital with Private Placements of Debt" (1991) 14 J. Fin. Research 1; McConnell & Servaes, supra note 20 (increasing institutional ownership associated with higher "Tobin's Q" (the ratio of the firm's market value to the replacement cost of tangible assets). See also J. Cable, "Capital Market Information and Industrial Market Performance: The Role of West German Banks" (1985) 95 Econ. J. 118 (finding a significant positive relationship between bank involvement in German corporations and financial performance).

\textsuperscript{25} McConnell & Servaes, supra note 20 (institutional ownership is positively correlated with "Tobin's Q" and with various accounting measures of profitability).

\textsuperscript{26} See, for example, A. Agrawal & G.N. Mandelker, "Large Shareholders and the Monitoring of Managers: The Case of Anti-takeover Charter Amendments" (1990) 25 J. Fin. & Quan. Anal. 143 (firms with high institutional ownership experienced on average no price reaction to the adoption of anti-takeover amendments, while firms with low institutional ownership had negative price reactions).

takeover provisions. As the recent experience with Pennsylvania’s anti-takeover statute demonstrates, the presence of institutional investors has been pivotal in pressuring many corporate managements to opt out of wealth-reducing legislation designed to protect managers.

As indicated above, the aggregate holdings of institutional shareholders have grown steadily over the past four decades and, in the aggregate, institutional shareholders hold the largest stakes in many public Canadian corporations. Commensurate with this growth in market power has been a progressive change in the attitude of institutional investors. While most institutional investors would once have sold their investments as a matter of course when dissatisfied with management (the “Bay Street Rule”), institutions are increasingly retaining their investments and attempting to influence management’s course of action. Although Canadian institutions have made little attempt to influence day-to-day management, they have become actively involved in important issues such as dual class recapitalization, takeover

28 See J.A. Brickley, R.C. Lease & C.W. Smith, Jr., “Ownership Structure and Voting on Anti-takeover Amendments” (1988) 20 J. Fin. Econ. 267 (finding that institutional investors were more likely to vote on wealth-reducing management anti-takeover proposals, and that their presence increased the number of “no” votes cast). This has also been the case in Canada. See W.S. Allen, “Post Pillage” (1990) 2:5 Corp. Gov. Rev. 4. Although the latter indicates that poison pills have been approved by shareholders in all cases in Canada, many of the votes have been extremely close, contrary to the usual corporate experience in which shareholders routinely vote in favour of management proposals. It may be that conflicts of interest have induced some institutional shareholders to vote in favour of poison pills. See J.G. MacIntosh, “Poison Pills in Canada: A Reply to Dey and Yalden” (1991) 17 Can. Bus. L. J. 323 at 354-355; and see Part IV, below.


30 See Part I, above. The concentration of shareholdings in Canadian corporations is even more striking than in the U.S., due in part to the “foreign property rules” applicable to pension and mutual funds. See infra note 47 and accompanying text.

31 In the U.S., the power of institutions has been further augmented by state takeover legislation, poison pills, and judicial decisions favouring management in takeovers, which have all diminished the popularity of takeovers, and have revitalized the proxy contest (in which institutional investors play a bigger role) as a means for transferring control. Brancato, supra note 1 at 4-5. The so-called “Avon Letter” issued by the Department of Labour, stating that the exercise of proxy voting powers is a part of institutional fiduciary responsibility, has also played a role. Ibid.
Institutional and Retail Investors

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institutions (such as poison pills, the issuance of non-voting shares or "blank cheque" preferreds, and "shark repellant" charter amendments), related party transactions, and corporate restructurings. Institutions have also shown increased interest in executive compensation and corporate governance matters, with particular focus on the issue of independent directors. If the recent experience in the U.S. is any indication, both these issues are likely to grow in importance in the near future. Moreover, the trend towards a more activist stance is likely to continue: in a survey of Canadian institutional investors, Kathryn Montgomery found that institutions themselves believe not only that institutional activism has increased substantially over the past decade, but that it will continue to increase in the future.

In Canada’s tightly knit financial community, much institutional “activism” has taken the route of quiet, behind-the-scenes diplomacy, whereby institutions meet privately with management in order to make their views known. The more diplomatic approach is reflected in part

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32 Koval reports that institutional investors in Canada have directed their attention to “charter and by-law amendments, such as staggered boards, super-majority and ‘fair price’ provisions, shareholder rights, or ‘poison pill’ plans and other ‘shark repellant’ devices proposed by management.” P.A. Koval, “Trends in Canadian Shareholder Activism,” in The Canadian Institute, Duties and Liabilities of Officers and Directors (19 November 1992) at 26. She also reports that “[i]n the 1990’s, the categories of technical issues have expanded, [and] corporate transactions, including reorganizations and related party transactions, have been increasingly scrutinized.” Ibid. at 26-27. In the U.S., institutional activity has focused on anti-takeover defenses, shareholder advisory committees, and installing outside directors. See R.S. Gilson & R. Kraakman, “Reinventing the Outside Director: An Agenda for Institutional Investors” (1991) 43 Stan. L. Rev. 863 at 868-879. See also B.D. Fromson, “The Big Owners Roar” Fortune (30 July 1990) 66; and J.G. Macintosh, “The Poison Pill: A Noxious Nostrum for Canadian Shareholders” (1989) 18 Can. Bus. L. J. 276 at 305-311.


34 Montgomery’s survey of Canadian institutional investors found that 83 per cent of the institutions surveyed (mostly public and private pension funds, and investment managers) believed that institutional activism has increased over the past decade. See K.E. Montgomery, “Survey of Institutional Shareholders” (1992) 4:4 Corp. Gov. Rev. 5 at 7. Thirty-three per cent indicated that their own institution had adopted a more active or substantially more active stance in the past two years, while only 2 per cent indicated that their institution had become less active in the same period. Ibid. at 9. Further, 85 per cent believed that institutional shareholders are likely to become even more active in the future. Only 64 per cent indicated that they would sell or reduce their holdings if they strongly disagreed with “a key direction taken by ... management.” Ibid. at 8. Twenty-eight per cent indicated that they would retain or reduce their holdings while engaging in some form of activism. This is a substantial change from the past, when few institutional shareholders would actively challenge management initiatives.

35 Koval, supra note 32 at 21-23 and at 43-46. Montgomery’s survey of institutional shareholders discloses that the strategies most commonly used are voting against management, consulting with management over proposed initiatives, and acting collectively with other...
in the failure of Canadian institutions (unlike their U.S. counterparts) to make significant use of the "shareholder proposal" mechanism to influence corporate affairs. This approach is also evidenced by the virtual absence in Canada of institutional "shareholder advisory committees," a mechanism through which many U.S. institutional shareholders have made their views known to management. In addition, unlike their U.S. counterparts, Canadian institutions have not made use of the relatively confrontational "just vote no" tactic, which includes both abstaining from corporate votes and supporting dissident shareholder nominees as a protest against poor management performance. Nor, in the main, have Canadian institutional investors become embroiled in proxy battles or other initiatives to replace senior executives and/or directors, as has recently occurred in a number of highly publicized cases in the U.S.

36 See, for example, CBCA, supra note 17, s. 137 and see Koval, ibid. at 34-43 (discussing practical and legal reasons why shareholder proposals have not been frequently used in Canada). Allenvest (now Fairvest) has sponsored a number of shareholder proposals, including proposals made to Inco's shareholders to terminate a poison pill and to institute confidential voting. Koval, ibid. at 37-38; W.S. Allen, "Confidential Voting" (1990) 2:4 Corp. Gov. Rev. 1. See also C. McCall & R. Wilson, "Shareholder Proposals, Why Not in Canada?" (1993) 5:1 Corp. Gov. Rev. 12; and see Part II(f) below (suggesting amendments to the proposal mechanism to make shareholder proposals more palatable to institutional investors). Shareholder proposals have been widely used in the U.S., particularly in relation to anti-takeover measures. See Gilson & Kraakman, supra note 32 at 868.

37 Shareholder advisory committees consist of representatives of the largest shareholders, often institutions, who meet with management to discuss and review management's performance. Gilson & Kraakman, ibid. at 868, 871-72; Koval, ibid. at 51-53 (expressing the view that such committees will not likely become common in Canada due to potential legal liabilities and intra-investor difficulties in agreeing on the role, objectives, and mandate of such committees); E.J. Waitzer, "Accountability and Performance—The GM Watershed" (1992) 4:2 Corp. Gov. Rev. 12 at 13.

38 Such tactics may result in the inability to muster a shareholder quorum. Gilson & Kraakman, ibid. at 880 and note 60; Koval, supra note 32 at 55-57. Where abstention from voting is involved, the tactic might more appropriately be styled a "just no vote" strategy.

39 Koval, ibid. at 55-57. Two exceptions are briefly explored supra note 18.

40 Gilson & Kraakman, supra note 32 at 872-876. The General Motors saga is the most widely reported such event, although there have been other U.S. cases in which institutional shareholders have been instrumental in securing changes in board composition and/or senior management. See Koval, supra note 32; Waitzer, supra note 37 at 12. Such interventions have tended to arise only in crisis situations (i.e., egregiously bad management performance). Moreover, Gilson and Kraakman report that institutional participation in proxy battles has not been frequent, and has often been the outcome of deals between management and institutional shareholders resulting in the latter supporting management. Ibid. at 882. Van Nuys also indicates that non-institutional block shareholders may sometimes play an instrumental role in arousing institutional investors to act. See Van Nuys, supra note 18 (discussing a proxy challenge to management supported by many...
institutions have generally not sought to place representatives on the boards of directors of public companies (although management will sometimes request institutional nominations for directors).\(^4\)

Nonetheless, institutional investors expect, and usually receive, an audience with management on issues of importance to them, and the most important corporate initiatives will often be floated with institutional investors before being made public.\(^4\) If institutional support is lacking, such initiatives are frequently modified or abandoned.\(^4\) In cases where management has proceeded without consulting institutional investors, or despite institutional opposition, institutions have resorted to publicly ventilating their opposition to the proposed initiative, or have simply voted against management. Although institutions have not been successful in winning many shareholder votes, votes on such matters as poison pills have become increasingly close.\(^4\)

Indeed, looking only at the results of shareholder votes conveys a misleadingly pessimistic impression of institutional power; where institutional opposition is particularly strong, it is likely that the issue will never go to a shareholder vote at all.\(^4\)

In Canada, increasing shareholder activism can be traced in part to enhanced shareholder rights, particularly given the increasing statutory and administrative popularity of "majority of the minority" voting requirements that give institutional investors considerable leverage in connection with a growing number of corporate transactions.\(^4\) In addition, the comparatively small size of the Canadian institutional shareholders, but funded by a non-institutional blockholder).

\(^{41}\) Koval, ibid. at 53-55.

\(^{42}\) Ibid.

\(^{43}\) Koval, ibid.; W. Riedl, "Trizoe Listens" (1992) 4:2 Corp. Gov. Rev. 10; Wilson, supra note 33. This practice creates a selection bias in academic studies that look at the influence of institutional shareholders on decision-making outcomes, since these studies typically focus on events that go to a shareholder vote. This bias will tend to result in understating the influence of institutional shareholders.

\(^{44}\) See MacIntosh, supra note 28 at 354 and note 120. The experience in the U.S. has been similar. See Gilson & Kraakman, supra note 32 at 893, note 91 and accompanying text; Van Nuys, supra note 18 at 24-25 (case study of Honeywell proxy contest in which 54.9 per cent and 46.5 per cent of all institutional investors in sample voted with management on two anti-takeover proposals).

\(^{45}\) Supra notes 14, 35 and accompanying text.

equities market—particularly when combined with the effect of the “foreign property” rules, which limit the extent to which registered pension funds and mutual funds that are “registered investments” may purchase foreign equities⁴⁷—has left many institutional investors with relatively few investment choices. Coupled with the relative illiquidity of the Canadian market, the lack of available investment options may diminish the attractiveness of selling when dissatisfied with management performance and thus may increase the relative allure of shareholder activism.⁴⁸

Both in the U.S. and in Canada, institutional activism has become increasingly collective in nature as institutions have learned the value of coordinating their opposition to disfavoured management initiatives.⁴⁹ Indeed, coordination is frequently a sine qua non of institutional power, since few institutional shareholders hold stakes in individual companies in excess of 10 per cent, and most holdings are smaller than this.⁵⁰ Direct coordination of activities has been supplemented by indirect coordination through trade organizations, such as the Pension Investment Association of Canada (PIAC);⁵¹ and through institutional brokers such as the Fairvest Securities Corporation (formerly the Allenvest Group Limited) that serve as fora for discussion of governance issues, collect data on shareholder and institutional

shareholders to defeat a proposed dual class recapitalization. Such majority of the minority requirements, however, are not necessarily an unambiguous good. See MacIntosh, “Corporations,” ibid.

⁴⁷ Income Tax Act, S.C. 1970-71-72, c. 63 [hereinafter Tax Act], s. 206. The foreign property rules, which apply to all tax exempt investors (including holders of Registered Retirement Savings Plans, or “RRSPs,” registered pension plans, and charities) limit the extent to which shares of non-domestic issuers may be purchased as portfolio investments. Failure to conform to the requirements of the Tax Act results in tax penalties. The foreign property rules affect mutual funds that wish to sell interests to holders of RRSPs, since in order to qualify to do so a fund must become a “registered investment” and comply with the foreign property rules. See Tax Act, ibid. Part X.2.

⁴⁸ The small and relatively illiquid Canadian market and the foreign property rules may not, however, be as important as commonly supposed in spurring institutional activism. See Montgomery, supra note 34 (survey showing that many institutional investors do not think that these factors pose a serious problem in liquidating investments).

⁴⁹ Montgomery, ibid. at 8.

⁵⁰ Many institutional shareholders cannot legally hold more than 10 per cent. See Part II(K)(1), below. The institutional shareholders that tend to hold the largest stakes, both because of their size and because of the fact that they are not legally limited to ten per cent holdings, are the Caisse de Dépôt et Placement du Québec, OMERS, the Ontario Teachers' Pension Plan Board, and the Canadian Pacific and Canadian National pension funds.

⁵¹ PIAC represents about 100 funds, including both public and private sector pension plans, endowments, and university funds, collectively controlling about $175 billion in assets. Koval, supra note 32 at 48.
voting, offer institutions advice on how to vote, and generally promote institutional interests.\textsuperscript{52} Such organizations play a useful role not only in collectivizing institutional action, but also in protecting the identities of the institutional investors who stand behind them. This is important in assisting institutions like corporate pension plans, banks, and insurance companies in opposing management free of the corrupting influence of managerial pressure or political concerns.\textsuperscript{53}

Canadian institutions, institutional trade organizations, and corporate governance consultants have also begun to systematically review particular types of corporate initiatives (such as poison pills and director independence) and to formalize proxy voting guidelines.\textsuperscript{54} Some of these parties, including the Ontario Teachers’ Pension Plan Board (OTPPB), have indicated that they will generally oppose a variety of takeover defenses, including poison pills, “blank cheque” preferreds, super-majority amendments, classified boards, and sales of the “crown jewels,” as well as certain types of executive remuneration.\textsuperscript{55} OTPPB has also indicated that it will promote the role of independent directors in corporate governance.\textsuperscript{56}

\textsuperscript{52} PIAC is an example of a Canadian trade organization whose Corporate Governance Committee is charged with the task of formulating proxy voting guidelines for pension fund members. On the investment advisor side, Stephen Jarislowsky (of the firm Jarislowsky Fraser) and Fairvest Securities Corporation (formerly Allenvest Group Limited, which dispenses advice to institutional investors and champions institutional causes through its “Corporate Governance Review”) have been the leaders in advancing institutional shareholder interests. The championing of institutional causes by parties like Jarislowsky and Fairvest has often been funded through the use of “soft dollar” commission arrangements, whereby representation of institutional causes is traded for institutional brokerage business. See, for example, J. Partridge, “Fighting Southam-Torstar settlement made Royal Insurance lose director” The Globe and Mail (29 September 1985) B5.

There are a number of organizations that have stepped into this role in the U.S., including the Corporate Governance Service of the Investor Responsibility Research Center (which collects statistics on shareholder voting, and also publishes monographs on subjects of interest to institutional investors), the Council of Institutional Investors (an institutional pension and mutual fund collective), Institutional Shareholder Services (which sells advice to institutional investors), The Institutional Voting Research Service Analysis Group (which also sells advice to institutions), and Institutional Shareholder Partners (which represents institutional investors and targets particular companies for reform). See Black, supra note 1 at 573; Koval, supra note 32 at 25-26.

\textsuperscript{53} See Black, ibid. and Part IV, below. Public sector pension funds are relatively immune to management pressure because they do not do business with corporations. However, they are particularly susceptible to political pressure.

\textsuperscript{54} Koval, supra note 32 at 46-48.

\textsuperscript{55} Ibid. at 46-47.

\textsuperscript{56} Ibid. OMERS has published very similar guidelines. See Proxy Voting Guidelines (January, 1993).
Of course, most large Canadian public corporations have a non-institutional controlling shareholder. Because a controlling shareholder is likely to monitor effectively for breaches of the duty of care, corporate disputes are much more likely to involve intra-shareholder conflicts than manager/shareholder conflicts. While the role of institutions in the policing of management conduct is lessened by the existence of a controlling shareholder, institutions still have an important role to play in policing the conduct of controlling shareholders. Should management or a controlling shareholder behave in a way that is likely to reduce share values, institutions have on occasion been able to alter management's intended course of action by raising a public row and drawing critical attention to the proposed initiative. Indeed, as indicated above, institutions are not infrequently polled by management even before intended initiatives are made public, and, if institutional support is lacking, the initiatives are often modified or abandoned. Finally, should market suasion fail to alter management's intended course of action, institutional shareholders command the financial wherewithal to enlist the aid of the courts or securities regulators in seeking redress—a threat largely absent in firms with only retail investors. For these reasons, the presence of institutional investors improves market monitoring of corporate management, even where there is a controlling shareholder.

Improved market oversight has direct implications for corporate and securities laws. Market and legal oversight mechanisms can be thought of as substitutes. At one extreme, one can imagine a world in which market mechanisms are completely ineffective in constraining managerial or controlling shareholder overreaching. In such a world, legal restraints become critical to the conduct of corporate enterprise.

57 Daniels & MacIntosh, supra note 5.
58 Ibid.
59 Indeed, since managers often act at the behest of the controlling shareholder, institutional policing will frequently involve direct challenges to managerial as well as controlling shareholder conduct.
60 In Montgomery's survey, institutional investors indicated that they would most likely be active in cases involving "abuse of power by management or majority shareholder." Thus, institutional investors view themselves as playing an active role in corporate governance even, or perhaps particularly, in cases where there is a controlling shareholder. See Montgomery, supra note 34 at 7. See also, supra note 35 (strategies used by institutional investors to oppose management).
61 Daniels & MacIntosh, supra note 5.
62 As the recent saga of Westfield Minerals illustrates (relatively impecunious retail investors complained loudly of abuse by the dominant shareholder, but failed to sue). See ibid. at 921-32.
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At the other extreme, one can imagine a world in which market mechanisms never fail to align managerial and controlling shareholder self-interest with the pursuit of overall shareholder wealth maximization. In this world, legal controls are worse than redundant; they simply invite expensive opportunistic suits, while producing no marginal benefit. Hence they will actually subtract from the achievement of shareholder’s objective of achieving wealth maximization.

Of course, it is illusory to believe that the latter state will ever be achieved. Even in well-functioning markets there are always instances of opportunism and overreaching, whether caused by last-period problems, asymmetric information, fraud, or other factors. Thus, it is certain that there will always be a role for the law to play in filling the interstices left in market disciplinary mechanisms. However, legal controls are expensive. Most immediate are the direct expenses associated with litigation (including the cost of courtrooms, judges, and other support facilities) which are borne both by the litigants and by the state. There are also opportunity costs occasioned by litigation, as profitable transactions are held up or aborted and management attention diverted from business matters. These costs are amplified by the danger that opportunistic litigation will be undertaken purely to capture a larger slice of the corporate pie.

Thus, the appropriate extent of legal rules constraining managerial or other corporate misbehaviour can only be judged in the context of the efficacy of market mechanisms in redressing problems of opportunism. As market oversight improves, the benefits yielded by legal rules decline relative to their costs. Because institutional oversight is an important component of market monitoring and managerial disciplinary mechanisms, the growing institutionalization and efficiency of Canadian markets is likely to lessen the need for regulatory oversight of capital markets.

In a variety of ways, legal restraints have interfered with institutional activism, and hence with the monitoring and discipline of managers and shareholders. In some cases, these legal restraints have not yielded sufficient benefits to justify their continued existence. In other cases, further legal intervention is warranted to enhance the role of institutional shareholders in corporate governance. A number of suggested regulatory reforms are briefly canvassed below.
A. Confidential Voting

Institutional shareholders such as banks, insurance companies, and trust companies often do business with corporations in which they have invested. By threatening to withdraw this business, management can often coerce institutional investors into voting in favour of management initiatives. This pressure would be significantly alleviated by requiring confidential voting supervised by independent scrutineers. Such a requirement would ensure that management would not be able to determine how particular shareholders had cast their votes. Similarly, the tactic of “bundling” initiatives together for shareholder votes—for example, as was initially done by Inco management when it put its poison pill before shareholders—should be prohibited, as has recently been proposed in the U.S.

B. Proxy Rules

The proxy rules are also a deterrent to effective institutional oversight. As currently structured, these rules discourage informal communications between investors, since such communications might be construed as proxy “solicitations” requiring the expensive assembly of a

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63 It is for this reason that public pension funds and investment managers have been the most active institutional investors in challenging management initiatives, and banks and insurance companies the least active. See Brickley, Lease & Smith, Jr., supra note 28; J.E. Heard & H.D. Sherman, Conflicts of Interest in the Proxy Voting System (Washington: Investor Responsibility Research Center, 1987); J. Pound, “Proxy Contests and the Efficiency of Shareholder Oversight” (1988) 20 J. Fin. Econ. 237; and Van Nuys, supra note 18.

64 Like auditors, such “independent” scrutineers would have to be selected by management. However, aside from counselling fraud, it would be far more difficult for management to interfere with the process of counting votes than it is for management to influence the audit process.

65 See generally P.S. McGurn, “Confidential Proxy Voting” (Washington: Investor Responsibility Research Center, 1989); and Allen, supra note 36. The case in favour of imposing mandatory confidential voting is not completely airtight, however.

See generally J.G. MacIntosh, “Should Canadian Corporate Law be Mandatory or Enabling?” (paper prepared for Consumer and Commercial Law Workshop, Faculty of Law, McGill University, 1992). It might be better to supply a default rule which requires confidential voting, but allows firms to contract out by a combination of a special resolution of shareholders and approval by a majority of the minority.

66 See MacIntosh, supra note 32 at 309-310.

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“dissident’s proxy circular.” The recent amendment of Securities and Exchange Commission (SEC) proxy rules to facilitate shareholder communications is to be applauded, and ought to be emulated in Canada by appropriate amendments to corporate and securities legislation. It is interesting (and perhaps telling) that the proposals to amend the U.S. proxy legislation were initially put forward by one of the largest U.S. institutional investors.

C. Secondary Distributions

Institutional oversight is also discouraged by rules relating to secondary distributions of securities. The provisions of the Ontario Securities Act (OSA) are illustrative. The OSA includes in the definition of “distribution” any “trade in previously issued securities of an issuer from the holdings of any person, company, or combination of persons or companies holding a sufficient number of any securities of that issuer to affect materially the control of that issuer.” A person holding 20 per cent or more of the securities of an issuer is deemed to have a material affect on the control of the issuer. These “control persons,” as they are informally referred to by securities lawyers, can only sell securities under

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69 Supra note 67. These are summarized in C. McCall, “Shareholder Communications in the U.S. and Canada” (1992) 4:4 Corp. Gov. Rev. 12. The proposals were adopted on 16 October 1992. Reforming the proxy process is perhaps less urgent in Canada than in the U.S., both because regulators have been sympathetic in permitting informal shareholder communications and because the prevalence of corporations with controlling shareholders in Canada has made non-consensual transfers of control less important.

70 Ibid.

71 This was the California Public Employees' Retirement System (often referred to as CalPERS). See the letter from Richard Koppes, CalPERS's General Counsel, to Linda Quinn, Director of the SEC Division of Corporation Finance (dated 3 November 1989), (1990) 1 Practicing Law Inst, 2nd Annual Conference on Securities Regulation 298.

72 OSA, supra note 68, s. 1(1) (definition of “distribution”).

73 Ibid.
a prospectus,\textsuperscript{74} or through the use of a specific\textsuperscript{75} or discretionary prospectus exemption.\textsuperscript{76} Sale under the exemption specifically applicable to control persons is conditioned on the lapse of a "hold period" ranging from six to eighteen months,\textsuperscript{77} the filing of an intention to sell, a declaration that the seller has no undisclosed material information, and an insider trading report.\textsuperscript{78} In some cases, the hold period for all securities held by a control person runs from the date of acquisition of the last share acquired.\textsuperscript{79} Thus, becoming a control person can result in significant impairment of the liquidity, and hence the value of the control person's holdings. Institutional investors will therefore be anxious to avoid the control person designation. However, in a number of situations canvassed below, there exists a non-trivial risk that this status might be unwittingly acquired.\textsuperscript{80}

1. Coordination problems

a) \textit{Institutional coordination}

Where an institution coordinates its activities with other institutions, it might be found to form part of a combination of persons or companies that is able to materially affect the control of the issuer. Since the ability to materially affect control is all that is required in order to be deemed a control person, neither \textit{de jure}\textsuperscript{81} nor \textit{de facto} control\textsuperscript{82} is necessary; possessing a power of negative control, or in many cases

\textsuperscript{74} Ibid. s. 53(1).
\textsuperscript{75} See, for example, \textit{OSA}, \textit{ibid.} ss. 72(1), 72(7), 73(1); and \textit{Regulation made under the Securities Act}, R.R.O. 1990, Reg. 910 [hereinafter \textit{OSA Regulation}], ss. 14-32, especially s. 25.
\textsuperscript{76} \textit{OSA}, \textit{ibid.}, s. 74.
\textsuperscript{77} \textit{OSA Regulation}, \textit{supra} note 75, s. 25.
\textsuperscript{78} \textit{OSA}, \textit{supra} note 68, s. 72(7)(b).
\textsuperscript{79} \textit{OSA Regulation}, \textit{supra} note 75, s. 25(2). Contrast s. 25(1), \textit{ibid.}
\textsuperscript{80} See generally M.J. Davidge, "Insider and Control Issues" (Toronto: Insight Information, November 1991, conference proceedings) [hereinafter "Insider and Control Issues"]; "Control and Insider Issues," (Toronto: Insight Information, December 1990, conference proceedings) [hereinafter "Control and Insider Issues"].
\textsuperscript{81} \textit{De jure} control arises where the controller owns or exercises direction over 50 per cent or more of the votes of the issuer.
\textsuperscript{82} \textit{De facto} control can arise where the controller owns or exercises direction over sufficient votes to determine the outcome of an ordinary resolution.
simply holding a substantial block, will be sufficient. Thus institutions that coordinate their activities in order to pressure management, influence the outcome of a shareholder vote (by collecting proxies or by some other means), or promote a shareholder proposal might find themselves tagged with the control person label, regardless of whether such activities are done publicly or through behind-the-scenes maneuvering. The control person characterization would almost certainly apply in any case in which institutional shareholders act singly or jointly to place nominees on the board of directors.

The fuzziness of the “materially affecting control” standard enhances the risk of acquiring control person status. The proximate result is to discourage institutional shareholders from acquiring large blocks of stock, or from coordinating their activities with other institutions to influence corporate conduct. This is not a trivial problem, in view of the fact that institutions have increasingly coordinated their activities to pressure management on proposed initiatives.

b) Shareholder voting agreements

A related problem arises when institutions agree, either formally or informally, to vote together on a particular issue or to refrain from voting absent mutual consultation. Such agreements might be construed to have affected materially the control of the issuer.

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83 Institutional investors frequently exercise only episodic influence over corporate affairs, often through private consultations with management rather than public opposition. There is nothing in the definition of “control person,” however, that excludes the possibility that such episodic or private influence (perhaps even limited to a single occasion) will permanently “taint” the investor as a “control person.”

84 See Montgomery, supra note 34 at 8 (coordinated efforts with other investors is the second most commonly employed tactic to exert influence over management).
2. Aggregation problems

a) Managers tending multiple accounts

Management companies and portfolio managers (collectively referred to below as "managers," or "money managers") often invest funds for more than one institutional client, and frequently exercise the power to vote such investments. For example, many management companies will manage a variety of otherwise unconnected pension and mutual funds. In such cases, there is a risk that all of the holdings of each managed account might be aggregated for the purposes of determining that the manager is a control person. There is also a risk that the various unaffiliated clients of a common manager will be found to be control persons either because they represent "a combination of persons or companies" owning 20 per cent or more of the shares of an issuer, or because the common manager possesses the ability to affect materially the control of the issuer.

b) Funds split between multiple managers

Many institutional funds are split between internal managers and a number of external managers (or solely among a number of external managers), each of whom may have discretionary authority to purchase and vote investments. Since purchase decisions are made independently, there exists a significant risk that the aggregate of securities beneficially owned by the fund will be inadvertently pushed across either the 20 per cent or the "affects materially" threshold by the non-coordinated actions of different managers.

85 This term is defined in OSA, supra note 68, s. 1(1) as "a person or company who provides investment advice, under a management contract."

86 This term is defined in OSA, ibid. as "an advisor registered for the purpose of managing the investment portfolio of clients through discretionary authority granted by the clients." A portfolio manager may be employed by a management company or hired on contract to manage part of an investment portfolio.

87 Firms like Jarislowsky Fraser, CIBC Investment Management Corp., Mackenzie Financial Corp., and Royal Bank Investment Management Inc. manage billions of dollars of both pension and mutual fund assets. See Roseman, supra note 3.

88 The increasingly common practice of marketing internationally diversified funds and farming out management to managers in several countries is obviously likely to enhance the independence of investment decisions.
c) *Multiple funds under common ownership*

Institutions often sponsor a variety of funds under independent management. For example, a bank might market a number of different types of mutual funds. Despite the fact that managerial decisions are made independently, the existence of common fund ownership again results in a risk that the non-coordinated activities of the different managers may unintentionally push the sponsoring institution across the "control person" threshold.

d) *Institutions owning or managing securities in different capacities*

Many institutions own securities in a variety of capacities. A trust company, for example, may beneficially own securities for its own account and also manage discretionary trust accounts in respect of which it possesses legal, but not beneficial, ownership. Once again, a variety of managers will make independent purchase or sale decisions, and this creates a risk that the control person thresholds will be inadvertently exceeded.

e) *Branch holdings of securities*

Different branches of the same institution may hold securities without the knowledge of head office or other branches. This might happen, for example, where a branch of a bank or a trust company forecloses on shares given as security for a loan and the resulting shareholding is not communicated to other branches or to head office. Once again, this magnifies the risk that an institution may inadvertently become a control person.

It can be seen, then, that "aggregation" problems cleave into two main groups: cases where there is common beneficial or legal ownership but separate management, and cases where there is common management but separate beneficial or legal ownership.

This enumeration of potential coordination and aggregation pitfalls does not purport to be an exhaustive list of situations in which the pertinent thresholds can accidentally be crossed; clearly, there are further permutations and combinations that yield additional opportunities for mishap.

From a policy perspective, it is at least clear that guidelines are necessary to clarify when regulators will aggregate holdings in the course
of calculating the holdings of any person, company, or combination of persons or companies. Present uncertainties create a serious disincentive for institutions to acquire sizeable blocks or to act jointly. But more than regulatory clarification is in order. The secondary distribution prospectus requirement is based on the presumption that a control person has access to confidential corporate information. Thus, the requirement can be safely dispensed with in any case where it is clear that investors acting alone or in concert do not have access to privileged information.

As a general matter, institutional investors are rarely privy to privileged information. This conclusion is strongly supported by a large corpus of empirical research which demonstrates that, on average, institutional investors do not "beat the market" as they would be expected to do if the possession of private information were common. Even recent studies which apparently indicate that mutual fund managers (and perhaps others) can beat the market, show that the trading advantage is very small (approximately 1 per cent per annum), and is likely no more, and possibly less than adequate compensation for the cost of collecting the information. This evidence, in my view, justifies a complete exemption for institutional traders from the secondary distribution requirements. Failing this, the securities legislation should be amended to provide a safe harbour from control person status for investors who coordinate their activities on an ad hoc basis to influence the control or direction of the issuer. The legislation should also be amended to provide exemptions from aggregation both where there is common ownership, but fractured management, and where there is common management, but fractured ownership. These exemptions should apply to all managers (i.e., management companies and portfolio managers) as well as to institutional owners and clients.

It should be noted that, if other recommendations in this paper are adopted, institutional investors could be expected to gain regular access to confidential information. Even assuming that this is the case, the policy of encouraging more active monitoring of corporate

89 See Part VI, below.
90 The qualification is important. See infra notes 209-213 and accompanying text.
91 Ibid.
93 See infra notes 209-213 and accompanying text.
managements by institutions would still, in my view, make it desirable to adopt an exemption from the secondary distribution requirements. Such a policy would subject institutions only to the regime of insider trading rules suggested in the following section.

D. Insider Trading Regulation

One strategy that might be followed by an institution that wishes to become actively involved in corporate governance (or to have a lever with which to police managerial conduct) is to put a representative on the board of directors. This, however, subjects the institution to two related disabilities: potential insider trading liability, and/or a loss of liquidity.94

All those who are in a “special relationship” with a reporting issuer are liable should they trade in the securities of that issuer while in possession of material undisclosed information concerning the issuer. A director is in a special relationship with the reporting issuer.95 If the nominee director communicates material information about the issuer to the sponsoring institution, then that institution is also in a special relationship with the reporting issuer.96

Once this characterization arises, any trading by the institution while in possession of material information that has not been generally disclosed will result in insider trading liability. This is the case no matter what the source of the information.97 The potential liability is fourfold. Insider trading is a criminal offence under provincial securities law,98 and the fine may be as much as three times the profit made.99 Insider trading may also result in civil liability, running both to the party on the other side of the trade and to the reporting issuer itself.100 Finally, insider trading may subject both the institution and its managers to

94 Liquidity will not be of coequal concern to all institutional investors. Life insurance companies and many pension funds have lengthy average hold periods, and the cost of illiquidity will be comparatively small. See K.A. Froot, A.F. Perold & J.C. Stein, “Shareholder Trading Practices and Corporate Investment Horizons” (1992) 5:2 J. Applied Corp. Fin. 42.

95 See, for example, OSA, supra note 68, s. 1(1) (definition of “insider”).

96 OSA, ibid., s. 76(5)(e).


98 OSA, supra note 68, s. 76.

99 Ibid. s. 122(4).

100 Ibid. ss. 134(1), (4).
administrative penalties such as a denial of trading exemptions.\textsuperscript{101} A denial of exemptions effectively results in exclusion from Ontario's capital markets. Obviously, institutional traders and their managers will be anxious to avoid these potential liabilities.

One way in which insider trading liability can be avoided is by not trading while in possession of material information that has not been generally disclosed. This strategy, however, carries an obvious liquidity penalty; it reduces the fund's flexibility to sell an investment, even if the reason for selling has nothing to do with the undisclosed information held by the fund.

How often will this be a problem? Canadian securities law requires all reporting issuers to file a press release and a report with the regulators on the occurrence of material events.\textsuperscript{102} Once information is made public, there can be no liability for trading on that information.\textsuperscript{103} Nonetheless, the law also permits a reporting issuer to keep sensitive information confidential by filing only a confidential report.\textsuperscript{104} Should the issuer elect to follow this route, those in a special relationship with the issuer will suffer diminished liquidity because of the necessity to avoid trading while the report remains confidential.

In addition, there is a risk that the reporting issuer will fail to issue a press release or material change report in relation to information that is later found by a court or administrative tribunal to have been material. If an institutional shareholder trades while in possession of such information, then insider trading liability may follow. This exacerbates the risk that an institution that puts itself in a position to receive confidential information and then trades will later be found to have engaged in insider trading.

A sponsoring institution might attempt to avoid these problems by constructing a "Chinese Wall" between itself and its nominee director.\textsuperscript{105} An abbreviated version of the Chinese Wall would forbid the nominee director from passing any non-public information to any person connected with the institution. Even an abbreviated Wall, however, greatly diminishes the effectiveness with which the institution

\textsuperscript{101} Ibid. s. 128.

\textsuperscript{102} See, for example, \textit{OSA}, \textit{ibid.}, s. 75. See also "National Policy No. 40: Timely Disclosure" (1987), O.S.C.B. 6294 [hereinafter NP40].

\textsuperscript{103} \textit{OSA}, \textit{ibid.} note 68, ss. 76(4), 134(1)(a).

\textsuperscript{104} \textit{OSA}, \textit{ibid.}, s. 75(3). See also NP40, supra note 102, Part G.

\textsuperscript{105} See \textit{OSA} Regulation, supra note 75, ss. 175(1), (3), which would appear to furnish a Chinese Wall defense to an institution that has nominated a corporate director.
can police management through the use of nominee directors. Where such a Wall is in place, the nominee director must be trusted to exercise judgment about which information may be disclosed to the institution and which information may not. There is a risk that a court or tribunal will later disagree with the nominee director’s judgment about whether a particular item of information was or was not confidential. In addition, a director receives a great deal of information about his or her company, and may not always remember what information is confidential and what is not. Thus, the only effective Chinese Wall is one that is absolute and forbids communication between the nominee director and the sponsoring institution. Obviously, however, an absolute Wall blunts to an even greater degree the efficacy of using nominee directors to police management. It is thus not terribly surprising that institutional investors rarely place a representative on the board of directors of a public company.\textsuperscript{106}

Even short of board representation, an institutional investor will be in a special relationship with a reporting issuer once it acquires 10 per cent of the voting rights of the issuer.\textsuperscript{107} An institution crossing the 10 per cent threshold thus has a greatly diminished incentive to acquire information about the investee corporation, since possession of privileged information will result in reduced liquidity and/or potential insider trading liability.\textsuperscript{108}

Indeed, Ontario’s securities legislation includes in the definition of “special relationship” any “person or company that is engaging in or proposes to engage in any business or professional activity with or on behalf of the reporting issuer.”\textsuperscript{109} Many institutional investors engage in business relationships with reporting issuers in which they invest. For

\textsuperscript{106} Koval, \textit{supra} note 23 at 53-55. It is both interesting and significant that institutional investors \textit{will} place representatives on boards of private companies. Koval, \textit{ibid.} at 54. This suggests that institutional reluctance to place nominees on boards has more to do with potential liabilities associated with public companies, like insider trading, than with any institutional culture of passivity or non-involvement in corporate affairs.

\textsuperscript{107} See, for example, \textit{OSA, supra} note 68, ss. 1(1) (definition of “insider” of a reporting issuer), 76(5)(a) (including “insider” in the definition of person in a special relationship). Note that since ownership of 10 per cent of all voting rights (rather than simply shares) triggers the “insider” relationship, a fund might cross the insider trading threshold by holding less than 10 per cent of the equity of an issuer.

\textsuperscript{108} Similar problems have occurred in the U.S., but are more serious because of potential “short-swing” trading liability under Rule 16(b) of the \textit{Securities Exchange Act of 1934}, § 16, 15 U.S.C. § 78(p) (1988). Also, see Roe, “A Political Theory,” \textit{supra} note 27 at 26-27; Black, \textit{supra} note 1 at 546-48 (also discussing “deputization” theory).

\textsuperscript{109} \textit{OSA, supra} note 68, s. 76(5)(b).
example, banks may have made loans to, or taken deposits from, firms in which they hold shares. Similarly, insurance companies may underwrite some aspect of the investee issuer’s business. These institutions will be in a special relationship with the reporting issuer.

It will be apparent from the above definition that an institution need not actually be engaging in business with an issuer to be in a special relationship with that issuer, however. The definition extends to any institution that “proposes to engage in any business” with the issuer. Although the meaning of “proposes” is not clear, it would seem to include, at a minimum, any institution that is actively seeking the business of the issuer. While perhaps unlikely, it might even embrace any institution that has some hope of obtaining the business of the issuer in the future, even if not presently wooing the issuer. An institution captured by this part of the definition of “special relationship” is as much at risk of insider trading liability (should it come into possession of confidential information) as an institution that has placed a nominee director on the board.

Potential insider trading liability appears to be a problem primarily for larger institutional investors. In a survey of public and private pension funds and investment managers, Kathryn Montgomery found that relatively large public sector pension funds “consider potential insider trading conflicts to be a most important deterrent to activism, second only to the time involved,”\(^\text{110}\) while private sector pension funds and investment counsellors do not consider potential insider trading liability to be a problem.\(^\text{111}\)

As is the case when determining whether control person status applies, issues of aggregation greatly cloud the determination of whether insider status will attach to investors. The OSA includes in the definition of an insider (and hence, special relationship):

\[
\text{any person or company who beneficially owns, directly or indirectly, voting securities of a reporting issuer or who exercises control or direction over voting securities of a reporting issuer or a combination of both carrying more than 10 per cent of the voting rights} \ldots [\text{emphasis added}]\(^\text{112}\)
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Thus, insider status may be acquired either on the basis of beneficial ownership or through the exercise of control or direction over voting securities. Clearly, the aggregation and coordination problems

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\(^{110}\) Montgomery, \textit{supra} note 34 at 10.

\(^{111}\) Ibid. ("Such potential conflicts do not appear to alarm investment counsellors or private sector pension funds, both of which classify this factor among the least important deterrents").

\(^{112}\) OSA, \textit{supra} note 68, s. 1(1) (definition of “insider”).
canvassed in Part C above are recreated in the issue of determining who is an insider.\textsuperscript{113} Thus, like the definition of a "control person," the definition of "insider" requires further refinement. In particular, it makes little sense to aggregate the ownership or control powers of funds under common ownership when management is split among many managers who have little or no contact with one another. In such a case, common ownership gives an illusion of control and, hence, access to inside information that does not mirror reality. Given the direct and opportunity costs of compliance, the rules should make it clear that regulators will not aggregate holdings invested by multiple managers making independent investment decisions. Similarly, where common managers purchase the same securities for a number of otherwise unconnected funds, they will not typically be seeking or exercising any measure of control, nor will they have any privileged access to information. Without more, it is inappropriate to aggregate holdings lacking a common owner for the purposes of determining if a group of funds exercises control or direction over an issuer.

Coordinated but \textit{ad hoc} institutional action intended to influence management, and single issue voting agreements, are also unlikely to be associated with privileged access to corporate information, as suggested by the empirical evidence on institutional performance referred to earlier.\textsuperscript{114} Because the costs of exposing institutions to potential insider trading liability exceed the likely benefits,\textsuperscript{115} doubts about whether coordinated action will give rise to aggregation for the purpose of identifying insiders should be resolved by specific exemptions.\textsuperscript{116}

As with the case of secondary distribution prospectus and disclosure requirements, however, further institutional and/or regulatory

\textsuperscript{113} Because of space limitations, much detail must be omitted from this discussion.

\textsuperscript{114} Supra notes 89-93 and accompanying text.

\textsuperscript{115} It could be argued that no harm is done by drawing institutions into the insider and hence "special relationship" net, since they might possess confidential information and will, in fact, not be liable for insider trading unless they do possess such information. However, this argument fails to recognize that because of the fuzziness of the insider definition, prudent institutional fund managers will tend to avoid purchasing large blocks or getting close to corporate affairs simply because of the risk of insider trading liability.

\textsuperscript{116} The likelihood that multiple legal persons engaging in coordinated activity will be found to be an insider is perhaps less than the risk of a coalition being found to be a control person, or to have made a takeover bid, given the absence in the insider definition of wording specifically including a combination of persons or companies, or persons or companies acting jointly or in concert. OSA, supra note 68, s. 1(1) (definition of insider). For a more detailed discussion of the difficulties associated with the definition of insider (with particular application to mutual funds), see Davidge, "Insider and Control Issues," \textit{supra} note 80; and Davidge, "Control and Insider Issues," \textit{supra} note 80.
changes may be in order. The thrust of this section is to recommend changes to the law that will raise the likelihood of institutional activism, and hence the likelihood that institutions will come into possession of confidential information. The most difficult question is therefore how to redesign insider trading laws to accommodate this more active role. One possible means for overcoming the risk of insider trading liability while preserving the incentive for institutions to engage in corporate monitoring may be found in a proposal by Professors Gilson and Kraakman. They suggest that institutional investors create a class of professional independent directors who would function as external monitors, without communicating inside information\textsuperscript{117} to their institutional principals.\textsuperscript{118} However, a number of potential difficulties arise. One difficulty involves the question of what will induce highly paid business people to abandon their careers to become professional directors.\textsuperscript{119} Another is the eternal question of who will monitor the monitors. Gilson and Kraakman argue that a central institutional clearinghouse could both nominate directors and evaluate their performance, perhaps by the use of performance indices. They never address, however, the difficulty of evaluating the performance of a single director who is part of a \textit{team} of directors,\textsuperscript{120} a difficulty that is greatly exacerbated by the fact that the evaluator can only observe "noisy"

\textsuperscript{117} Gilson and Kraakman in fact discuss only "short-swing" liability under s. 16(b) of the \textit{Securities Exchange Act}, supra note 108, and suggest that institutions would incur no liability under that provision for nominating and voting in a minority of the board of directors. See Gilson & Kraakman, \textit{supra} note 32 at 902-03. They do not discuss broader insider trading liability, but it seems to be implicit in their proposal that inside information will not actually be passed to institutional investors, particularly as they envision an institutional "clearing-house" performing the job of nominating and monitoring the outside directors. Coffee has criticized this proposal, however, on the grounds that it would give institutional investors access to inside information and that it would violate s. 16(b). Coffee, \textit{supra} note 1 at 1348.

\textsuperscript{118} Such directors would be paid by the corporation, but would be nominated and elected by institutional shareholders (or an institutional shareholder clearing-house), who could deprive them of employment by withholding their votes—hence the use of the word "principal" in the text.

\textsuperscript{119} Gilson and Kraakman argue that, although becoming a professional director would involve a pay cut, there will be those who will seek such employment in order to reap the benefits of the "great autonomy and clear institutional mandate" associated with being a professional director, and because of the "intrinsic idealism of the position." Gilson & Kraakman, \textit{supra} note 32 at 891 and note 88. This, however, remains somewhat speculative. One wonders whether the institutional mandate will in fact be any clearer than the mandate of the business manager to maximize profits, and just how much more idealism will be implicated than in the average business career.

\textsuperscript{120} The team that the director is a part of is in fact the entire team of directors, managers, and employees in the firm. Attributing good or bad performance to one individual is obviously a hazardous undertaking. See generally A.A. Alchian & H. Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62 Amer. Econ. Rev. 777.
signals of firm performance.\textsuperscript{121} It is difficult enough to evaluate an entire managerial team, let alone a subset of directors appointed by institutions or an individual director within that subset of directors. The difficulty of monitoring the monitor is almost certain to create considerable slack in the institution-director agency relationship. Hence, it seems unlikely that the Gilson and Kraakman proposal can promise more than marginal improvements over the institution of outside directors as currently constituted.\textsuperscript{122}

I offer an alternative suggestion which I call the "self-identification" regime.\textsuperscript{123} Under this regime, institutional traders who are in a special relationship with a reporting issuer and trading in possession of confidential information could escape liability by publicly declaring, prior to trading, an intention to trade while in possession of confidential information. They would not, however, have to reveal the information. Failure to make the required disclosure while trading in possession of confidential information would result in the usual insider trading liability.

This rule will result, on average, in the complete dissipation of any institutional insider trading gains. Where an institution announces that it is trading with the benefit of inside information, the market will either discount or bid up stock prices sufficiently to ensure that, on

\textsuperscript{121} All performance evaluation schemes are noisy. Accounting-based schemes, for example, are subject to managerial manipulation and even without manipulation may only loosely reflect changes in the economic condition of the firm. See, for example, R.L. Watts & J.L. Zimmerman, "Towards a Positive Theory of the Determination of Accounting Standards" (1978) Acct. Rev. 11. Schemes based on share price are also subject to inaccuracy in that share prices are noisy. See F. Black, "Noise" (1986) 41 J. Fin. 529; L. Chan & J. Lakonishok, "Are the Reports of Beta's Death Premature?" (University of Illinois at Urbana-Champaign, 1992) [Working Paper 92-0168]. Further, share price changes are a product not only of managerial effort and skill, but of exogenous market forces. See, for example, B. Holmstrom, "Moral Hazard and Observability" (1979) 10 Bell J. Econ. 74. They will also be an imperfect measure of managerial performance because of the influence of firm-specific factors unrelated to the effort and skill of the managers, such as a product liability suit arising from products marketed by a previous managerial team. Finally (but not least importantly), to the extent that expectations of management performance are already impounded in share prices, changes in share price may bear little relation to management's performance. See S. Keane, "Can a Successful Company Expect to Increase its Share Price?" (1990) 3:3 J. Applied Corp. Fin. 82.

\textsuperscript{122} Gilson and Kraakman argue that at present outside directors are only effective in crisis situations. Nonetheless, they also indicate that under their proposal "sustained bad corporate management would not remain a boardroom secret forever. Dramatic business mistakes would come to light in the business press, in which case professional directors could expect to be called upon to explain what efforts they had made to avert disaster." Gilson & Kraakman, supra note 32 at 891 (emphasis added). It is not clear, however, in what ways a dramatic business mistake differs from a crisis.

\textsuperscript{123} Unlike Gilson and Kraakman's proposal, this proposal clearly requires regulatory reform.
average, the institution earns no abnormal returns. Indeed, there is already good evidence that market makers and others dealing with insiders adjust their bid/ask spreads in view of the risk that the insider is trading on confidential information. 124

What are the advantages of this rule? The probability of apprehension for insider trading is low. As Montgomery’s survey shows, however, the potential criminal, civil, administrative, and reputational penalties associated with potential insider trading liability are nonetheless a strong deterrent to institutional activism. This betrays considerable risk aversion on the part of institutional money managers. Under the self-identification regime, highly uncertain legal and reputational penalties are replaced by a larger, but much more predictable, price penalty when trading while in possession of inside information—namely, the prophylactic price adjustment that occurs when an institution announces it will trade with the benefit of inside information. Viewed ex ante by the risk-averse manager, the latter might easily be more appealing than the former.

The ex ante appeal of the self-identification regime is heightened by the fact that when an institution wishes to trade while not in possession of inside information, its liquidity will actually be improved. The absence of an “insider trading” announcement will credibly125 signal the market that the institution is not trading with inside information. This will enable the institution to trade without the prophylactic price adjustment which would otherwise occur were the market to suspect that the institution was trading on confidential information.

Of course, I have already argued that institutions rarely trade with the benefit of inside information. However, the very point of the self-identification regime is to raise the probability that institutions will acquire inside information. Thus, the fact that the self-identification regime allows institutions not possessing inside information to trade without the prophylactic price penalty plays an important role in encouraging institutional activism.

The self-identification regime will also improve the efficiency of stock pricing. The rule will encourage an important class of shareholder—institutions—to acquire inside information. It will also

124 See, for example, T.C. Copeland & D. Galai, “Information Effect on the Bid-Ask Spread” (1983) 38 J. Fin. 1457.

125 It is credible precisely because institutional managers have revealed a risk aversion to insider trading sanctions. The credibility of the signal is enhanced by the virtual certainty that the criminal and civil liability that will result should the institution be found to have engaged in insider trading will greatly exceed any potential profit from engaging in insider trading.
encourage them to trade while in possession of inside information. Further, under the self-identification regime, the market will know with considerable accuracy when an institution is trading while in possession of confidential information, and will be able to draw the appropriate inferences. Thus, inside information is more likely than at present to be impounded into market prices. Indeed, the rule results in more accurate stock pricing, while enabling corporate issuers to keep the exact character of competitively sensitive information from the public purview.

Finally, it should be noted that the prophylactic price adjustment that will occur when an institutional trader announces that it is trading with confidential information will destroy any incentive of institutions to purchase block holdings for the purpose of engaging in insider trading. By the same token “outside” traders will be no worse off than at present. The main purpose and effect of the rule will be to encourage institutions to purchase large holdings and carefully monitor management with a view to improving corporate performance. Indeed, there are few changes in the law (aside from no regulation of insider trading) that are likely to have such a positive impact on monitoring by institutional investors.

A common objection to the view that institutions can be effective monitors is that institutional investors do not have the expertise to engage in active “hands-on” monitoring of management. See, for example, Gilson & Kraakman, supra note 32 at 876-79 (rejecting proposals that envision institutional investors directly engaging in active monitoring, because these “clash with the existing role and basic identity of institutional investors.”); Coffee, supra note 1 at 1332. The answer to this objection, in my view, is that when legal impediments to institutional activism are removed, there is nothing to prevent them from developing such expertise. The culture of passivity is not purely market driven; it is also regulation driven. Cf. Roe, “Legal Restraints,” supra note 27.

Another objection to the self-identification rule is that it would give institutions a coercive ability to force concessions from management by threatening to declare themselves in possession of insider information and then sell the stock, causing it to drop in price. Making good on such a threat, however, will be costly to institutional investors (because of the price penalty paid to exit the firm). This diminishes the credibility of the threat. It also suggests that institutional investors will make such threats only when they genuinely believe that management plans to take measures that threaten share prices more than institutional selling. Thus, the added leverage which the proposed rule gives to institutional investors, is likely to result in better corporate governance, rather than facilitation of institutional bribery.

E. Takeover Bid Regulation

Under provincial legislation, a "takeover bid" occurs when a person (offeror) purchases shares that "together with the offeror's securities, constitute in the aggregate twenty per cent or more of the outstanding securities of that class of securities."\textsuperscript{128} The term "offeror's securities" is defined as "securities of an offeree issuer beneficially owned, or \textit{over which control or direction is exercised} ... by an offeror or any person or company acting jointly or in concert with the offeror."\textsuperscript{129} The OSA further provides that "it is a question of fact as to whether a person or company is acting jointly or in concert with an offeror."\textsuperscript{130} However, any "agreement, commitment or understanding, whether formal or informal," to exercise voting rights gives rise to a presumption that the parties have acted jointly or in concert.\textsuperscript{131} Although space limitations forbid exploration of the details, it is obvious that these definitions recreate the coordination and aggregation problems already canvassed in relation to "control persons" and "insiders."\textsuperscript{132} In particular, since an \textit{informal} agreement, commitment, or understanding between institutions and/or money managers might result in a characterization of having acted "jointly or in concert," institutional investors and money managers are exposed to a significant risk that they will inadvertently trigger the costly takeover rules which require that an offer be extended to all shareholders if no exemption can be found.\textsuperscript{133} Even in the absence of joint action, portfolio managers purchasing the same securities for different accounts may trigger the takeover threshold by virtue of exercising "control or direction" over the requisite 20 per cent of an issuer's securities. Similarly, where management of a single fund is parcelled out to a variety of managers acting independently, the threshold might be inadvertently crossed. Indeed, for federally

\textsuperscript{128} OSA, \textit{supra} note 68, s. 89(1) (definition of "take-over bid").
\textsuperscript{129} \textit{Ibid.} (definition of "offeror's securities") (emphasis added).
\textsuperscript{130} \textit{Ibid.} s. 91(1).
\textsuperscript{131} \textit{Ibid.} ss. 91(1)(2).
\textsuperscript{132} See generally Davidge, "Insider and Control Issues," and Davidge, "Control and Insider Issues," \textit{supra} note 80.
\textsuperscript{133} OSA, \textit{supra} note 68, s. 95.1. As in the case of secondary distributions, there are both specific and discretionary exemptions available. See OSA, \textit{ibid.}, ss. 93 and 104(2)(c).
incorporated companies, the takeover bid threshold is only 10 per cent, magnifying the risk of inadvertent transgression of the legislation.\textsuperscript{134}

These difficulties highlight the folly of lowering the takeover threshold to 10 per cent, as proposed by the Canadian Securities Administrators (CSA) in 1990.\textsuperscript{135} Such action would almost certainly discourage institutional acquisition of significant stakes in Canadian corporations and, therefore, the amount of corporate monitoring engaged in by institutional investors.\textsuperscript{136} The CSA proposal would thus have the effect of diminishing corporate accountability and should not be revived. Indeed, it would be better to \textit{increase} the takeover threshold in both provincial and federal legislation to 30 per cent.

As in other cases where uncertainties surround the question of when coordinated action, joint management, or joint ownership will be construed to have triggered the pertinent ownership/control threshold, clarification is required. These uncertainties heighten the risk of block ownership, reduce institutional stakes in Canadian corporations, and impact negatively on institutional monitoring.

There is, in fact, a very strong case for completely exempting institutional owners, whether on an individual or an aggregated basis, from the application of the takeover rules, unless the institution or institutions actively make or participate in an offer to all shareholders. Institutions rarely participate in takeover bids except as sellers; indeed, the equity stakes of many institutional investors (such as banks, mutual funds, and life insurance companies) are capped, making such participation legally difficult or impossible.\textsuperscript{137} At the very least, when ownership is common but management is split between independently managed funds or independent managers, the rules should make it clear

\textsuperscript{134} \textit{CBCA}, supra note 36, s. 194. Note, however, that the \textit{CBCA} creates less onerous coordination and aggregation problems.


\textsuperscript{136} The \textit{CBCA} "takeover" threshold should be increased at least to the 20 per cent level found in provincial legislation. \textit{Accord}, P. Anisman, "Submission to The Canadian Securities Administrators Take-Over Bid Subcommittee By Allenvest Group Limited" (1990) 2:6 Corp. Gov. Rev. 7 at 16. I also agree with Anisman's suggestion (at 17) that the securities legislation be amended to allow investors inadvertently making a takeover bid (whether by violation of the 20 per cent threshold, the stock exchange "normal course" rules, or otherwise) to apply for an \textit{ex post facto} exemption from the takeover bid requirements.

\textsuperscript{137} See Part II(K)(1), below.
that aggregation of holdings will not occur. In such cases, the rationale underlying the takeover rules—that all shareholders should be treated equally on a change of control\textsuperscript{138}—does not apply since there is no joint exercise of control. Similarly, where control or direction is common but beneficial ownership is not (as with a portfolio manager managing a variety of mutual funds), the likelihood that the otherwise unconnected owners will contemplate exercising joint control is remote, and again the aggregation rules should not apply. Nor should coordinated institutional activity to influence management on an \textit{ad hoc} basis be subject to aggregation for purposes of determining if the takeover threshold has been crossed. It was never contemplated that such episodic influence over management would trigger the takeover rules, and applying the rules to such conduct will harm all shareholders by interfering with institutional monitoring.\textsuperscript{139}

F. Poison Pills

Concerted institutional action has also been dealt a blow by the recent adoption of “poison pills” by many of the large publicly traded (and management controlled) corporations in Canada. A poison pill consists of an issuance of rights to shareholders which, once activated, allows all shareholders, save the acquiror, to purchase shares at some fraction (usually one-half) of market price.\textsuperscript{140} The pill is typically activated when an “acquiring person” acquires “beneficial ownership” of more than a stated percentage of voting shares—usually 10 or 20 per cent.\textsuperscript{141} For the purposes of determining beneficial ownership, most plans aggregate holdings managed by portfolio managers for unaffiliated

\textsuperscript{138} The policies that underlie the takeover legislation are to ensure equal treatment of shareholders on a change of control and to give shareholders adequate time and information with which to decide whether to tender. The former is the key policy underlying the definition of a takeover bid. See Ontario, \textit{Report of the Attorney General’s Committee on Securities Legislation in Ontario} (March 1965) (Chairman: J.R. Kimber), especially para. 3.10.

\textsuperscript{139} There is again the possibility that institutions will become active bidders in the future. If so, my preference would be to eliminate most of the existing regime of rules in any case. See MacIntosh, \textit{supra} note 135.


\textsuperscript{141} See, for example, Anisman, “Acceptable Plan,” \textit{ibid.} at 3.
clients. Even those plans that have exemptions for such managers stipulate that the manager loses the exemption upon becoming involved in a variety of governance issues, and typically give the board discretion to determine if the exemption has been lost in a specific case. Similarly, under most plans, joint institutional activity in relation to corporate governance issues will result in aggregation for the purposes of determining beneficial ownership, again subject to board discretion. Institutions participating in a shareholder proposal or proxy solicitation, or perhaps even acting jointly to oppose management on a particular issue, may unwittingly find that they have collectively become an acquiring person. Poison pill plans thus make both large block purchases and institutional activism extremely risky activities for institutional investors and money managers, since inadvertently becoming an acquiring person (and triggering the pill) will result in the institution(s) or manager(s) (and their clients) incurring large losses.

If poison pill plans are to be permitted, strict regulation is indicated. Because money managers and institutional investors are rarely acquirors in takeover bids, the rules should mandate that the “acquiring person” threshold exclude portfolio managers and institutional investors from the definition of an “acquiring person” in all circumstances except where there is participation in an offer to all shareholders. The triggering threshold for becoming an acquiring person should be mandated as no less than the 20 per cent threshold contained in the definition of a “takeover bid,” and the rules should forbid pills from excluding partial bids. In addition, the common requirement that a “permitted bid” be made only by a person holding an even lower percentage of shares than the “acquiring person” threshold (often 5 or 10 per cent) should be prohibited. Also, because some

142 Ibid. at 3-4; “Corporate Governance,” supra note 140 at 1-5. As a result of pressure from Allenvest (now Fairvest) and other sources, some plans now make specific exceptions for portfolio managers. Koval, supra note 32 at 43.

143 “Corporate Governance,” ibid.

144 Ibid. at 2-4; Koval, supra note 32 at 42.


146 For an argument that such plans ought not to be permitted, see MacIntosh, supra note 28; although see also J.G. MacIntosh, supra note 32.


institutional shareholders may be corrupted by management pressure,\textsuperscript{149} shareholders should be required to approve poison pills by a supermajority of at least two-thirds, rather than a simple majority. This would put the poison pill, the most potent of all takeover defenses, on an even footing with modifications to the articles of incorporation (whether for the purpose of defending against a takeover bid or otherwise) and other corporate fundamental changes. Indeed, it would be better still to require that a pill be approved by a majority of the minority of shareholders.

Finally, the potentially adverse impact of the poison pill on share price requires that an appraisal right be extended to shareholders on the adoption of a poison pill. This could be done by amendment to the corporate legislation.\textsuperscript{150}

G. Insider Reporting Requirements

Provincial legislation typically requires that “insiders” of reporting issuers file monthly reports of all trading activities.\textsuperscript{151} The difficulties of determining who is an “insider,” already discussed in relation to insider trading, recur in the reporting context. Indeed, inadvertent breaches of the reporting requirement may already be a common occurrence. Such breaches may be more than a nuisance to institutional investors, given that repeated breaches may provoke the ire of regulators and result in the application of powerful discretionary sanctions, such as a denial of trading exemptions, to either the fund or its managers.

\textsuperscript{149} See Part IV, below.

\textsuperscript{150} It could also be done through provincial or national policy statements issued by securities regulators. In my view, this would be an excessive use of regulatory jurisdiction. See J.G. MacIntosh, “The Excessive Use of Policy Statements by Canadian Securities Regulators” (1993) 1 Corporate Financing 19; \textit{Ainsley Financial Corporation v. Ontario Securities Commission} (1993) 14 O.R. (3d) 280 (Gen. Div.) [hereinafter \textit{Ainsley}].

The Allinvest Group (now Fairvest) has been the primary mover in convincing a number of pill-adopting firms to water down their poison pills (most notably in connection with the Transalta pill) along the lines indicated in the text, in addition to championing other worthwhile amendments which probably ought to be mandated by legislation (including: “sunset provisions”; limiting the discretion of directors to decide whether securities or other laws have been complied with; not requiring that the bidder obtain a “fairness” opinion or valuation; not requiring that the bidder maintain an up-to-date list of holdings, \textit{etc.}). See \textit{supra} note 148; and see C. McCall, “An Acceptable Poison Pill? Transalta’s New ‘Shareholder Bid Approval Plan’” (1992) 4:5 Corp. Gov. Rev. 6; and MacIntosh, \textit{supra} note 28. As McCall indicates, even the modified Transalta pill is highly imperfect and more likely to deter bids than it is to increase takeover premia.

\textsuperscript{151} See, for example, \textit{OSA}, \textit{supra} note 68, s. 107.
The application of insider reporting requirements to institutional investors is of questionable utility. As indicated above, institutional investors are rarely privy to inside information. Thus, requiring insider reports is not likely to further the statutory policy of preventing insider trading. At the same time, the cost of the requirement is not trivial, particularly if institutions and money managers are forced to aggregate their disparately held holdings in order to file a report. Thus, the requirement is not cost effective.

While securities regulators may view market transparency as an independent desideratum, the value of exposing institutional holdings to public purview is questionable. The cost is more apparent; it is not unusual for institutional investors to purchase 9.9 per cent of a firm's shares in order to escape insider and "early warning system" disclosure and to preserve the confidentiality of an institution's investment portfolio. Institutional traders and money managers should be exempted from insider reporting obligations.

H. The Early Warning System

The "early warning system" (EWS) creates a related regulatory hindrance to institutional activity. Under the OSA, for example, the acquisition of a 10 per cent stake in any voting or equity securities of a reporting issuer requires the immediate filing of a press release and a report to the Commission within two business days. Each acquisition of an additional 2 per cent triggers a similar requirement. Further, crossing either reporting threshold puts a freeze on further acquisitions for a period of one business day.

Like the definition of "insider," the EWS disclosure threshold consists of a disjunctive beneficial ownership or control test. However, the test is arguably even more prone to coordination and aggregation risk, as the statute states that "every offeror that acquires beneficial ownership of, or the power to exercise control or direction over" voting

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152 I exclude from consideration here funds that are forbidden from owning more than 10 per cent of the shares of any one issuer. Accord, Davidge, "Insider and Control Issues," supra note 80 at 12-13 (investment program is proprietary asset of fund; knowledge of fund purchases may affect the market price and adversely affect the fund's owners). Confidentiality is particularly valued by publicity-shy public pension funds. See infra notes 239-240 and accompanying text.

153 OSA, supra note 68, s. 101(1).

154 Ibid. s. 101(2).

155 Ibid. s. 101(3).
securities is subject to the Ews obligations.\textsuperscript{156} Since the \textit{power} to exercise control or direction is almost certainly broader than exercising control or direction,\textsuperscript{157} portfolio managers are even more at risk of inadvertently violating the Ews requirements than of violating the insider trading or reporting requirements.\textsuperscript{158}

Like the insider reporting obligation, the rationale for extending the Ews to institutional traders is thin. The purpose of the Ews is to inform the market at an early stage of an impending takeover bid by requiring public disclosure of the acquisition of a "toehold" or "springboard" block. However, institutional investors almost never participate in takeovers except as sellers. Indeed, many institutions are legally unable to purchase a substantial fraction of the equity of a single issuer.\textsuperscript{159} Thus, the policy that underlies the Ews would not be defeated by exempting institutions from its coverage. At the very least, following the U.S. lead,\textsuperscript{160} a simplified annual reporting system that would embrace both the Ews and insider trading reporting rules should be instituted.\textsuperscript{161} However, the limitation in the U.S. exemption, that the exempted institution must not purchase shares for the purpose of changing or influencing control, should not be included.\textsuperscript{162} Otherwise,

\begin{itemize}
  \item \textsuperscript{156} Ibid. s. 101(1) (emphasis added).
  \item \textsuperscript{157} A power to exercise control or direction need not be exercised to trigger the Ews requirement.
  \item \textsuperscript{158} Managers selecting the same securities for independently owned funds are the most likely to be drawn into the wider net.
  \item \textsuperscript{159} See Part II(K)(1), below.
  \item \textsuperscript{161} A similar view is expressed in Anisman, supra note 136 at 14-15.
  \item \textsuperscript{162} The U.S. exemption requires certification that the institution has acquired securities without "the purpose ... [or] effect of changing or influencing the control of the issuer" (whether alone or in concert). Rule 13(d)-1(b)(i), supra note 160. After this paper was written, the osc published for comment "Proposed Refinement of the Early Warning, Insider Reporting and Take-Over Bid Regimes" (1993), 16 OSCB 4539 (September 10, 1993). The proposals include an abbreviated, quarterly reporting early warning regime for certain "passive" investors and their advisors, in addition to relief from insider reporting requirements for certain "passive" investors and their advisors that comply with the abbreviated early warning regime. The proposals also indicate that "[s]taff is also considering whether any modification of the take-over bid requirements or restrictions on distributions from 'control blocks' is required in the context of securities in managed accounts." This proposal is clearly a step in the right direction, although in my view it does not go far enough.
\end{itemize}
the overarching purpose of encouraging active institutional participation in corporate governance will be impaired.


As indicated earlier, the shareholder proposal provisions have not been used extensively in Canada.\(^{163}\) It has been suggested that a practical reason for this non-use is that most public corporations have a controlling shareholder and the prospects of success are typically not great.\(^{164}\)

While this is undeniably true, the shareholder proposal mechanism is nonetheless important and useful. While the prospects for success may be poor in an individual case, shareholder proposals nonetheless serve an educational function by putting issues of concern to institutional investors on the public (and the managerial) agenda.\(^{165}\) This can have the salutary effect of creating pressure on corporate managers not to adopt wealth-reducing measures. By generating public debate, shareholder proposals can also cause many normally passive shareholders to reconsider their sometimes unthinking support of management.

In a number of ways, the law has discouraged the use of shareholder proposals. McCall and Wilson have proposed a number of simple and sensible amendments to the proposal mechanism, which might well enhance the frequency with which this device is used in Canada.\(^{166}\) For example, under existing law the proposing shareholder is entitled to have the company circulate to shareholders a statement of only 200 words in support of the proposal.\(^{167}\) This could easily be increased to 500 words (as in the U.S.) without adding more than marginal cost to the management proxy circular.\(^{168}\)

Existing rules also ban resubmission of a proposal within two years of the defeat of substantially the same proposal.\(^{169}\) This ignores the educational function of the proposal mechanism and should be

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163 Supra note 36.
164 See Koval, supra note 32 at 39.
165 See McCall & Wilson, supra note 36.
166 Ibid.
167 See, for example, CBCA, supra note 17, s. 137(3).
168 McCall & Wilson, supra note 36 at 14.
169 See CBCA, supra note 17, s. 137(5)(d).
deleted from the legislation. Shareholders may also be discouraged from acting jointly in discussing, making, or supporting a shareholder proposal for fear of triggering the requirement to assemble a dissident’s proxy circular. This fear would be greatly alleviated by changing the definition of “solicitation” in the manner proposed earlier. In a similar vein, institutions may fear that joint action in support of a proposal will trigger either a poison pill, the insider trading or MWS reporting requirements, or the takeover bid requirements, or that it will give the cooperating institutions control person status, thus reducing the liquidity of the institutional holdings. Implementation of the reforms suggested earlier would diminish or eliminate these dangers.

J. The Shareholder’s Appraisal Right

The appraisal right, which effectively allows shareholders to “put” their shares to the corporation on the occurrence of designated corporate fundamental changes, was primarily designed to allow dissenting shareholders a mechanism for exiting the corporation on the undertaking of a fundamental change without suffering a loss in value, while at the same time not impeding majority action. Although the appraisal right is designed to facilitate “exit” rather than “voice,” the appraisal right can in fact have a salutary effect in bolstering institutional voice. This is due to the fact that it is the corporation that must buy the dissentent’s shares. A sufficient number of dissenters can create a severe cash drain and can conceivably cause management to amend or abandon the proposed fundamental change. The threat of dissent thus strengthens institutional bargaining power.

170 McCall & Wilson, supra note 36 at 13.
171 See supra note 68 and accompanying text.
172 See, for example, CBCA, supra note 17, s. 190.
174 The term “exit”, now commonly used in the corporate literature, is used to indicate a strategy of selling when dissatisfied with management. See A.O. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organisations, and States (Cambridge: Harvard University Press, 1970). In contrast, the term “voice” (also coined by Hirschman) is used to indicate the various means by which investors actively seek to convince management to change its intended course of action, including persuasion, voting, mounting a proxy contest, or litigating.
175 Ibid. at 264.
Unfortunately, the appraisal right has proved to be an unreliable shareholder protection. Perhaps the main deficiency is the costliness of exercise. Under existing adversarial procedures, both the corporation and the dissenting shareholder typically call upon a large number of expert appraisers to make their case, and the aggregate costs of the dissent procedure discourage all but the bravest and largest institutional shareholders from enlisting the right. This problem, along with other infirmities, must be cured before institutional investors can effectively use the threat of triggering the appraisal right as a tool to influence corporate conduct.

K. Legal Constraints on Institutional Ownership

At least six different types of legal constraints limit or inhibit institutional purchases of equity (and in some cases debt) securities of private sector firms:

1. Caps on ownership of individual firms

Many institutions cannot hold more than a stated percentage of the equity of a single company. For example, banks and other federally chartered financial institutions are prohibited from owning more than 25 per cent of the equity or controlling more than 10 per cent of the voting rights of a single issuer (although recently enacted regulations enable such institutions to hold interests in “specialized financing corporations,” which may own a controlling interest). Mutual funds (wherever

176 The risk is exacerbated by the application of the usual “costs follow the event” rule, which can saddle a dissenting shareholder with huge costs should the shareholder’s proffered valuation be more distant than the company’s from the judicially determined “fair value.” MacIntosh, supra note 173; and M. Leith, “The Dissent Route, Once is Enough” (1993) 5:1 Corp. Gov. Rev. 7.

177 Other infirmities include labyrinthine procedures, the tax cost of exercise (at least for taxable investors), the inability of non-expert judges to determine fair value reliably, and the fact that courts award simple, rather than compound, interest. Proposals for reform may be found in MacIntosh, ibid.; and Leith, ibid.

178 The examples that follow are illustrative only. No attempt has been made to exhaustively review all federal and provincial regulatory requirements.

179 See, for example, Bank Act, S.C. 1991, c. 46, s. 466(1); Trust and Loan Companies Act, S.C. 1991, c. 45 [hereinafter TFLCA], s. 451(1); Insurance Companies Act, S.C. 1991, c. 47 [hereinafter FICA], s. 493(1). In each case, there is an exception for a “temporary” investment of up to two years in duration, so long as the regulated institution does not control more than 50 per cent of the aggregate votes. Bank Act, s. 471; TFLCA, s. 456; FICA, s. 498. A further exception applies to
chartered) are similarly prohibited, and, in addition, may not “purchase securities for the purpose of exercising control or management of the issuer of such securities.” Provincial institutions, such as those chartered in Ontario, are subject to similar limits.

2. Limits on the proportion of portfolio assets that may be invested in equities

Most federally chartered financial institutions cannot invest more than 70 per cent of their regulatory capital (which is essentially their shareholders’ equity) in common shares. Nor may such institutions invest more than 100 per cent of regulatory capital in

“realizations” (for example foreclosures), again with a two-year divestiture limit. See Bank Act, s. 473; FTLCA, s. 458; and FICA, s. 500. Another important exception relates to interests in companies carrying on cognate or ancillary businesses. See Bank Act, ss. 468-469; FTLCA, ss. 495-496; and FICA, ss. 453-454. Similar rules are expected for pension funds. With respect to specialized financial corporations (SFC), see Specialized Financing Corporation (Trust and Loan Companies) Regulations, SOR/92-351; Special Financing Corporation (Banks) Regulations, SOR/92-357; Specialized Financing Corporation (Insurance Companies) Regulations, SOR/92-358 (in each case, limiting the amount of capital the financial institution can invest in SFCs, and the size of any single investment by an SFC).


181 Ibid. at s. 2.04, para. (8). As the limitations on mutual fund investment policy are contained only in a policy statement, their legal status is highly questionable, particularly after the Ainsley decision, supra note 150.

182 Life insurance companies incorporated in Ontario may not own more than 30 per cent of a single issuer. Ontario Insurance Act, R.S.O. 1990, c. L.8 [hereinafter OIA], s. 434(1)(d) (insurer may not own more than “30 per cent of the common shares or 30 per cent of the total issued shares of any one corporation”). Companies subject to the Ontario Loan and Trust Corporations Act, R.S.O. 1990, c. L.25 [hereinafter OLTCA] may not “hold more than 10 per cent of the issued and outstanding shares of a class of voting shares of any one body corporate.” Ibid. s. 168(1). The Ontario Pension Benefits Act, R.S.O. 1990, c. P.8 [hereinafter OPBA], s. 72(1) provides that “[a] pension fund shall not own more than 30 per cent of the voting shares of any corporation.” Under the OIA and the OLTCA, there are exceptions for cognate or ancillary businesses broadly similar to those in the federal legislation. See OIA, s. 433(8); OLTCA, s. 169. It should also be noted that under Ontario’s “equals approach,” institutions chartered in other jurisdictions but doing business in Ontario must comply both with the Ontario rules and the rules of their incorporating statute.

183 See, for example, Bank Act, supra note 179, s. 478; FICA, supra note 179, s. 508(e) (life insurers); FTLCA, supra note 179, s. 466. In addition, the aggregate of all real estate holdings and equities may not exceed 100 per cent of regulatory capital. Bank Act, s. 479; FICA, s. 509(e); FTLCA, s. 467. Other federal financial institutions are subject to broadly similar restrictions. See, for example, FICA, ss. 508(f), 509(f)-(g) (no property and casualty insurer may invest more than 25 per cent of the assets of the company in equities, or 30 per cent [in some cases 35 per cent] in real estate holdings plus equities).
common shares plus real estate.\textsuperscript{184} Provincial financial institution legislation, such as that in Ontario, contains similar limitations.\textsuperscript{185}

3. Limits on the proportion of portfolio assets that may be invested in a single security or corporation

Some institutions, such as Ontario insurance companies, cannot invest in a single security or corporation where such investment would exceed a threshold amount (in the case of Ontario insurance companies, 10 per cent of the book value of the total assets of the insurer).\textsuperscript{186}

4. "Legal for life" restrictions

"Legal for life" investment restrictions, which are still found in much of the provincial legislation, prohibit investments in non-qualifying issuers\textsuperscript{187} with the exception in some cases of investments undertaken through the "basket clause," which permits investment of a stated percentage of the portfolio in otherwise prohibited assets.\textsuperscript{188} The effect of these rules is to limit institutional investments in smaller firms without substantial track records or in firms experiencing financial distress.

\begin{footnotesize}
\begin{enumerate}
\item[184] See, for example, Bank Act, ibid., s. 479; FICA, ibid., s. 509(e); FTLCA, ibid., s. 467.
\item[185] Under the OIA, supra, note 182, "the total book value of the investments of an insurer in common shares ... shall not exceed 25 per cent of the book value of the total assets of the insurer," OIA, s.435(e). Similarly, no loan or trust corporation may have more 10 per cent of total assets invested in common shares, or more than 25 per cent of total assets invested in securities of any kind. See OLTCA, supra, note 182, s.167(4).
\item[186] OIA, ibid., s. 435(1)(c). A similar limit may be found in the OPBA, supra note 182, s. 70.
\item[187] See, for example, OIA, ibid., s. 433(1)(n); OLTCA, supra note 182, s. 162(1)(c). See generally Stikeman, Elliott, \textit{Legal for Life: Institutional Investment Rules in Canada}, 4th ed. (Scarborough: Carswell, 1992) at xiii-xxiv. As the authors explain (at xiii):

\begin{quote}
Generally, under the legal list approach, investments are restricted on the basis of the status of the issuer of the debt or equity, security or collateral offered to support the debt, or historical solvency or earnings of the issuer. In addition, in many cases, because a category of institution has access to more capital than sources of investments meeting legislated standards, the institution is permitted to invest a set percentage of its assets in areas not otherwise provided for. The institution may also lend on the security of the assets it is authorized to invest in.
\end{quote}

Legal for life tests have recently been stripped out of the federal legislation, although similar rules apply to some institutional investors by virtue of the Income Tax Act, supra note 47, s. 207.1 (applying tax penalties to RRSPs and other tax exempt investors that fail to invest in specified "qualified investments").
\item[188] See, for example, OLTCA, ibid., s. 166(1).
\end{enumerate}
\end{footnotesize}
5. Capital adequacy rules

Federal capital adequacy rules require that federally chartered financial institutions maintain a minimum ratio of capital to risk-weighted assets. The theory that underlies the test is that holdings of riskier assets should be supported by a larger capital base than less risky assets in order to provide an adequate cushion against insolvency. Thus, various types of investments are risk weighted in determining their contribution to assets. Consequently, asset categories with the highest risk weightings require the largest amount of capital in support. The least risky assets, like cash and claims on OECD governments, receive a 0 per cent risk weighting and, hence, need not be counted in assets at all. The most risky assets, including all holdings of equity and debt securities in private sector corporations, receive a 100 per cent risk weighting. The result is that holdings of either equity or debt securities of private sector firms are comparatively expensive for financial institutions because of the opportunity cost associated with maintaining a larger capital base. This operates as an additional disincentive for a federally chartered financial institution to invest in corporate equity or debt securities. 190

6. The doctrine of equitable subordination

Another legal constraint that may inhibit institutional purchase of equity stakes is the doctrine of equitable subordination, under which a lender exercising some measure of control over an issuer—for example, through a concurrent holding of equity securities—may find its debt claim subordinated in insolvency proceedings to the interests of other creditors.

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189 See, for example, Bank Act, supra note 179, s. 485, and Office of the Superintendent of Financial Institutions, “Subject: Capital Adequacy Requirements” (26 June 1992); FTLCA, supra note 179, s. 473; and FICA, supra note 179, s. 515 (life insurance companies), s. 516 (property and casualty insurers). The risk-weighted approach reflects the standards adopted by the Bank for International Settlements.

190 By comparison, the provinces (including Ontario) use a borrowing multiple approach, under which the size of deposits held must not exceed a stated multiple of capital. See OLTCA, supra note 182, s. 157. Such an approach does not attach a penalty to equity ownership.
7. Evaluation

Aside from the doctrine of equitable subordination, a common thread of risk reduction and protection against insolvency runs through these limitations on equity purchases. Many of these restrictions, however, no longer make good sense, if indeed they ever did. By limiting ownership in individual firms, equity caps reduce the incentive for institutions to engage in monitoring of corporate managements. So long as an institution diversifies adequately, limitations on the acquisition of control serve no added prudential function. Legal for life restrictions greatly reduce institutional investment in second market companies and thus reduce their liquidity and pricing efficiency, as well as the efficacy with which managers of such companies are monitored. Legal for life restrictions also result in institutional investors constructing inefficient investment portfolios; efficient diversification is achieved when the fund holds a combination of assets of all risk classes.191

Equity caps and legal for life restrictions are based on the erroneous view that each investment in an institutional portfolio must be prudent by itself; without reference to other holdings in the portfolio. It is portfolio risk that matters, and holding large and/or risky stakes in some corporations is consistent with prudent investment management.192 The new “prudent person” standard that has been introduced in the federal and some of the provincial legislation would appear to reflect this view,193 although without definitive judicial interpretation there is still room for doubt.194

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191 See, for example, Ross & Westerfield, supra note 7 at 144-180.

192 See, for example, J.N. Gordon, “The Puzzling Persistence of the Constrained Prudent Man Rule” (1987) 62 N.Y.U. L. R. 52. Coffee argues that some institutional buyers, and particularly banks, might choose not to purchase large equity stakes even if the rules were altered. See Coffee, supra note 1 at 1314-15. While not denying the existence of the market forces identified by Coffee, the institutional culture of passivity is in my view at least as much a product of legal regulation as it is of market factors. Thus, changing the rules applicable to institutional investors will, over time, lead to larger institutional stakes and more active institutional monitoring.

193 See, for example, FICA, supra note 179, s. 492; FTLCA, supra note 179, s. 450; Bank Act, supra note 179, s. 465; OPBA, supra note 182, s. 22; and Regulation made under the Pension Benefits Act, R.R.O. 1990, Reg. 909, s. 67(2). Some statutes combine the legal for life and prudent person approaches. See, for example, OLTC, supra note 182, ss. 154, 162(1)(c), 166(1). All of these statutes (and/or amplifying regulations) specifically indicate that prudence is to be judged in the context of the portfolio as a whole.

194 The statutes and/or regulations referred to, ibid. all indicate that the fund’s managers must avoid “undue risk of loss,” possibly supplying the means by which a court could reintroduce a single investment prudence standard in addition to a portfolio prudence standard. The American
Limits on the proportion of assets that may be invested in equities and risk-weighted capital adequacy rules both serve a useful prudential function and are not objectionable in principle. However, these protections are unnecessarily duplicative. In my opinion, the latter rules are sufficient by themselves to advance the goal of prudential management. At the least, the federal limits on the proportion of assets that may be invested in equities are too low and should be raised. Obviously, however, a stronger case exists for retaining the aggregate equity limits in provincial statutes that do not have risk-weighted capital adequacy tests.

Limitations on the proportion of total assets that may be invested in a single issuer probably do little harm, but add little to the requirement to act prudently by adequately diversifying. Provincial enactments that contain such requirements would do well to delete them (as well as the legal lists) in favour of a “prudent person” investment standard.

It is unclear at present if the doctrine of equitable subordination actually exists in Canada.195 In my view, two measures are in order. The first is legislative clarification of the circumstances in which equitable subordination will be applied. Clarification is necessary in order to quantify a presently unknown risk that may operate to discourage equity purchases by institutions or attempts to influence control of an issuer, where the institution holds both equity and debt claims or debt claims alone, and exercises some measure of control over the issuer. Second, such legislative clarification should make it clear that simply influencing control of the issuer, or even exercising control, should not by itself be sufficient to trigger application of the doctrine. Rather, a showing of conduct specifically prejudicial to other creditors (and unfairly so) should be required.

experience with similar wording suggests that this is a real possibility. See Black, supra note 1 at 553-56; Roe, “A Political Theory,” supra note 27 at 18-19, 24; and M.J. Roe, “The Modern Corporation and Private Pensions: ERISA’s Errors” (Law and Economics Workshop, Faculty of Law, University of Toronto, WS 1992-93-(4)), at 17-22 [hereinafter “Modern Corporation”].

L. Limitations on the Ownership of Institutions

Whether institutional shareholders will engage in monitoring depends in part on the motivation of institutional managers. Institutional managers who have strong incentives to engage in profit maximizing behaviour are likely to be more aggressive corporate monitors. Conversely, if there is considerable slack in the incentives of institutional managers, it can be expected that corporate monitoring will also be slack.

Restrictions on the ownership of Canadian financial institutions are likely to adversely affect the incentives of institutional managers. For example, no person may own more than 10 per cent of a federally chartered financial institution. Both federal and provincial legislation forbid foreign ownership from exceeding, in the aggregate, 25 per cent of a Canadian financial institution. There is no single inspiration for these rules, and discussion of the multiple rationales is beyond the scope of this paper. Nonetheless, it is worth pointing out that this type of ownership restriction impairs direct shareholder oversight, and effectively removes affected institutions from the market for corporate control. Since both direct oversight and the control market are important sources of managerial discipline, such restrictions are bound to increase managerial agency costs. These increased agency costs will in turn adversely affect institutional incentives to actively monitor enterprises in which they have invested.

Although not mandated by law, much of the insurance industry is held in “mutual” form under which the policy holders are effectively the shareholders. Under federal law, insurance companies may “demutualize,” but are then subject to a 10 per cent ownership restriction

196 See Bank Act, supra note 179, s. 372; FICA, supra note 170, s. 407; and FTLCA, supra note 179, s. 375. There are some exceptions to this rule. See, for example, Bank Act, ss. 374-380; FTLCA, ss. 376-78; FICA, ss. 408-411. See also Bank Act, s. 381; FTLCA, s. 379; and FICA, s. 411 (public holding requirements).

197 See, for example, Bank Act, ibid., s. 399; FICA, ibid., s. 429; FTLCA, ibid., s. 397; OLTCA, ibid., s. 60.

198 As indicated above, there is good evidence that concentrated ownership is associated with increased operating efficiencies (subject, however, to the caveat that the relationship between ownership concentration and firm value does not appear to be monotonic). See supra notes 19-29 and accompanying text. With respect to the value of the market for corporate control, see, for example, M.C. Jensen, “The Takeover Controversy: Analysis and Evidence,” in J.C. Coffee, Jr., et al., eds., Knights, Raiders and Targets: The Impact of the Hostile Takeover (New York: Oxford University Press, 1988) at 314.
like that applied to banks.\textsuperscript{199} Mutualization is probably the best way to insulate management from any external control,\textsuperscript{200} and thought should be directed to the issue of forcing demutualization of mutualized insurance companies.\textsuperscript{201}

III. INSTITUTIONAL INDEXATION AND MONITORING

Aside from legal impediments to institutional activism, some have raised concerns that the growing practice of “indexing” institutional funds, rather than trying to “beat the market” by selecting undervalued securities or promising performers, will compromise institutional activism.\textsuperscript{202} A related concern, explored in Part X, below, is whether indexation will impair market efficiency.

In the discussion that follows, I will distinguish between “indexing,” “passive,” and “active” investment strategies. An indexing strategy is one in which the fund manager constructs a fund portfolio that closely replicates a common market index, such as the Toronto Stock Exchange (TSE) 35. A passive strategy is one in which a fund manager selects investments on some basis other than replication of a market index, but will sell the investment when dissatisfied with management. Investments are individually selected in an active strategy as well, but, in addition, the dissatisfied fund manager will attempt to alter corporate management’s intended course of action by attempting to persuade management of the folly of their undertaking, by voting against management, by participating in a proxy battle or takeover contest, or by other means.\textsuperscript{203} I will refer to passive and active strategies

\textsuperscript{199} FICA, supra note 179, s. 237.

\textsuperscript{200} There is effectively no direct oversight by unorganized, free-riding policy holders with atomized interests and deficient incentives to monitor management, and there is no control market. See generally H. Hansmann, “The Organization of Insurance Companies: Mutual versus Stock” (1985) 1 J. Law Econ. & Org. 125.

\textsuperscript{201} The case for demutualization is not clear cut, and merits further study. Cf. R.W. Masulis, “Changes in Ownership Structure: Conversions of Mutual Savings and Loans to Stock Charter” (1987) 18 J. Fin. Econ. 29 (finding that conversions of mutual S & Ls to stock ownership result in efficiency enhancements); D. Meyers & C.W. Smith, Jr., “Ownership Structure and Control: The Mutualization of Stock Life Insurance Companies” (1986) 16 J. Fin. Econ. 73 (finding that mutualization of life insurance companies is on average efficiency enhancing).

\textsuperscript{202} See generally Gilson & Kraakman, supra note 32.

\textsuperscript{203} In almost all cases, an active strategy will involve no more than voting against management, collective action with other shareholders to persuade management, and/or private consultations with management. See Montgomery, supra note 34 at 8. Given that these tactics involve far less commitment of resources than participating in a proxy contest or a takeover bid, it
as “selection” strategies, since in each case the manager selects the individual investments that make up the portfolio on some basis other than their participation in a market index. It will become apparent that these strategies do not form watertight compartments; for example, managers who elect to index their fund can still engage in active measures to persuade or discipline corporate managements.

It is no great surprise that indexing strategies have gained increasing popularity with institutional investors. As a first approximation, it is reasonable to assume that the utility of fund managers is negatively correlated with the effort expended in managing the portfolio. Obviously, the strategy of indexing a fund considerably reduces managerial effort. But the adoption of an indexing strategy is also likely to generate costs for the manager. For one thing, managerial fees are typically based on asset size and successful fund management can have a strong, positive impact on the fees paid to the manager. But even where managerial remuneration is divorced from fund performance, manager utility is likely to be positively correlated with fund performance given that a successful fund is likely to attract more investors and thus increase the probability that the manager will retain her job or acquire a better one. Moreover, good performance is a source of pride and prestige; successful managers frequently find their names and faces splashed across the front pages of business sections of newspapers with admiring accounts of their financial finesse. Clearly, an indexing strategy will never lead to this kind of superior performance.

might be preferable to categorize participation in a proxy contest or takeover bid as a “super-active” strategy. However, for the purposes of this paper, nothing turns on this over-inclusiveness; the main purpose in view is to contrast “selection” strategies (passive and active strategies) with indexing strategies.

204 About one-third of equity investments held by U.S. institutions are indexed. See D.M. Walker, “The Increasing Role of Pension Plans in the Capital Markets and in Corporate Governance Matters,” in Sametz, supra note 1, 34 at 36. Because of their size, indexing appears to be particularly popular with public pension plans. For example, approximately 60 per cent of the $58 billion California Public Employees’ Retirement System fund was indexed in 1990, with an increase to 85 per cent projected for 1991. See S. Clark, “Why Dale Hanson Won’t Go Away” (April 1990) Institutional Investor 79 at 80.

Indexing is much less prevalent in Canada. For example, while the Canadian pension fund market consists of about $275 billion in assets, only about $12 billion of this is indexed. See E. Roseman, supra note 3. However, indexation strategies are growing rapidly in popularity, as evidenced by the 100 per cent increase in pension fund indexation between 1991 and 1992. Ibid.

205 See M.K. Berkowitz & Y. Kotowitz, “Incentives and Efficiency in the Market for Management Services: A Study of Canadian Mutual Funds” (University of Toronto, August 1992) (finding a strong positive correlation between the performance of Canadian mutual funds and management fees paid, resulting from the fact that small differences in performance can translate into large differences in assets under administration). This suggests that Coffee’s assumption that asset-based remuneration schemes are inefficient is wrong. See Coffee, supra note 1 at 1326.
There is evidence, however, that selection strategies do no better, on average, than a market index.\textsuperscript{206} Such evidence is consistent with semi-strong form market efficiency (although recent evidence to the contrary is canvassed subsequently in this paper).\textsuperscript{207} Indeed, because of the transaction costs associated with selection strategies, such strategies may result in performance that lags behind the market index.\textsuperscript{208} In particular, selection strategies typically involve active trading in the attempt to identify overvalued and undervalued securities, a process that generates large brokerage costs. Since institutional investors tend to hold large blocks of securities, trading costs may be amplified by the fact that the sale (or purchase) of a large block can result in temporary downward (or upward) pressure on market price, thus generating an implicit trading tax.\textsuperscript{209} The larger the size of a holding and the smaller the public float, the larger the implicit tax.\textsuperscript{210} In net, managers who elect to pursue a selection strategy may well anticipate that the fund will do no better, and quite possibly worse, on average, than indexed funds.


One deficiency in these studies is that they do not distinguish between funds that have adopted indexing, passive, and active strategies. It would be useful to know if there is any difference in the average returns of funds adopting different strategies.

\textsuperscript{207} Infra notes 216-220 and accompanying text.

\textsuperscript{208} Supra note 206.

\textsuperscript{209} U.S. studies that show some market movement in response to large trades include L.Y. Dann, D. Mayers & R.J. Raab, Jr., "Trading Rules, Large Blocks and the Speed of Price Adjustment" (1977) 4 J. Fin. Econ. 3; M.S. Scholes, "The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices" (1972) 45 J. Bus. 179. A Canadian study on point is N. Close, "Price Reaction to Large Transactions in the Canadian Equity Markets" (1975) 31 Fin. Anal. J. 50. For further discussion of this issue, see infra notes 273-275 and accompanying text.

\textsuperscript{210} Ibid.
Therefore, an indexing strategy that lowers the managers' efforts but not their prospective reward appears to be the more rational choice. This would seem to be particularly true given the rapidly increasing size of the average institutional fund and the concomitantly larger expenditure of effort necessary to review carefully all fund investments.211

As indicated above, some commentators have expressed the concern that the widespread adoption of indexing strategies will greatly reduce institutional monitoring of corporate managers.212 Securities will no longer be selected on the basis of their promise as investments, but rather on whether they form part of the index that the fund manager seeks to replicate. Additionally, the goal of replicating a market index reduces the freedom of managers to sell fund investments when dissatisfied with performance.213 Finally, indexed funds tend to be widely diversified, and it is argued that the fund manager will have far too many investments to pay much attention to individual firms in the portfolio.

One response to these concerns is that it is highly improbable that all, or even most, investment fund managers will elect to adopt an indexing strategy. One disincentive for fund managers to adopt an indexing strategy is that the reduced trading and market research necessary to fund an indexed fund will almost certainly mean that the fund will require fewer investment managers. Thus, adoption of an indexing strategy may jeopardize the managers' jobs, leading them to prefer more labour-intensive strategies.214

But more fundamentally, it is no more likely that all investment clienteles will prefer indexing strategies than it is that the market will run out of investors who think that they can "beat the market." Many clients will prefer a selection strategy, and will either instruct the managers to proceed on that basis (if the client is the plan sponsor) or will invest in a fund that advertises itself as employing such a strategy.215 Indeed, a

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211 In addition, to the extent that larger funds purchase larger blocks of securities, the implicit trading tax will be greater.

212 See generally Gilson & Kraakman, supra note 32.

213 A fund that advertises itself as an indexed fund must, for obvious legal reasons, continue to replicate the index. Funds that are only partly indexed or that have not held themselves out as having such a policy will have more freedom to change investments. Most funds are in fact only partly indexed. See supra note 196.

214 On this view, managerial rejection of an indexing strategy is a cost paid by the beneficial owners. Of course, in some cases, the fund strategy will simply be dictated by the fund's sponsor.

215 In some cases, however, beneficial owners may have a strategy selected for them. This is likely to be true in the case of pension funds and life insurance companies, for example.
commonly heard complaint is that institutional investors are forced into adopting selection strategies that focus on short-term results, since fund managers are evaluated by fund sponsors or their superiors on a quarterly basis.\textsuperscript{216}

While the great majority of studies on point suggest that professional managers cannot earn abnormal trading returns,\textsuperscript{217} there is some recent evidence which suggests that at least some mutual fund managers can "beat the market" and earn abnormal returns at least sufficient to compensate investors for fund expenses, management fees, and investment "loads."\textsuperscript{218} Indeed, there is Canadian evidence that some mutual fund managers earn abnormal returns that more than compensate investors for management and load fees.\textsuperscript{219} Some of the studies showing abnormal returns to mutual fund managers are suspect, as the apparent abnormal return may be a product of misspecification of the "normal" benchmark return,\textsuperscript{220} although not all studies on point are equally susceptible to benchmark misspecification.\textsuperscript{221} If there are indeed managers, however, who are able to "beat the market" by exploiting private information, this obviously bolsters the argument that the use of selection strategies is likely to persist. Indeed, at present, only a small fraction of the Canadian institutional portfolio is indexed.\textsuperscript{222}


\textsuperscript{217} See supra note 206.


\textsuperscript{219} Berkowitz & Kotowitz, ibid.


\textsuperscript{221} See Berkowitz & Kotowitz, supra note 205.

\textsuperscript{222} Supra note 204.
Further, where indexation is used, the norm in both Canada and the United States is partial indexation, with selection strategies complementing indexation.

Even supposing for the purposes of argument that many, or even most, institutional funds will ultimately adopt an indexing strategy, it does not follow that fund managers will routinely take less interest in the quality of management. It is undoubtedly true that no manager of an indexed fund can follow all of the investments in the fund. Nonetheless, it is a mistake to believe that just because all fund investments cannot be monitored, none will be monitored. Because an indexing strategy removes the “exit” or sale option, the only way in which the manager can improve fund performance, aside from attempting to improve the efficiency of the system as a whole, is to engage in active monitoring of some of the firms in the portfolio. In other words, fund indexation is not inconsistent with, and may even enhance the likelihood of, “targeting” strategies in which institutions single out particular firms for special attention or active hands-on monitoring.

The smaller the institution’s holding, the greater the “free rider” problem associated with institutional oversight. Montgomery’s survey of Canadian institutional investors found that the largest deterrents to shareholder activism, in rank order, were that activism was “too time consuming,” “too expensive,” and the managers had “insufficient knowledge of company and industry.” See Gilson & Kraakman, supra note 32 (development of a class of professional directors). Gilson and Kraakman argue (at 867) that, since increased performance of one firm in the indexed portfolio will only come at the expense of other firms in the portfolio, the only way for an indexed investor to improve fund performance “is by improving the corporate governance system rather than by attempting to improve the management of particular companies.” In my view, this overstates the case because it assumes that improvements in single firm efficiency are always zero sum gains from a systemic point of view. While clearly part of the gain may come at the expense of other firms in the index, reductions in agency costs at particular firms, leading to enhanced profitability, are not likely to be fully matched by commensurate reductions in profitability at other index firms. Moreover, the firms that lose as a result of efficiency enhancements at other firms may be firms that are not in the index, such as private or foreign firms.

Montgomery’s survey of public and private pension funds and investment managers found that “90 per cent of the large institutions [which are more likely to index at least part of their portfolio] believe that institutional shareholders are likely to become more active in the future.” [Ibid.] Moreover, 47 per cent of large institutions indicated a willingness to challenge management initiatives with which they strongly disagreed, compared to only 25 per cent of medium sized institutions and 20 per cent of small institutions. These statistics tend to refute the notion that large institutional investors will either index or adopt a passive investment strategy and not engage in active monitoring of management.

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224 Systemic improvements are the focus of the Gilson and Kraakman proposal. See Gilson & Kraakman, supra note 32 (development of a class of professional directors). Gilson and Kraakman argue (at 867) that, since increased performance of one firm in the indexed portfolio will only come at the expense of other firms in the portfolio, the only way for an indexed investor to improve fund performance “is by improving the corporate governance system rather than by attempting to improve the management of particular companies.” In my view, this overstates the case because it assumes that improvements in single firm efficiency are always zero sum gains from a systemic point of view. While clearly part of the gain may come at the expense of other firms in the index, reductions in agency costs at particular firms, leading to enhanced profitability, are not likely to be fully matched by commensurate reductions in profitability at other index firms. Moreover, the firms that lose as a result of efficiency enhancements at other firms may be firms that are not in the index, such as private or foreign firms.

225 Montgomery's survey of public and private pension funds and investment managers found that “90 per cent of the large institutions [which are more likely to index at least part of their portfolio] believe that institutional shareholders are likely to become more active in the future.” Montgomery, supra note 34 at 11. Montgomery also found that:

[I]he large institutions assigned the lowest mean score (2.4) to factors deterring activism, followed by the small institutions (2.6) and finally medium institutions (2.8). This suggests that deterrents to activism are viewed less importantly by large institutions... An

Ibid. Moreover, 47 per cent of large institutions indicated a willingness to challenge management initiatives with which they strongly disagreed, compared to only 25 per cent of medium sized institutions and 20 per cent of small institutions. These statistics tend to refute the notion that large institutional investors will either index or adopt a passive investment strategy and not engage in active monitoring of management.
The overall economic dividend of the adoption of targeting strategies by a non-trivial number of institutional shareholders will be significant, even assuming partial correlation of targeting decisions by institutional investors. So long as there is a non-trivial random element in institutional decisions to target particular firms, targeting strategies will result in the monitoring of a large number of firms.226

Coffee has forcefully argued that many institutions—including banks, insurance companies, and mutual funds—cannot afford to purchase large, illiquid blocks of securities because of a need to maintain liquidity against the event of widespread withdrawals by investors or policy holders.227 This argument seems overdrawn. Unless it is likely that withdrawals will force the wholesale, short-term liquidation of an institutional fund, adequate liquidity can be supplied by keeping part of the portfolio in liquid assets and devoting a part (perhaps even a substantial part) to less liquid block holdings. Wholesale short-term liquidation does not seem to be a realistic scenario for most institutional investors for at least two reasons: (1) the low probability that market performance will be so poor as to cause a run on the institution; and (2) the existence of regulatory safeguards against institutional collapse, including ex ante monitoring of institutional investors by regulatory authorities, the intervention of bankruptcy, insolvency, and reorganization laws designed to give the debtor breathing room to reorganize and avoid collapse, and the likelihood of government bailouts ex post.228

In addition, the existence of deposit insurance for deposit-taking institutions greatly mitigates the cost of disastrous performance for depositors and lessens the likelihood of a “run on the bank,” thus diminishing the need for liquidity. Thus, many institutional investors can afford to purchase a substantial number of block interests without risking economic ruin. Indeed, the comparatively small size of the

226 Indeed, it may well be that institutional investors will find that they can profit the most by targeting firms that other institutional investors have avoided buying, both because the marginal benefits of monitoring may be greatest in such cases and because the relative increase in the fund’s performance resulting from efficiency improvements will be the greatest. Black suggests that institutional investors already divide the field, improving the efficacy of targeting. See Black, supra note 1 at 579. For evidence that institutional investors adopt a heterogeneous variety of investment strategies, see J. Lakonishok, A. Shleifer & R.W. Vishny, “The Impact of Institutional Trading on Stock Prices” (1992) 32 J. Fin. Econ. 23.

227 Coffee, supra note 1 at 318-320.

228 The collapse of a number of Canadian trust companies in the past decade offers confirming evidence. While heightened withdrawals preceded collapse, no serious “runs” have occurred and liquidations have been effected in an orderly fashion by regulatory authorities.
Canadian market has effectively forced all large institutions to purchase substantial interests in many different companies.\(^{229}\)

The need for liquidity is roughly commensurate with the portion of the institution's assets in obligations that will or may become due in the short term. On this score, open-end mutual funds have the highest need for liquidity. Life insurance companies, however, hold mainly stable and predictable long-term obligations,\(^{230}\) as do pension funds. Closed-end mutual funds, which do not face demand withdrawals, do not have any substantial need to maintain liquidity.\(^{231}\) This emphasizes that the need for liquidity is not always compelling.\(^{232}\)

A further reason for believing that indexing is not incompatible with institutional activism is that some management initiatives, like poison pills, are likely to have a similar effect on share price for a wide range of companies. Thus, a keen knowledge of the internal affairs of a company proposing such an initiative is not necessary for the fund manager to vote the fund's shares effectively. In fact, institutions in both the U.S. and Canada have directed much of their attention to specific types of governance issues, such as anti-takeover defenses and dual class recapitalizations.\(^{233}\)

That indexing can, and does, coexist with passive or active strategies (whether on a targeting basis or simply by dividing the portfolio between indexing and selection strategies) is indicated by the experience of the California Public Employees Retirement System

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\(^{229}\) Although see Part II(K)(1), above (regulatory caps on equity interests of some institutional investors).

\(^{230}\) A common explanation for the overrepresentation of life insurance companies in the purchase of relatively illiquid private placements is the absence of a need for liquidity. See, for example, Wruck, supra note 24. See also G.A. Jarrell, "The Economic Effects of Federal Regulation of the Market for New Security Issues" (1981) 24 J. L. & Econ. 613 at 661 (life insurance companies are the largest purchasers of private placements).

\(^{231}\) The argument that the need for liquidity does not exclude the holding of some sizeable blocks is strengthened by American evidence that mutual funds, with the highest turnover rate of all U.S. institutional investors, hold equity interests for an average of one year, "active" pension funds hold investments on average for 1.9 years, and insurance companies for 2.5 years. See Froot, Perold & Stein, supra note 100 at 52. Although the turnover rate is a somewhat loose proxy for liquidity needs, it does supply some indication that holding some large blocks for long periods of time would not be detrimental to institutional interests.

\(^{232}\) Some Canadian statutes have specific requirements to maintain part of the investment portfolio in liquid assets. See, for example, OLTCA, supra note 182, s. 160, and R.R.O. 1990, Reg. 733, ss. 85-87.

\(^{233}\) See, for example, Gilson & Kraakman, supra note 32 at 868-876; and Koval, supra note 32. There are exceptions to this rule, like the use of shareholder advisory committees and targeted criticism of specific issuers. See text below.
(CalPERS), one of the largest U.S. institutional investors. Because of its size, a large percentage of the fund is indexed. Despite this, CalPERS has been amongst the most active of all U.S. shareholders in policing corporate managements. CalPERS in fact divides its portfolio between indexing and selection strategies and also engages in targeting. Most recently, CalPERS has begun a practice of publicly announcing the names of companies it regards as “underperformers” and targeting these for specific reforms.

In Canada, the adoption of an active strategy is made all the more likely by the ever-widening sphere of minority shareholder rights, as well as the increasingly common requirement that a “majority of the minority” be taken in connection with various types of corporate transactions. Both of these developments give institutional investors—not excluding those managing indexed funds—a good deal more bargaining power vis-à-vis corporate management than was once the case.

Even assuming that funds that adopt an indexing strategy engage neither in selecting investments on the basis of merit nor in monitoring corporate managements, an equilibrium will develop in which indexing, passive, and active strategies coexist. Institutional investors are the marginal investors whose research activities make securities markets efficient. Thus, if no funds engage in selection strategies, this will create massive pricing inefficiency. Institutions willing to adopt selection strategies (i.e., engage in fundamental analysis) will then earn abnormal trading returns. Similarly, if no funds engage in active monitoring of management, funds that are willing to change their strategy and actively

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234 CalPERS has approximately $68 billion in assets under administration. See Koval, ibid. at 24.

235 As much as 85 per cent. See Clark, supra note 176 at 79-80. CalPERS' average holding period for shares is from six to ten years. See Gilson & Kraakman, supra note 32 at 863.

236 See Clark, ibid. See also Walker, supra note 204, indicating that many institutions divide their portfolios between indexing and active strategies.

237 Black, supra note 1 at 568-69, 579, and at 582. Many other U.S. institutional investors engage in targeting. Ibid.

238 Waitzer, supra note 37 at 13.

239 See also supra note 45 and accompanying text (the influence of institutional investors is often felt before the issue in question goes to a shareholder vote).

240 I do not mean to suggest that these requirements are an unambiguous good. See MacIntosh, supra note 65. Nonetheless, to the extent that they facilitate institutional oversight, this must be added to the positive side of the ledger.

241 This is the view taken by Coffee, supra note 1 at 1341.
monitor managements can earn abnormal returns. It is thus unlikely in the extreme that all institutions will prefer indexation over passive and active strategies. Indeed, the move towards indexation has prompted the creation of at least one fund whose purpose is to identify "rotten apples" in institutions' indexed holdings, and to improve their performance by purchasing large stakes and seeking board representation or otherwise improving performance.

This is not to say that institutional oversight is perfect. There are many defects. Aside from the fact that in a large portfolio, managers cannot follow all investments closely, management sometimes has leverage to exert commercial pressure on institutional investors to vote with management. Through agenda setting, bundling of shareholder votes, and other techniques, management can sometimes derail shareholder opposition. Moreover, compensation schemes for fund managers may not always create the appropriate incentives to engage in active monitoring. Many have also raised concerns that the short-term focus of institutional investors creates deficient incentives to monitor for the long term. Others have raised the issue of whether the interests of institutional investors and other investors might sometimes diverge and have questioned whether institutions have the appropriate expertise to assume an active managerial role.

242 This is subject to Black and Coffee's caveat that an incentive to monitor will exist only for institutions that are "overweight" in a particular stock, that is, that hold a higher percentage of the stock than the average of their institutional rivals. See B.S. Black & J.C. Coffee, Jr., "Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation" (paper presented at the conference on Relational Investing, 6-7 May 1993) [unpublished] (organized by The Institutional Investor Project, Centre for Law and Economic Studies, Columbia University School of Law) at 85. This idea is developed further, infra note 296 and accompanying text.

243 See Waitzer, supra note 45 at 14 (regarding the Lens Fund).

244 See generally Coffee, supra note 1.

245 See Part IV, below.

246 See, for example, J. Gordon, "Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice" (1988) 76 Cal. L. Rev. 1; and Black, supra note 1 at 560-562.

247 See Coffee, supra note 1 at 1341-42 although see supra note 205.

248 See, for example, Coffee, ibid. at 1324-25; and Porter, supra note 216 at 6.

249 See Coffee, ibid. at 1312 and at 1334-35. In my view this concern is not a serious one; in most cases institutions and other minority interests will share the same goal—increasing the share price.

250 It is a mistake, in my view, to believe that monitoring is only effective when it consists of day-to-day monitoring of corporate affairs. Institutions can play an important role in scrutinizing major corporate decisions (like the adoption of poison pills), even though the managers know little or nothing about the day-to-day operation of the business. And, it is in relation to more important
some funds, particularly public pension funds, are publicity shy and prefer to avoid open confrontation with management.\textsuperscript{251} Money managers may also fear a loss of access to "soft information" if they oppose management,\textsuperscript{252} or a political backlash for "excessive" activism.\textsuperscript{253} Many money managers may also have become captive to a "culture of passivity."\textsuperscript{254} At least some of these factors undoubtedly detract from the ability of institutions to play an active role in monitoring corporate managements. Nonetheless, in my view, gloomy scenarios that paint indexing strategies as the end of corporate monitoring are simply overwrought. While institutional oversight is not perfect, institutional investors, whether indexed or not, are more capable monitors than retail investors.

\section*{IV. INSTITUTIONAL AGENCY COSTS AND CONFLICTS OF INTEREST}

An issue of great importance for further research is that of agency problems internal to institutional investors.\textsuperscript{255} The question is whether the web of market and legal mechanisms that play a role in disciplining fund managers is sufficient to align manager and owner interests or whether it leaves fund managers room to act self-interestedly, either by diverting fund assets for their own benefit or by failing to manage diligently. Although a full discussion must await another day, the potential for abuse is clear. For example, employee stock ownership plans have occasionally been used in the U.S. as vehicles for propping up incumbent management, rather than as a means for decisions (or extremely poor corporate results) that institutional monitors have tended to get involved. Thus, in my view, the concern about lack of institutional expertise tends to be much overplayed. See Roe, "Legal Restraints," \textit{supra} note 27 at 56.

\textsuperscript{251} This style is perhaps best exemplified in Canada by the Ontario Municipal Employee's Retirement Fund. Other public pension funds, particularly the Caisse de Dépôt et Placement du Quebec, have been much more openly active. This is not to say that OMERS has not been effective in monitoring corporate managements, however; only that they have adopted a more "backroom" style of intervention.

\textsuperscript{252} "Soft" information is impressionistic information communicated to analysts through conversations with senior managers, tours of company facilities, \textit{etc.}

\textsuperscript{253} Black, \textit{supra} note 1 at 565; and Coffee, \textit{supra} note 1 at 1323.

\textsuperscript{254} Black, \textit{ibid.} at 562-64.

\textsuperscript{255} See generally J. Heard & H. Sherman, \textit{Conflicts of Interest in the Proxy Voting System} (Investor Responsibility Research Center, 1987); Coffee, \textit{supra} note 1 at 1321-22; and Black, \textit{ibid.} at 595-608.
Institutional and Retail Investors

securing the best interests of employee beneficial owners. Pension fund purchases of own-firm shares may be used for the same purpose. The same dangers exist in Canada. For example, the manager of the pension fund of a large Canadian corporation recently pled guilty to charges of misusing pension fund assets in an attempt to influence the outcome of a battle for corporate control. In general, however, the greatest danger may not be that managers will steal or otherwise misuse fund assets, but that they will simply fail to exert maximum efforts to secure good performance.

In examining the potential agency problems arising within institutional investors, the entire kaleidoscope of market and legal controls, including possibilities for opportunistic misuse of funds and the formation of self-interested coalitions between fund and corporate managements, must be examined for each type of institutional investor. Private pension funds appear to create the greatest possibilities for abuse. Employee beneficiaries do not typically have the power either to direct investment strategy or to replace ineffective managers; thus one potential source of oversight is non-existent. Nor, because of collective action problems, do employee beneficiaries have incentives to monitor. Further, since private pension funds are not subject to hostile takeovers (unless, of course, the entire company is taken over and the trustees replaced), the discipline exerted by control markets is removed. Finally, employees do not have the option of withdrawing their investments and placing them with another fund, thereby removing another important source of market discipline. On the conflicts side of the ledger, pension money managers are frequently pressured by management to take a pro-management stance, and will often do so for

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256 See, for example, Shamrock Holdings, Inc. v. Polaroid Corp. (1989), 559 A.2d 278 (Del. Ch.); and see Black, ibid. at 562.

257 See generally “Modern Corporation,” supra note 193.


259 See J.A. Grundfest, “Subordination of American Capital” (1990) 27 J. Fin. Econ. 89 at 108 (arguing that institutional agency problems are more likely to arise in the form of a failure to act diligently than in the form of a failure to act honestly, because fund managers have fewer opportunities than corporate managers to divert fund assets for their own benefit).


261 Although, of course, the trustees may be replaced other than in a hostile control battle (i.e., managerial markets are not inoperative).
fear of losing pension management business.\textsuperscript{262} Both because market controls over manager performance leave some slack, and because of the danger that pension fund assets will be misused, legal controls become particularly important. For this reason, standards of fiduciary conduct should be rigorously applied to pension fund managers.\textsuperscript{263} Legal rules should also put as much distance between corporate management and pension fund managers as possible.\textsuperscript{264}

Mutual funds present a very different case. Although it is not likely that shareholders will displace management, mutual fund investors are quick to vote with their feet in response to poor performance. This renders legal controls less important.

Other institutional investors, like public pension funds, banks, credit unions, and trust companies each present a unique combination and potency of market controls and opportunities for self-favouring behaviour by managers; thus each has differing needs for legal controls. For example, public pension funds are generally immune to the sort of management pressure that can be brought to bear by management on banks and insurance companies by threats to withdraw current or future business,\textsuperscript{265} but are vulnerable to political interference in investment selection.\textsuperscript{266}

\begin{footnotesize}
\begin{enumerate}
\item Black, \textit{supra} note 1 at 596-598. Offsetting this danger is the incentive of corporate management to maximize pension fund performance either to secure labour peace or (in defined benefit plans) to minimize the probability that future corporate top-ups will be required (or, in some jurisdictions, to maximize the size of the fund surplus that can be reappropriated to corporate uses).
\item Allowing the corporation to reallocate pension fund surpluses of defined benefit plans to corporate purposes as a matter of course will tend to reduce the dangers of managerial misdirection of fund assets since it gives the corporation a more substantial stake in the performance of the fund.
\item To some extent, this has been done in the U.S. by rules that require pension funds to vote their holdings and to vote in the best interests of fund beneficiaries. See Black, \textit{supra} note 1 at 554 and at 607.
\item Public pension funds like the Ontario Municipal Employees' Retirement Fund and the Caisse de Dépôt have been particularly active for this reason. Montgomery's survey found that 45 per cent of public pension funds indicated that they "will engage in some form of activism when they strongly disagree with a key direction taken by management," whereas only 21 per cent of the private sector pension funds surveyed indicated that they would do so. See Montgomery, \textit{supra} note 34 at 11. Public pension funds appear to have been the most active institutional investors in the U.S. as well. See Coffee, \textit{supra} note 1 at 1288.
\item It is commonly suggested that the Caisse de Dépôt has bowed to political pressure and has invested funds with a view not only to profit, but to fostering entrepreneurship in Quebec. It is clear that this has sometimes been true. See, for example, P. Arbour, \textit{Québec Inc. and the Temptation of State Capitalism} (Montreal: Robert Davies, 1993); "Caisse-Criticism," Canadian Press (26 July 1993) No. 1868371 (QL) (interference in Univa takeover bid in order to maintain Quebec ownership of supermarket chains). Nonetheless, the Caisse's 11.7 per cent average annual return
\end{enumerate}
\end{footnotesize}
A discussion of the full legal ramifications of this interesting problem are beyond the scope of this paper; nonetheless, it is clearly an issue to which legislators and securities regulators will need to pay close attention in the future.

V. THE DECLINING ROLE OF THE RETAIL INVESTOR, MARKET LIQUIDITY, AND MARKET EFFICIENCY

As already indicated, one of the most important trends in securities markets over the past four decades has been the relative decline of the retail sector and the growing institutionalization of securities markets. More than ownership is affected; a steadily higher proportion of securities trading has been accounted for by institutional investors, although the share of agency equity business transacted over the TSE by retail investors has been stable since 1989.

The question I wish to explore in this section is whether the decline in retail participation will in any way be detrimental to securities markets. I start out with the observation that there is no inherent value over the past decade (versus 11.9 per cent for private pension funds) suggests that profit has remained the primary investment objective. See “Caisse-Criticism,” Canada Press (27 August 1993) No. 1879103 (QL).

Montgomery's survey of institutional investors disclosed, however, that public sector pension funds viewed publicity as a significant deterrent to investor activism, likely owing to the political pressures that are sometimes brought to bear and the need to “uphold a positive public image.” See Montgomery, supra note 34 at 10. See also K.P. Ambachtsheer, “Transforming Pension Funds From Cookie Jars to Cornucopia” (1991) 4:2 Can. Invt. Rev. 5.

See supra notes 1-4 and accompanying text.

The growth in the proportion of trading accounted for by institutional investors is indicated by the increasing percentage of agency equity business derived from institutional trading between 1981 and 1992 for members of the Toronto Stock Exchange:

<table>
<thead>
<tr>
<th>Year</th>
<th>81</th>
<th>82</th>
<th>83</th>
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<th>86</th>
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<th>92 (2ndQ)</th>
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<tbody>
<tr>
<td>Institutional</td>
<td>52</td>
<td>57</td>
<td>55</td>
<td>60</td>
<td>59</td>
<td>58</td>
<td>57</td>
<td>65</td>
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<tr>
<td>Retail</td>
<td>48</td>
<td>43</td>
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<td>42</td>
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<td>31</td>
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Curiously, between 1983 and 1989, the percentage of Canadians investing directly in stock market equities increased from 9 per cent to 16 per cent of the population. See The Toronto Stock Exchange, Canadian Shareowners: Their Profile and Attitudes (Toronto: The Toronto Stock Exchange, 1989) [hereinafter Canadian Shareowners] at 8. This suggests either that the decline of the retail sector has been relative, rather than absolute, or that the average retail stake invested in the stock market has dramatically declined. Unfortunately, the TSE report does not indicate (nor will the TSE make public) the dollar volume of retail and institutional trading done by member firms, making it difficult to identify which of these two hypotheses is correct.

Fritz, ibid.
in having retail investors in the marketplace. Rather, the argument in favour of preserving a retail sector must be that retail investors play an instrumental role in improving the allocative or transactional efficiency of securities markets. They might do this by expanding the pool of savings that is directed into real investment, by enhancing the efficiency with which capital is allocated to competing investment projects, by augmenting the accuracy of the price discovery mechanism, or by supplementing the liquidity of secondary financial markets. I will argue in this section that the decline of the retail sector has in fact neither diminished the pool of savings available for investment nor imperilled the allocative efficiency of primary markets. Nor has it adversely affected market liquidity or had a negative impact on the efficiency of the price discovery mechanism. Indeed, in recent history, liquidity and pricing efficiency appear to have improved.

A. The Pool of Savings Available for Investment

The withdrawal of the retail investor from the market does not mean that the pool of savings represented by such investors will no longer be available for real investment. Withdrawing investors do not hide their cash under a mattress; rather, they continue to invest their savings in mutual funds, pension funds, bank accounts, life insurance policies, trust funds, and the like. In other words, the withdrawal of the retail investor has been, and will continue to be, associated with increased intermediation rather than disinvestment. The financial intermediaries that are the beneficiaries of this increased intermediation will continue to direct the pool of savings into real investment.

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270 See generally R. Clark, “The Four Stages of Capitalism” (1981) 94 Harv. L. Rev. 961 (noting a long-run trend towards increasing financial intermediation of savings). See also D. Kelly, supra note 1 at 4-5 (retail investors have shifted into mutual funds, pension funds, and insurance); D. Kelly, “Bay Street discounter’s riding high: No-frills brokers win fifteen per cent of market” The Financial Post (20 January, 1992) 10; and L. Grogan, “Private financing to dominate in the ’90s: study” The Financial Post (26 July 1990) 13. The increasing intermediation through life insurance companies, one of the largest institutional investors, arises from the fact that as Canada’s population ages, an increasing share of the population is buying life insurance. See J. McNish, “Private placements threaten capital markets” The Globe and Mail (23 October 1989) B1 at B5. The aging of the population is also a factor in the growing size of pension funds.

271 There is some danger that limits on institutional investing may result in some inefficiency in the mix of economic activities funded (directly and indirectly) by savings (for example, by biasing investment decisions towards government securities, mortgages, etc.). This is an added reason to constrain institutional selection of investments as little as possible. See above, Part II(K)(7).
While institutional investors are active purchasers of initial public offerings (IPO), the very smallest IPOs depend mainly or exclusively on retail purchasers. Thus, the argument that disinvestment will occur appears to be strongest in relation to small firm IPOs. However, there is ample reason to believe that retail investors will not desert small business IPOs. Although institutional investors have trading advantages over retail investors in relatively liquid public markets, the advantage is reversed in the case of smaller firms with relatively illiquid trading. In part, this is because the opportunity costs of becoming informed about small capitalization (small cap) issuers are less for retail than for institutional investors. It is also because the very act of trading large institutional blocks may temporarily affect the price of the securities bought or sold, resulting in an implicit trading tax. This tax is more severe for comparatively illiquid small cap issuers, and it is for this

272 There is less publicly available information concerning smaller firms than large, and such information is more costly to obtain. See, for example, Arbel, Carvell & Strebel, supra note 10; and S.E. Stickel, "The Effect of Value Line Investment Survey Rank Changes on Common Stock Prices" (1985) 14 J. Fin. Econ. 121. While this equally affects both retail and institutional buyers, it is likely to have a particular impact on institutions. Given that the average institutional investment in a large firm will exceed that in a small firm—a condition that probably does not hold for retail investors—the relative costliness of acquiring information in a small firm is likely to be greater per dollar of investment for institutional traders.

In addition, the implicit institutional entry and exit tax, referred to in the text below, will be greater for smaller issuers. Thus, investments in information concerning small firms will yield a comparatively low expected return for institutional traders.

273 A number of factors pertinent to small capitalization issuers will widen bid/ask spreads, and hence diminish liquidity. These include a small number of shareholders (H. Demsetz, "The Cost of Transacting" (1968) 82 Q. J. Econ. 33); small transaction volume (K.D. Garbade, Securities Markets (New York: McGraw-Hill, 1982); and a comparatively poorly developed information record concerning the issuer (T.C. Copeland & D. Galai, "Information Effect on the Bid-Ask Spread" (1983) 38 J. Fin. Econ. 1457; and L.R. Glosten & P.R. Milgrom, "Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders" (1985) 14 J. Fin. Econ 71). For all these reasons, small capitalization issuers are likely to be relatively illiquid, and illiquidity is a cost to all investors. See Y. Amihud & H. Mendelson, "Asset Pricing and the Bid-Ask Spread" (1986) 15 J. Fin. Econ. 223 [hereinafter "Asset Pricing"]; and Y. Amihud & H. Mendelson, "The Effects of Beta, Bid-Ask Spread, Residual Risk, and Size on Stock Returns" (1989) 44 J. Fin. 479 [hereinafter "Effects of Beta"]). However, illiquidity has a more pronounced impact on institutional (or other large block) traders for two reasons. First, the larger the block being traded, the greater will be the difficulty of finding traders on the other side of the market to absorb the block. This will lead to an enhanced probability that price concessions will be necessary to induce other investors (or market making dealers) to trade. Second, large block traders are more likely than other traders to have privileged access to inside information, and a purchase (or a sale) thus has a higher probability of being construed as a signal of inside information that results in price change. The second factor is not as likely to be as important as the first, however. See Parts II(3), II(4), and II(7) above, especially notes 89-93 and accompanying text (institutional traders not likely to have inside information).
reason that most institutional investors tend not to invest in such firms\textsuperscript{274} (although some institutions have attempted to capitalize on the apparently superior risk-adjusted returns of smaller issuers\textsuperscript{275} by marketing funds that invest in small cap issuers). The relative illiquidity of small cap issuers has a much more modest impact on small lot retail traders. Finally, many retail investors undoubtedly derive utility from investigating and investing in small businesses, a benefit not shared by institutional investors.\textsuperscript{276} Thus, my guess is that retail investors will

\textsuperscript{274} The magnitude of the entry/exit tax for large issuers can easily be overstated. In his Canadian study, Close concluded that "Canadian institutional investors trade a large value of stock with little adverse price effect." Close, supra note 209 at 56. Likewise, Montgomery found that:

large institutions ... accorded considerable importance to the ready availability of alternative investments as a deterrent to activism. This would indicate that contrary to an opinion held by many, the Canadian equity markets are liquid, and despite the high degree of corporate concentration, there are other Canadian equity investment alternatives available to a large institutional shareholder.

Montgomery, supra note 34 at 11. She also found that "difficulty in selling holdings" was ranked only sixth by the institutional investors in the survey as a reason for becoming involved in the direction of a company. Ibid. at 7.

There is evidence, however, that the entry/exit tax is larger for small capitalization issuers without substantial public floats. Close, ibid. Indeed, empirical evidence on market price reaction to institutional block trades almost certainly understates the magnitude of the entry/exit tax for smaller issuers. Since institutional investors will avoid purchasing the smallest issuers, block trades in these issuers will not be observed, biasing block trade samples away from firms with the highest cost of block trading. Montgomery's survey of institutional investors suffers from a similar selection bias.

It is clear that institutional investors tend to avoid small issuers. For example, Lakonishok, et al., found that 97 per cent of the institutional purchasing in their sample was confined to the largest two quintiles of NYSE, AMEX, and OTC firms by market value. See Lakonishok, et al., supra note 226. Similarly, using discriminant analysis, Hessel and Norman found that institutional investors avoid small capitalization issuers. See C.A. Hessel & M. Norman, "Financial Characteristics of Neglected and Institutionally Held Stocks" (1992) 7 J. Acct. Aud. & Fin. 313. Canadian evidence that institutional investors purchasing private placement securities prefer the securities of larger issuers may be found in M.J. Gordon & A.K. Srivastava, The Structure of Price Discounts on Private Equity Placements (16 December 1991) [unpublished].

The difference in the severity of the entry/exit tax between holdings in small and large firms suggests that Coffee somewhat overstates the case in positing a systematic trade-off between liquidity and control. See Coffee, supra note 1. There does not appear to be a serious trade-off for holdings in large firms.

\textsuperscript{275} See infra note 305 and accompanying text.

\textsuperscript{276} Fischer Black was perhaps the first to suggest the somewhat iconoclastic notion that one argument of the investor's utility function is securities trading itself. See F. Black, "Noise" (1986) 41 J. Fin. 529 at 534. This argument seems to make most sense for retail investors, and particularly so in the context of initial public offerings, where the excitement and promise of a new issue are likely to yield the highest trading utility.

Although small capitalization funds can offer retail investors superior diversification, they cannot replicate the utility associated with individual stock-picking. Moreover, because of the comparatively large size of the holdings of small cap funds, they pay a higher liquidity tax. See supra
continue to dominate the small business IPO market for the foreseeable future.277

Even supposing that small cap issuers will encounter increasing difficulty raising capital from the retail sector, the extent to which this is likely to affect small business financings can easily be overstated. So long as small business investments promise an adequate risk-adjusted return, the withdrawal of the retail investor will be met by the entrance of other investors. Indeed, since the withdrawal of retail investors is likely to be associated with increased financial intermediation, institutional investors like pension funds, mutual funds, and life insurance companies will have even larger pools of capital to invest. Because of this, they will almost certainly be forced to commit funds to smaller issuers.278 This will increase the liquidity of investments in small cap issuers, which will induce yet other institutional investors to invest in such firms.279 Thus, any withdrawal of the retail investor from the small business sector will likely be met, at least to some extent, by an enhanced role for institutional investors.

In net, it therefore seems unlikely that a withdrawal of direct investment by retail investors will diminish the aggregate pool of savings ultimately available for real investment, either for small businesses, or generally.

notes 273-274 and accompanying text.

277 To the extent that the explosion in investment funds has enhanced the ability of retail investors to diversify their investment portfolios, they can arguably afford to put more money in small cap new issues and still realize an acceptable portfolio risk/return trade-off. See Khoury & Martel, supra note 1 (indicating that in 1978 there were seventy-seven TIC investment funds worth about $2 billion; by 1988 this had grown to over 500 funds worth over $20 billion).

278 The preferred instrument by which institutions supply capital to small issuers is the private placement. In the short term, both the recession and the fallout from the U.S. savings and loan debacle have tended to drive institutional investors back to so-called investment grade securities. See S. Bavaria, "Private Placement Investors Tip Toeing Back to High-Yield" (1992) 58:7 Investment Dealers Digest 18; D. Robinson, "Europe to the Rescue" (1991) Euromoney 73; S. Bavaria, "Hidden Treasure in Private Placements" (1991) 57:47 Investment Dealers Digest 18. However, in the long run, both these factors are likely to diminish in importance. See A.J. Sherman, "Private Placements" (1991) 39:4 Dunn & Bradstreet Rep. 46.

279 By increasing liquidity, trading begets further trading, which further increases liquidity, which further increases trading, etc. In order to get this chain reaction, however, it would appear that there must be a critical mass of trading. See E. Kirzner, "The Unfolding Derivatives Story: Abroad and in Canada" (1988) 1:1 Can. Invt. Rev. 73 at 77.
B. The Efficiency with which Funds are Directed to Real Investment Projects

As indicated above, the decline of the retail sector has been associated with commensurate growth in the institutional sector. Assuming that this trend continues, this means that more and more of the pool of savings will be controlled and directed by professional managers, who almost certainly have an advantage over retail investors in distinguishing good investment projects from bad.\textsuperscript{280} For example, assuming that institutional investors gradually replace retail investors in funding small business IPOs, professional money managers will bring to bear higher levels of expertise, experience, and business acumen in pricing and selecting attractive investment opportunities. Thus, it is likely that market institutionalization will improve the efficiency with which savings are directed to competing investment projects.

C. The Efficiency of the Price Discovery Mechanism

Will the decline of the retail sector impair the price discovery mechanism? Because of a number of factors working in contrary directions, theoretical predictions are difficult. However, evidence presented below suggests that the increasing role of the institutional investor has in fact enhanced market efficiency.

Increasing institutionalization of the market will tend to increase the size of the average shareholding. \textit{Prima facie}, this will tend to result in the execution of fewer trades, an increase in the average time between trades, and an increasing "lumpiness" to public market order flow. If so, there is a danger that the posted market price will reflect stale information, rather than the best information currently available. If this is indeed the case, then some impairment of market efficiency might result.

However, there are two mitigating factors. One is that actual trading is not necessary for publicly available information to be impounded in bid and ask prices posted by market makers and other

\textsuperscript{280} Although the bulk of the evidence indicates that professional traders do not on average "beat the market" (see supra notes 216-220 and accompanying text), it is nonetheless the profit-seeking efforts of professional and institutional traders that render securities markets efficient. This is the paradox of market efficiency. See supra note 278 and accompanying text.
Institutional and Retail Investors

281 The second is that all classes of institutional investors in the U.S., save passively managed pension funds and foundations, engage in more frequent trading than retail investors. Canadian institutional investors appear to have lower turnover rates than their American counterparts, but also likely engage in more frequent trading than retail investors. Other things being equal, more frequent trading will enhance market efficiency (as well as market liquidity).

The danger to market efficiency, however, is supplemented to an uncertain extent by the fact that market institutionalization may affect the balance between "informed" and "noise" traders in securities markets. Informed traders trade on real information—information not already impounded in securities prices—while noise traders trade on spurious information, or information that is already reflected in market prices. The role of noise traders in securities markets is not completely understood. The presence of noise traders offers informed traders profit opportunities and hence induces them to acquire information and to trade on it. This enhances market efficiency. However, excessive noise trading may move securities prices away from fundamental values for short or even long periods of time. Noise trading may also increase market volatility. The trade-off between factors that enhance and factors that diminish market efficiency suggests

281 See, for example, N. Hakansson, G. Kunkel & J. Ohlson, "Sufficient and Necessary Conditions for Information to have Social Value in Pure Exchange" (1982) 37 J. Fin. 1169.

282 See Froot, Perold & Stein, supra note 94 at 52. The fact that institutional investors account for a much higher percentage of trading volume than market ownership is also indicative of the higher average turnover rate of institutional portfolios. See, for example, Hessel & Norman, supra note 274 at 313 (U.S. institutions account for 40 per cent of market ownership, but 70 per cent of trading).

283 Froot, Perold & Stein, ibid. at 49.

284 The enhanced liquidity may unevenly affect institutional and retail traders. Infra notes 293-296 and accompanying text.

285 For a discussion of the role of noise traders in modern markets, see Black, supra note 276 at 531; and Froot, Perold & Stein, supra note 94 at 44.

286 Black, ibid. at 531.

287 The view that excessive noise trading drives stock prices away from fundamentals is consistent with the view that securities markets are driven by "fads," "fashions," or "bubbles." See, for example, R.J. Shiller, Market Volatility (Cambridge: MIT Press, 1990).

288 Shiller, ibid.; and Black, supra note 276 at 533-34. See, however, K.R. French & R. Roll, "Stock Return Variances: The Arrival of Information and the Reaction of Traders" (1986) 17 J. Fin. Econ. 5, which presents evidence that noise trading has a relatively minor impact on securities prices.
that there is an optimal balance between noise and informed traders in securities markets.

Our incomplete understanding of the role of noise trading creates two problems in analyzing the effect of institutionalization on market efficiency. First, it is not entirely clear if institutional investors are more or less likely than retail investors to be noise traders. Some have suggested that institutional investors are prone to "herding" and/or "positive feedback" trading strategies that are divorced from investment fundamentals, thereby destabilizing stock prices and increasing market volatility. On the other hand, professional money managers likely have greater and more timely access to fundamental information, suggesting that they are more likely to be informed traders.

Second, because the optimum balance between noise and informed traders is unclear, it is difficult to know whether a particular change in the balance will result in movement towards, or away from, the optimum.

These ambiguities suggest that only empirics can answer the question of whether market efficiency is helped or hindered by market institutionalization. Figures presented in the following section show that throughout the 1980s, while retail trading declined relative to institutional trading, TSX liquidity and price continuity increased markedly. This is consistent with U.S. evidence (also discussed below) that suggests that market institutionalization has been associated with enhanced, rather than diminished, market efficiency.

D. Market Liquidity and the Cost of Capital

A concern that is closely related to a loss of market efficiency is that the withdrawal of retail investors will result in impairment of secondary market liquidity, given that institutional trading tends to result in a smaller number of larger trades, adding lumpiness (and hence

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289 "Herding" behaviour occurs when investors engage in parallel trading in the same stocks. "Positive feedback" trading occurs when investors purchase securities which have performed well in the past, or sell those that have performed poorly. Models of herding and/or positive feedback behaviour are presented (inter alia) by K.A. Froot, D.S. Scharfstein & J.C. Stein, "Herd on the Street: Informational Inefficiencies in a Market with Short-Term Speculation" (1992) 47 J. Fin. 1461; and D.M. Cutler, J.M. Poterba & L.H. Summers, "Speculative Dynamics and the Role of Feedback Traders" (1990) 80 Amer. Econ. Rev. 63.

290 See Part V(D), below.
illiquidity) to the order flow. Illiquidity is costly to investors, since the inability to liquidate securities to satisfy an immediate need for cash creates an opportunity cost. In addition, illiquidity is associated with larger bid/ask spreads, since market-making dealers must anticipate holding securities for a longer period of time before resale. Because illiquidity is costly to investors, it lowers the expected return to holding illiquid securities. This, in turn, increases the average cost of capital faced by the issuers of such securities, impairing the process by which savings are converted into real investment.

However, it should be kept in mind that many large institutions, such as insurance companies and pension funds, trade mainly or exclusively with other institutions, not only because it is expensive and time consuming to break large institutional blocks into smaller packages for the retail trade, but because throwing large blocks on the public market may depress the market price. Thus for institutional investors, the withdrawal of the retail investor will have comparatively little effect on market liquidity. Any reduction in liquidity will mainly affect retail investors, investment advisors, and institutions like trust companies that manage relatively small portfolios and that engage in crossover trading with retail investors. Further, as indicated above, institutional investors trade more frequently than retail investors. This offsetting factor may mean that market institutionalization will result in increased market liquidity for institutional traders.

The evidence indeed suggests that market institutionalization has been associated both with enhanced liquidity and pricing efficiency. Although the relative size of the retail sector shrunk during the 1980s, Table 1 indicates that both the liquidity and price continuity of the TSE improved over this period. This is consistent with evidence from the United States. For example, Jones, et al., found that a higher volume of institutional trading was associated with lower bid/ask spreads, as well as

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292 See Amihud & Mendelson, ibid.
293 The longer the period during which the dealer holds a given security, the greater the risk that the market price will change adversely, resulting in trading losses. Ibid.
294 In a nutshell, increased illiquidity lowers transactional efficiency, which in turn impairs the achievement of allocative efficiency.
295 Supra note 209, and notes 273-274 and accompanying text.
296 Supra notes 282-283 and accompanying text.
lower market volatility (both over time and cross-sectionally).297 Similarly, a study by Lakonishok, et al., found little evidence to support the hypothesis that institutional traders engage in herding or positive feedback trading, even in smaller stocks.298 Indeed, the Lakonishok study suggests that, at least in larger stocks, institutions tend to stabilize the market by engaging in negative-feedback trading,299 and also appear to adopt a heterogeneous variety of trading strategies. This evidence suggests that institutional traders are informed traders whose trading activities improve market efficiency and liquidity. Thus, by improving transactional efficiency, market institutionalization is likely to have a favourable effect on the cost of capital and to enhance allocative efficiency.300 In the end, the decline of the retail investor may threaten the liquidity of investment bankers’ bank accounts more than that of securities markets.301 Regulatory intervention is not indicated.302


298 Lakonishok, Shleifer & Vishny, supra note 226.

299 Negative-feedback trading occurs when an investor buys losers and sells winners, trading contrary to prevailing trends. This is also sometimes referred to as “contrarian” trading.

300 A further benefit associated with market institutionalization is the economies of scale that result from trading larger blocks, leading to lower aggregate trading costs. These economies of scale are reflected in the lower unit trading costs experienced by institutional investors.

301 Retail trading has been a fertile source of both employment and profits for the investment banking industry. Kelly, supra note 1 at 5. While those in the industry tend to dispute the greater profitability of retail brokerage, it makes sense to believe that brokers would prefer a large number of small trades with retail investors to a small number of large trades with institutional investors; this will result in more trades, and hence more work for brokers. Moreover, institutions have sufficient market power to negotiate commissions aggressively, and conventional wisdom suggests that institutional commissions are low margin transactions. Finally, international competition for securities business in Canada has mainly by-passed the retail brokerage business, thus reducing competitive pressures (and likely increasing margins) relative to other aspects of the securities industry. See Andrews, supra note 1 at 1, and at 12-14.

Indeed, in the past ten years or so, as retail investors have been withdrawing from the market, international competition for securities business has intensified, and as bought deals with institutional investors have become common, commissions have accounted for a steadily smaller share of industry revenue. Kelly, ibid. at 4.

302 The case against regulatory intervention (even assuming that institutionalization impairs retail market liquidity) is strengthened by the availability of a self-help strategy for retail investors, namely, the purchase of highly liquid market indices, mutual funds, and similar vehicles offered by financial intermediaries.
Institutional and Retail Investors

TABLE 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Market Depth(^a)</th>
<th>Price Continuity(^b)</th>
<th>Market Spreads(^c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>87.01</td>
<td>79.66</td>
<td>.514</td>
</tr>
<tr>
<td>1981</td>
<td>88.60</td>
<td>80.67</td>
<td>.469</td>
</tr>
<tr>
<td>1982</td>
<td>89.92</td>
<td>83.33</td>
<td>.412</td>
</tr>
<tr>
<td>1983</td>
<td>90.78</td>
<td>83.83</td>
<td>.357</td>
</tr>
<tr>
<td>1984</td>
<td>96.62</td>
<td>94.32</td>
<td>.327</td>
</tr>
<tr>
<td>1985</td>
<td>96.62</td>
<td>94.43</td>
<td>.288</td>
</tr>
<tr>
<td>1986</td>
<td>96.25</td>
<td>94.14</td>
<td>.295</td>
</tr>
<tr>
<td>1987</td>
<td>94.69</td>
<td>92.88</td>
<td>.308</td>
</tr>
<tr>
<td>1988</td>
<td>97.88</td>
<td>96.75</td>
<td>.297</td>
</tr>
<tr>
<td>1989</td>
<td>98.58</td>
<td>97.67</td>
<td>.248</td>
</tr>
<tr>
<td>1990</td>
<td>98.43</td>
<td>97.34</td>
<td>.280</td>
</tr>
<tr>
<td>1991</td>
<td>98.49</td>
<td>97.64</td>
<td>.270</td>
</tr>
</tbody>
</table>

Notes:  
(a) per cent of volume that occurs within $0.125, or one-eighth of a point from the previous sale.  
(b) per cent of transactions that occur within $0.125, or one-eighth of a point from the previous order.  
(c) the average price difference between the best bid and ask over a given period of time.


VI. INSTITUTIONAL INDEXATION AND MARKET EFFICIENCY

In Part III, above, the effect of institutional indexation on corporate monitoring was considered. In this section, the related issue of whether institutional indexing will impair market efficiency is explored.

As a general matter, it is only by means of the profit-seeking activities of institutional traders and other sophisticated investors and analysts that securities prices are made efficient. These investors and analysts attempt to identify overvalued and undervalued securities and, in the process of doing so, increase the extent to which fundamental information is uncovered and impounded in securities prices. Because
indexed traders do not choose stocks on the basis of fundamentals but on the basis of their participation in a market index, indexation might pose some threat to market efficiency. Similarly, indexed investing may negatively affect market liquidity to the extent that it results in reduced trading. Arguably, the threat to both pricing efficiency and liquidity will be greatest in relation to small capitalization issuers, since institutional investors adopting an indexing strategy will tend to focus their interest on large companies such as those that make up the TSE 35. Other things being equal, this may tend to increase the size of the second market relative to the first.

If the adoption of indexing strategies initially results in less fundamental research, however, and reduced market efficiency, there is a self-correcting mechanism. This mechanism is reflected in Grossman and Stiglitz' solution to the paradox of market efficiency. The paradox is this: it is only through the activities of traders seeking arbitrage opportunities that markets are made efficient. However, once markets are completely efficient, no trader has an incentive to expend effort to identify overvalued and undervalued securities, since all securities are correctly priced. Thus, the very activity that makes securities markets efficient destroys the incentive to make securities markets efficient.

The "solution" to the paradox is that securities markets can never be completely efficient. Rather, an "efficient" market is characterized by an equilibrium amount of disequilibrium, in which those engaged in costly efforts to identify overvalued and undervalued securities earn a "normal" rate of return.

Thus, assuming that more and more institutions adopt indexing strategies (and do little or no fundamental research), any impairment of market efficiency will be only short-run in nature. Diminished efficiency will enhance the arbitrage opportunities available to traders engaging in fundamental research. This will in turn induce these traders to devote more resources to identifying over- and undervalued securities.

This initially suggests that increases in institutional indexation will result in a higher degree of separation between those pursuing indexing and selection strategies. Some institutional investors will index and, because the index is weighted towards larger firms, these funds will purchase mostly large capitalization issuers. To the extent that this creates arbitrage opportunities, others will exploit these opportunities by

303 Supra notes 273 and 274 and accompanying text.
Institutional and Retail Investors

adoption of selection strategies. Because the arbitrage opportunities will be greatest for smaller firms, these funds will pay particular attention to small cap issuers.

In fact, as indicated earlier, few institutions are fully indexed, and it is not unlikely that many institutions will pursue a bifurcated strategy in which part of the portfolio is indexed and part is selected on the basis of fundamentals. Thus, the separation of trading strategies may occur as much within institutions as between institutions. Overall, there seems little reason to believe that the trend towards indexation will impair market efficiency even for small cap issuers.

In fact, there is evidence that even as indexing strategies have grown in popularity, many institutions have focused more, rather than less attention on small cap and "neglected" firms. This increased attention augments market efficiency and increases the liquidity of such companies.

And, perhaps most importantly, evidence presented earlier suggests that the pricing efficiency and liquidity of both Canadian and American securities markets increased through the 1980s, a period during which indexing strategies greatly increased in popularity. Thus, it seems unlikely that institutional indexing will jeopardize either efficiency or liquidity.

It is important that the courts recognize that indexing, passive, and active strategies may all form part of a prudent institutional investment strategy. In particular, prudence must be judged in the context of the portfolio as a whole, and not on an investment-by-investment basis. Moreover, while fund diversification is obviously an important component of a prudent investment strategy, dedicating part of an institutional portfolio to the purchase of risky or large stakes is not by itself incompatible with the achievement of adequate diversification.

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Indeed, increasing institutional interest in small firms has apparently tended to dissipate the superior risk-adjusted returns earned by these firms. See Fama, supra note 92 at 1587-88; and Speidell, ibid. This is consistent with the hypothesis that the higher expected returns of smaller firms are at least partly "exploitable" and not simply artifacts of trading costs or mismeasurement of risk.

306 See supra notes 297-300 and accompanying text, and Table 1.
or the construction of a safe portfolio. The larger the fund, the greater the leeway that must be accorded the investor to hold risky and/or large stakes in some firms. The courts must also recognize that making shareholder proposals, nominating directors, participating in proxy contests, and generally engaging in active efforts to influence management can also form part of a prudent management policy. Finally, the courts should avoid placing inordinate reliance on past investment practices in deciding the content of the prudent portfolio standard. Such practice has been coloured by restrictive legal for life rules and for this reason investment managers tended to focus on the safety of individual investments, rather than on the portfolio as a whole.

In the end, indexing, passive, and active investment strategies all play an important role in securities markets, and it must be the market, rather than the law, which decides which strategy a particular fund adopts.

As a final observation, attempts to force institutional investors to "pass through" votes to beneficial owners should be staunchly resisted, since this will destroy the advantage of concentrated share ownership (and increased monitoring) brought about by market institutionalization.

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307 See supra notes 192-193 and accompanying text.

308 See Part II(K)(4), above.

309 Ibid.

310 On U.S. efforts in this direction, see D.M. Walker, "The Increasing Role of Pension Plans in the Capital Markets and in Corporate Governance Matters," in Sametz, ed., supra note 1, 34 at 42. Note that "National Policy Statement 41: Shareholder Communications" (1987), 10 O.S.C.B. 6306 requires intermediaries to pass through proxy materials to beneficial owners. When beneficial owners fail to return voting instructions, the intermediary may not vote the shares. This has the effect of completely sterilizing the votes attached to shares of unresponsive shareholders. This may not be inappropriate, if, as some have suggested, the tendency of intermediaries is to vote with management because of a desire to secure business (for example, underwriting contracts) from corporate issuers. See Black, supra note 1 at 560-61 and 603-04. However, if confidential voting is instituted (as recommended in the text), it would be far better to allow intermediaries to vote the shares of unresponsive shareholders. This would concentrate voting power in the hands of knowledgeable parties with an ability to add to corporate monitoring, rather than sterilizing the votes of unresponsive shareholders. Indeed, it would be better yet to remove the obligation to pass through proxy materials, and to allow an intermediary to vote shares absent specific instructions from the owner.
VII. RETAIL INVESTORS AND THE FEDERAL PROPOSALS TO AMEND THE INSIDER TRADING LEGISLATION

Concerns about the declining retail sector were one of the inspirations behind the federal government's recent proposals to amend the insider trading provisions of the *Canada Business Corporations Act*. Citing a TSE study, the proposal states that:

For those people who do not own stocks, a major factor behind their decision was their growing concern about insider trading. The survey results may suggest that many non-shareowners believe investors need inside information to make money in stocks. \[311\]

As argued above, one objection to this view is that the withdrawal of retail investors is not necessarily a development to be lamented. But more fundamentally, the connection between retail participation in securities markets and insider trading is tenuous at best. The TSE study cited by the proposal in fact draws a rather weak connection between retail participation and insider trading. \[312\] Further, it is simply wrong to assert that it is necessary to have inside information in order to make an attractive return in the stock market. \[313\] There is recent evidence that

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\[311\] See *Insider Trading and the Canada Business Corporations Act* (Ottawa: Ministry of Supply and Services Canada, 1991) at 3-4.

\[312\] In the part of the TSE survey cited by the federal proposal, non-shareholders were asked to agree or disagree with a variety of statements about why they owned no stock. Fifty-four per cent of the respondents agreed with the statement that one needs inside information to make money in stocks. However, because respondents were asked to agree or disagree with a variety of statements, there is a channelling of responses towards the proffered categories; one does not know how many people, left to their own devices, would have offered "insider trading" as a reason for not owning stock. More importantly, there were thirteen possible reasons for not investing in the stock market with which respondents could agree or disagree. Agreement with any one of these does not indicate whether the respondent had a weak or a strong belief in the accuracy of the statement, or how an individual would rank-order the reasons for not trading. In fact, there is some indication that other factors are more important, insofar as this can be judged from the percentage of those surveyed who responded affirmatively to particular items. Seventy-six per cent agreed with the statement that they did not invest in the stock market because they did not have enough money at the present time; 64 per cent indicated that they did not have enough information, and 59 per cent indicated that they did not know how the stock market works. See *Canadian Shareowners*, supra note 268 at 24-25. This last datum confirms the obvious: that the surveyed group, non-shareholders, are the least likely to have any familiarity with the stock market. For reasons that have nothing to do with household income: see *ibid.* at 10, few are likely to participate in financial markets in the future. In my view, it is rather odd to construct securities/corporate law policy on the basis of mistaken beliefs (see *infra* note 313 and accompanying text) held by those who are not participants in securities markets.

\[313\] This is not to say that insiders do not make superior trading profits; they clearly do. See, for example, J.F. Jaffe, "Special Information and Insider Trading" (1974) 47 J. Bus. 410; H.N. Seyhun, "Insiders' Profits, Costs of Trading, and Market Efficiency" (1986) 16 J. Fin. Econ. 189.
suggests that some mutual fund managers, and perhaps a small number of other traders, possess private information, and hence an advantage over retail investors.\textsuperscript{314} However, the size of the abnormal trading profits, and hence the institutional advantage, are at best small.\textsuperscript{315}

There are better explanations for why retail investors have increasingly preferred to place their funds with financial intermediaries, the chief ones being superior diversification and superior management skills. Another advantage is that institutional traders have lower unit trading costs than retail investors.\textsuperscript{316} As new technologies of risk management are developed and exploited, institutional investors are likely to have a further advantage, since many of these techniques will, as a practical matter, be open only to institutional investors.\textsuperscript{317}

Moreover, even if professional money managers sometimes have informational or other advantages not shared by retail investors, a self-help strategy is available: any investor can participate in the resulting benefits simply by investing through a financial intermediary, such as a mutual fund.\textsuperscript{318}

It is worth pointing out that the historic policy tilt in favour of retail investors is as much a product of “fairness” or distributional arguments as it is of efficiency arguments. That is, institutional investors have been perceived as representing monied interests, while retail investors have been seen to represent ordinary Canadians. In the main, this perception is false. Institutional investors such as pension funds (in aggregate, representing the largest institutional pool of funds), life insurance companies, banks, and trust companies invest the pooled

However, the presence of insider trading is consistent with markets being a “fair game” in which average realized returns equal expected returns. Empirical studies have shown that, in the main, markets in the U.S. and Canada are indeed a fair game. See Daniels & MacIntosh, supra note 5 at 872-74. Of course, this will not mean much if the game (in this case, investing in the public markets) does not yield attractive returns. But historical data indicates that stock market investing has been an extremely remunerative activity for non-insiders. See Ross & Westerfield, supra note 7 at 112-141. Moreover, the perception that insider trading is more prevalent now than in times past is questionable. Seyhun found that, although insider trading increased between 1975 and 1989, the increase did not outpace the aggregate increase in trading volume over this period. H.N. Seyhun, “The Effectiveness of the Insider-Trading Sanctions” (1992) 35 J. Law & Econ. 149 at 167-71.

It may be that retail investors mistakenly believe that it is necessary to possess inside information in order to profit in the stock market. If so, it would seem to make more sense to correct this misapprehension than to regulate securities markets based on a falsehood.

\textsuperscript{314} See supra note 92 and 297-300 and accompanying text.

\textsuperscript{315} Ibid.

\textsuperscript{316} Ross & Westerfield, supra note 7 at 311.

\textsuperscript{317} See Part XI, below.

\textsuperscript{318} Supra note 218.
savings of a deep cross-section of low- and middle-income Canadians.\textsuperscript{319} The lion’s share of any abnormal trading returns realized by institutional investors are passed on to the beneficial owners and other stakeholders, such as employees.\textsuperscript{320} Retail investors, on the other hand, are much more likely to be drawn from a privileged stratum of society.\textsuperscript{321} Thus, if distributional considerations are to play any role in the debate about corporate and securities law policy, they tend to favour the interests of institutional, rather than retail, investors.

The irony is that excessive regulation has contributed to the decline of the retail investor in the primary market. A key factor underlying increased issuer reliance on exempt markets for raising funds\textsuperscript{322} is the increasingly onerous burden of disclosure requirements associated both with primary market offerings and public company status. Given the current structure of securities laws, these regulatory requirements can be bypassed only by eliminating retail buyers. If regulators are seriously concerned about preserving retail involvement in primary market business, then their best hope of accomplishing this goal is to reduce the burden and costliness of assembling a prospectus so that fewer new issues are driven into the exempt market.\textsuperscript{323} Similarly, continuous disclosure obligations should be made less, not more, onerous, contrary to recent Canadian experience.\textsuperscript{324} These issues are further pursued in the following section.

\textsuperscript{319} Mutual funds, however, are more likely to represent more affluent investors. See Canadian Shareowners, supra note 268 at 10 (shareownership increases with income).

\textsuperscript{320} For example, virtually the entire benefit of any abnormal trading profit realized by a defined contribution pension fund is realized by the employees who are its beneficial owners. Investment profits realized by banks, trust companies, and insurance companies help to ensure the solvency of these institutions, protecting client capital as well as enhancing share values.

\textsuperscript{321} Canadian Shareowners, supra note 268.

\textsuperscript{322} Andrews, supra note 1 at 11. Of course, some of the increase in the use of exempt markets must be attributed to the fact that institutional investors, which form an ever larger share of the market, have historically been the primary buyers of private placements. \textit{Ibid.}


\textsuperscript{323} See Parts XIII and IX, below.

VIII. RETAIL INVESTORS AS FREE RIDERS: THE PRECARIOUS CASE IN FAVOUR OF MANDATORY DISCLOSURE

Securities law mandates the disclosure of information to investors in primary markets through the vehicle of the prospectus. The form of prospectus that is mandated by securities legislation is based on the presumption that buyers of new issues are unable to look after their own interests and are likely to be duped by false or exaggerated claims made by corporate issuers and promoters. As a result, the prospectus must contain copious amounts of information, at least some of which would not be produced in an unregulated market, or would not be produced in the form currently required by law.\footnote{325 The fact that issuers, by themselves, will not produce information in the amount or form thought to be essential by regulators is evidenced by the steadily mounting burden of mandated disclosure. If issuers were producing information sufficient to satisfy the regulators, then it would be unnecessary to extend mandated disclosure requirements. The history of mandated disclosure, however, is not one of fewer, but of steadily increasing layers of required disclosure. Most recently, see "Annual Information Form," \textit{ibid.}; and \textit{NP40, supra note 102.}}

It is important to realize that it is the retail investor who lies at the heart of these mandatory disclosure requirements. This is clear from the structure of the legislation; where the sole purchasers of a primary market issue are relatively sophisticated institutional buyers, prospectus exemptions are available.\footnote{326 Although not all prospectus exemptions are based on purchaser sophistication, the most important ones are. See, for example, \textit{OSA, supra note 68, ss. 72(1)(a), (c), (d), (p).}} Such investors, unlike retail investors, are assumed to have the sophistication, bargaining power, and experience to protect their own interests. Thus, there are two primary markets. In the "non-exempt" market, where securities are sold to the public, including the supposedly gullible retail investor, a prospectus is required.\footnote{327 I use the term "public" loosely here, since under the \textit{OSA} and other "closed system" statutes the prospectus requirement is no longer triggered by a "distribution to the public." Rather, any "distribution" (which essentially means a sale by the issuer or by a shareholder exercising some measure of control) requires a prospectus, unless an exemption is available. See, for example, \textit{OSA, ibid. ss. 1(1), 53, and 72. Nonetheless, the effect of the closed system is not dissimilar from a regime of rules based on a distribution to the public.}
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"exempt" market, where securities are sold to institutional investors, much more limited disclosure is required.\textsuperscript{328}

In this section, I argue that the distinction between exempt and non-exempt markets is increasingly artificial. For this purpose, it is necessary to subdivide the non-exempt market into two parts. In the first segment, there are both retail and institutional buyers. In the second, which is effectively restricted to small business financings (particularly small firm IPOs), new issues are sold primarily or exclusively to retail buyers.

In the first segment, it can no longer be seriously asserted—if ever it could be—that retail investors read or rely on the prospectus in making investment decisions. Most consign the prospectus to the waste bin.\textsuperscript{329} Rather, the chief protections for retail buyers of new issues are those supplied by the market. First, it is institutional investors who are pivotal in pricing new issues. Institutional investors will be canvassed by the underwriter throughout the process leading up to the issuance of the securities in order to gauge institutional interest and set a market clearing price. Thus the price that is set will be a product of the knowledge, acumen, and investigative efforts of institutional investors. However, because retail buyers purchase at the same price as institutional buyers, this means that retail investors free-ride on the investigative efforts of institutional investors.\textsuperscript{330} In this manner, institutional investors protect not only their own interests, but those of retail investors as well; relatively unsophisticated retail buyers can purchase new issues with reasonable confidence that the issue will not be overpriced.

Second, neither the underwriters nor the auditors of the issue will be eager to acquire a reputation for participating in the sale of

\textsuperscript{328} See, for example, Regulation made under the Securities Act, R.R.O. 1990, Reg. 1015 [hereinafter Reg. 1015], s. 32.

\textsuperscript{329} See, for example, H. Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose (New York: Law and Business Inc., 1979) at 14-15.

\textsuperscript{330} See, for example, A. Arbel, "Generic Stocks: The Key to Market Anomalies" (1985) J. Port. Man. 4 at 5. Institutional buyers purchase about 80 per cent of new debt issues and 65-70 per cent of new equity issues. See C.S. Perry, "Private Placements," in Rupert, ed., supra note 46 at 104. This is suggestive of the frequency with which retail investors will be able to rely on the investigative efforts of institutional investors to ensure that the offering is fairly priced. Indeed, it is likely that there need be only a thin margin of institutional buyers to ensure fair pricing of a particular issue.
overvalued securities and will endeavour, therefore, to price the issue fairly.\textsuperscript{331}

Third, brokers offering advice to retail clients also have an incentive, in order to acquire or maintain a good reputation, to ensure the quality of their investment advice and typically draw on the activities of well-funded research departments in providing such advice.

In the second segment of the non-exempt primary market in which new issues are sold primarily or exclusively to retail investors, clearly there is no free ride on the activities of institutional investors. At first sight, mandatory prospectus disclosure seems to play a more useful role. However, even in this segment of the market, the value of mandatory disclosure can be seriously questioned. While a higher proportion of retail investors read the prospectus, anecdotal evidence suggests that this proportion is still small; most will rely on the advice of a broker in making a purchase decision. As in the first segment of the market, these brokers will not be eager to develop a reputation for selling or recommending purchases of overvalued securities. And again, auditors and underwriters will have their reputations to protect.

The growing institutionalization of the market is likely to diminish the number of new issues that are sold exclusively to retail investors. If market protections for retail investors operate less effectively in the second segment of the new issues market, over time this segment is likely to diminish greatly in importance.

Further, even if the benefits of mandatory disclosure are greater in the second segment of the market, the proportional costs to issuers may be greater still. Small firms are typically young, start-up enterprises in a critical stage of their development, and the costs of making an issue by prospectus may be crippling. Indeed, the legal and accounting costs of making a primary market offering are proportionately greater for small offerings.\textsuperscript{332} Thus, the burden of mandatory disclosure falls disproportionately on small firms, putting such firms at a competitive disadvantage and creating a barrier to entrepreneurial activity. The sec


\textsuperscript{332} See J.G. MacIntosh, “Financing the Small, High Technology Firm in Canada” (27 July 1993) (Government and Competitiveness Project, School of Policy Studies, Queen’s University). This is true even aside from the fact that larger issuers can use the short-form prospectus system to issue securities. Even for long-form offerings, the cost of floating a new issue increases less rapidly than the size of the offering.
has recognized this disproportionate burden and has responded with a number of recent amendments to SEC rules designed to ameliorate the burden of mandated disclosure for small firms. Many Canadian small issuers may take advantage of the U.S. rules, with the result that many smaller firms now choose to raise money in the U.S. rather than in Canada. Canadian regulators should reduce the regulatory burden on small issuers at least to the extent of matching the U.S. rules.

There is empirical evidence suggesting that the market protections referred to above would be sufficient to protect investors in primary markets even absent mandated disclosure. On average, new offerings are underpriced to compensate buyers for the risks associated with new issues. The degree of underpricing is inversely related to the quantity and quality of information produced by the issuer and to the quality of intermediation (i.e., audit and underwriter) services provided by the issuer. The studies provide evidence that these attributes are priced by the market. This, in turn, supports the view that mandatory disclosure of information is unnecessary, since the issuer has an incentive to produce whatever information (and intermediation services) will minimize its cost of capital. It also supports the view that the distinction between exempt and non-exempt markets is artificial.


There is evidence that institutional investors are systematically better informed than retail investors about which new offerings are most likely to be underpriced, and hence more likely to scoop up the “best” new issues. The systematic underpricing of new issues may be a response to this information asymmetry in the sense that it is designed to keep uninformed investors in the market despite the fact that they cannot always participate in the best offerings. See R. Beatty, “Auditor Reputation and the Pricing of Initial Public Offerings” (1989) 64 Acct. Rev. 693.


The results of empirical tests conducted even before the explosive growth of the institutional sector in the 1980s cast grave doubt on the wisdom of mandated disclosure in primary markets. For example, a comprehensive study by Jarrell compared the returns and risk of primary market common equity and rights issues both before and after the introduction of the Securities Act of 1933 in the United States.338 Jarrell found that the introduction of the Act did nothing to improve the average return of new issues. In fact, primary market issues made before the Act offered better five-year returns than new issues made afterwards.339 Perhaps most surprisingly, new issues made in 1929, supposedly the height of the "speculative fever" to which the Act was addressed, did better than those of any other year in the study.340

Jarrell also compared the riskiness of new issues before and after the Act. Although the average systematic risk of new issues (beta) was almost the same for the two periods, the post-Act period was characterized by relatively few high beta issues.341 There was a clear lowering of unsystematic risk in the post-Act period.342

The findings with respect to risk, however, provide a very shaky base upon which to build a case in favour of mandated disclosure. For one thing, a reduction in unsystematic risk is of little or no benefit to investors. One of the most important teachings of modern portfolio theory is that the proper perspective from which to evaluate the riskiness of a security is its contribution to the riskiness of the portfolio as a whole. Unsystematic (diversifiable) risk does not contribute to the riskiness of a diversified portfolio. This lesson often seems to have been forgotten by securities regulators whose ambition frequently seems to be

338 Jarrell, supra note 230. But see also C.J. Simon, "The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues" (1989) 79 Amer. Econ. Rev. 295 (finding evidence that IPOs on regional exchanges were over-priced before but not after the passage of the Act). These studies followed an earlier, similar study by George Stigler. See G.J. Stigler, "Public Regulation of the Securities Market" (1964) 37 J. Bus. 117 (criticized in I. Friend & E.S. Herman, "The SEC Through a Glass Darkly" (1964) 37 J. Bus. 382). Although Stigler arrived at much the same conclusion as Jarrell and Simon (excepting Simon's finding regarding IPOs on regional exchanges), the latter were able to take advantage of sophisticated market models and statistical tools that were developed only subsequent to the Stigler study. See also D.W. Diamond, "Optimal Release of Information by Firms" (1985) 40 J. Fin. 1071.

339 Jarrell, ibid. at 637-646. The study compared the fate of new issues in the 1926-33 period (preceding the Act) with those in 1934-39 and 1949-55 (following the introduction of the Act).

340 Ibid. at 640.

341 The mean beta of the new issues was almost identical, but the pre-Act distribution of betas was skewed towards the right tail of the distribution. Ibid. at 649.

342 Ibid.
to force disclosure of any item of information that might conceivably have some relevance to investors, regardless of the information’s ultimate utility in constructing an investment portfolio or to the cost of producing it.\footnote{This cost can be considerable. See S. Phillips & R. Zecher, \textit{The SEC and the Public Interest} (Cambridge: MIT Press, 1981) at 51 (estimating issuer costs of producing mandated information but not estimating the administrative cost of mandated disclosure). A recent Canadian example of excessive mandated disclosure arises in connection with \textit{“OSC Policy Statement 9.1: Disclosure, Valuation, and Approval for Insider Bids, Issuer Bids, Going Private Transactions, Significant Asset Transactions and Other Related Party Transactions”} (1990), 13 O.S.C.B. 2075, which recent experience suggests has greatly burdened smaller issuers in a manner which exceeds the advantages.}

Moreover, while one interpretation of the reduction in unsystematic risk and the diminishing proportion of high beta stocks is that the \textit{Act} eliminated fraudulent issues, this explanation is less consistent with the data than the hypothesis that the \textit{Act} has merely prevented relatively high risk firms from going to market. When the highest risk issues were eliminated from the pre-\textit{Act} sample, the average performance of the sample worsened.\footnote{\textit{Supra} note 230 at 648-49.} Thus, the highest risk issues in the pre-\textit{Act} period appeared to be the best performers, rather than fraudulent issues.\footnote{This includes 1934, the year of the fastest growth in private placements. As Jarrell indicates, the fact that the buyers grew at a normal rate through this period suggests that the substitution towards private markets was induced by supply-side, rather than demand-side considerations. \textit{Ibid.} at 660-662.}

Indeed, Jarrell also found a dramatic increase in private placements in 1934 and after, despite the fact that life insurers, the primary buyers of privately placed bonds, did not grow at more than a normal rate through the 1930s.\footnote{This was true in all industries examined in the study. \textit{Ibid.} at 663-64.} Further, before the passage of the \textit{Securities Act of 1933}, private placements tended to be of lower risk bonds, while afterwards they tended to be of comparatively higher risk bonds. Added to this is the fact that there were fewer public issues of common shares and comparatively more public issues of bonds and preferred shares after 1933.\footnote{This includes 1934, the year of the fastest growth in private placements. As Jarrell indicates, the fact that the buyers grew at a normal rate through this period suggests that the substitution towards private markets was induced by supply-side, rather than demand-side considerations. \textit{Ibid.} at 660-662.} All of this evidence is consistent with the view that the \textit{Act} drove higher-risk, new issues out of the public market and into the exempt market.

The fact that the \textit{Act} appears to have eliminated risky but profitable public issues is unsettling. The riskiest new issues are likely to be those sold by relatively small firms without public track records, particularly those sold in initial public offerings. In a dynamic economic
environment in which entrepreneurship and innovation is critical, these firms constitute an increasingly vital sector of the economy, and excluding them from the public market is likely to result in diminished entrepreneurial activity and less competition for established firms. If, indeed, this is a primary effect of mandated disclosure, the conclusion that it has caused more social harm than good is compelling.

It is a mistake to believe that the end of mandated disclosure for primary market issuers would mean the end of disclosure. As in the regulation-free Euromarkets, private placement markets, and domestic securities markets prior to the advent of mandatory disclosure, issuers making public offerings would be compelled as a matter of business to make disclosures to prospective buyers.\textsuperscript{347} It may well be that the most important information currently mandated for inclusion in prospectuses would be replicated in the selling document. However, it is almost certain that some of the chaff would be eliminated.\textsuperscript{348}

The case in favour of mandated secondary market disclosure is also a fragile one. Two studies by Benston are noteworthy.\textsuperscript{349} If mandatory disclosures contain valuable information (i.e., information that the market does not already have), then public release of mandated

\textsuperscript{347} Where information is not disclosed, the market will exact a discount for information risk. \textit{Ibid.} Thus, the prospective cost of non-disclosure is passed back to the issuer. The extent of disclosure that could be anticipated in an unregulated market would depend on the financial and business risk of the issue and its planned use of proceeds. It seems likely that the greater the business and financial risk, the greater will be the information risk and associated price discount accompanying non-disclosure. Thus, one would expect riskier ventures to make fuller disclosure.

In general, it would be expected that issuers will engage in disclosure to the point where the issuer's cost of capital is minimized. This would be expected to occur when the marginal cost to the issuer of "information risk" associated with non-disclosure is balanced against the cost of making additional disclosure. \textit{Ibid.}

Because there is value in maintaining ease of comparability between prospectuses of different issuers, it may make some sense to continue to mandate a format for the presentation of various forms of information, while leaving it up to the issuer to decide whether or not to include a particular type of information. See R.R. King & D. Wallin, "Market-induced information disclosures: An experimental markets investigation" (1991) 8 Contemp. Acct. Research 170.

It is noteworthy that the Euromarkets have developed industry trade associations in order to police the conduct of market participants and to maintain investor confidence. See R. Edge, "The Euromarkets and the Canadian Issuer," in Rupert, ed., supra note 46, at 148. It may well be that the devolution of more and more regulatory power to both national and trans-national self-regulatory organizations is the wave of the future.

\textsuperscript{348} \textit{Ibid.}

\textsuperscript{349} G.J. Benston, "Published Corporate Accounting Data and Stock Prices" (1967) 5 J. Acct. Research 1; and G.J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934" (1973) 63 Amer. Econ. Rev. 132 [hereinafter "Required Disclosure"].
information should have an effect on market price. However, Benston found that, in general, the effect of mandatory disclosures on share prices was trivial.

The most compelling explanation for this result is not that information about matters like corporate earnings is not economically significant, but that most information of value finds its way into both public and private information networks, and from there, into publicly posted prices prior to the time when mandatory disclosures must be made. Institutional investors play a key role in this process, since institutional money managers and other sophisticated traders play a leading role in gathering information and (by trading) causing this information to be reflected in public prices. As in primary markets, retail investors free-ride on the investigative efforts of institutional investors, since these efforts bring information into the markets and help to ensure that securities markets are a fair game for retail investors.

Of course, as in the case of the primary market, there is a segment of the secondary market that is not populated by institutional investors. The value of continuous disclosure requirements may be greater in this market segment. Once again, however, as markets further institutionalize and institutional investors expand their investment horizons to smaller and previously neglected firms, the institutionally neglected segment of the secondary market will shrink, diminishing the need for mandatory continuous disclosure requirements.

In the end, the case in favour of mandatory disclosure in either primary or secondary markets is far more tenuous than commonly supposed. In particular, as institutional investors increasingly dominate

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350 Obviously, the effect could be positive or negative. The question is whether there is any effect, either positive or negative.

351 For example, Benston reports that “[o]n the average, a 100 percent unexpected increase (or decrease) in the [reported] rate of change of income is associated with a 2 percent increase (or decrease) in the rate of change of stock prices in the month of announcement.” Only sales data had a non-trivial effect on share prices. “Required Disclosure,” supra note 349 at 139.

352 Gilson and Kraakman indicate the channels through which corporate information finds its way into the public markets. See Gilson & Kraakman, supra note 325.

353 Ibid.

354 See this Part, above.

355 Supra note 305 and accompanying text.

356 Adoption of the proposals made in Part II(D) with regard to insider trading would likely contribute to the decline of the institutionally neglected market.
both primary and secondary trading markets, the extent of mandated disclosure must surely shrink, if not ultimately disappear.357

In the following section, this theme is taken one step further. I argue that the institutionalization and internationalization of securities markets will tend to **force** the deregulation of securities markets.

IX. DEREGULATORY PRESSURES CREATED BY INTERNATIONALIZATION, INSTITUTIONAL INVESTORS, AND THE GROWTH OF THE EXEMPT MARKET

Institutionalization, the internationalization of securities markets, and deregulation are all closely linked. Professional managers of institutional funds are more likely than retail investors to monitor international developments and to have the knowledge, contacts, and resources to move funds between jurisdictions in search of the best risk/return trade-off.358 Since the regulatory regime is part of the “product” that institutional investors buy when they decide to do business in a particular jurisdiction, this creates a market penalty for jurisdictions engaging in excessive or inefficient regulation.

The lowering of capital market barriers and developments in information technology have also enabled corporate issuers to tap a variety of different markets in raising capital. Increasingly, issuers are avoiding jurisdictions in which the regulatory burden is comparatively severe. The pressure created by increasing capital mobility has resulted in a number of deregulatory initiatives in Canada. These include the

357 A similar view is expressed in R.C. Merton, “Financial Innovation and Economic Performance” (1992) 4:4 J. Applied Corp. Fin. 12 at 19. See also Part XI (institutionalization of market and superior ability of institutional investors to manage risk facilitates lower levels of mandated disclosure).


358 Retail investors seeking international diversification are likely to do so, for obvious reasons, through the medium of a professionally managed fund.
short-form or "Pop" prospectus system,\textsuperscript{359} the shelf prospectus,\textsuperscript{360} and the multi-jurisdictional disclosure system.\textsuperscript{361}

The institutionalization of the market has also greatly facilitated the dramatic growth in the exempt market in which primary market offerings may be sold without a prospectus.\textsuperscript{362} Aside from reduced regulatory burden, exempt market sales to institutional buyers are cheaper for issuers in a number of ways. The issuer’s selling effort is confined to a much smaller group of prospective purchasers, reducing the transaction costs of lining up purchasers and selling the issue. Further, the terms of the securities can be tailored to a specific buyer or group of buyers, which results in a better fit between seller and buyer.\textsuperscript{363} The relative sophistication of institutional buyers also facilitates the use of complex or novel covenants that might be a difficult sell in a public issue. Moreover, the confidentiality of a private placement and the small number and sophistication of the buyers allow the issuer to communicate more and better information to the buyers, addressing problems of information asymmetry that normally plague public market offerings, and allowing the issuer to receive a better price for its securities.\textsuperscript{364} Institutional buyers may also exert less pressure than public security


\textsuperscript{360} “National Policy Statement No. 44: Rules for Shelf Prospectus Offerings After the Final Prospectus is Recepted” (1991), 14 O.S.C.B. 1844.


\textsuperscript{362} See Andrews, supra note 1 at 11.


\textsuperscript{364} In a normal public offering, particularly of equity securities, there is usually some "settling" of the market price following the public announcement of the issue, due to the fact that the market rationally anticipates that an issuer will choose to issue securities when its securities are overvalued by the public markets. See, for example, P. Asquith & D.W. Mullins, Jr., “Equity issues and Stock Price Dilution” (1986) 15 J. Fin. Econ. 61; and R.W. Masulis & A.N. Korwar, “Seasoned Equity Offerings: An Empirical Investigation” (1986) 15 J. Fin. Econ. 91. By contrast, Szewczyk and Varma found that private placements of debt securities by public utilities were accompanied by significant positive abnormal returns in share prices. See Szewczyk & Varma, supra note 24. While part of the price increase may be due to the better monitoring of corporate management that results from concentrating share ownership, this evidence is also consistent with the hypothesis that private placements reduce information asymmetries. See also V. Lewis, “Private Placements: A Capital Idea” (1990) 107:5 Bankers Mo. 73 (cost of private placement is normally about ten to fifteen basis points lower than a public offering).
holders for payment of dividends and may also be willing to wait longer to see a return on their investment.  

The fact that the regulatory burden is much less for exempt market issues than for public offerings gives an additional inducement for issuers to raise money in exempt markets. The diminished regulatory burden allows a private placement to be effected with great speed, allowing issuers to take advantage of investment projects with narrow windows of opportunity. Raising funds through a private placement also enables issuers to keep competitively sensitive information from becoming public, particularly if the firm is not already a reporting issuer. It will also typically require less expenditure of effort by executives. Since issuers will naturally favour the method of raising capital that creates the least cost to regulatory compliance (including direct costs, opportunity costs, and competitive costs), the ever-widening difference in regulatory burden between exempt and non-exempt markets greatly enhances the tendency towards the "privatization" of primary securities markets.

The growing dominance of the exempt market exerts a potent brake on the degree to which securities regulators are able to enhance their control of securities market activity. The more restrictive the rules imposed on public offerings, the greater the pressure for issuers to opt into the exempt market. By this means, regulatory attempts to consolidate control of the non-exempt market may ultimately diminish, rather than enhance the dominion of the regulators.

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365 P.E. Roth, “The Private Placement Market for Start-Up Banks” (1989) 172 Bankers Mag. 56. This is not uncontroversial, as many have claimed that the short-term focus of institutional investors distorts management incentives and detracts from the efficiency of North American enterprise. See supra note 248 and accompanying text.


367 The advantage of the private placement market is particularly acute for smaller issuers, given the relatively prohibitive cost of a public offering. See K.H. Wruck, “Equity Ownership Concentration and Firm Value” (1988) 23 J. Fin. Econ. 3 at 6 (finding that NYSE and AMEX firms tapping the private placement market were smaller than the average public firm on the CRSP data tape). See also P.S. Wilson, Jr., “Private Placements for Small Business” (1989) 59 C.P.A. Journal 12; and Lewis, supra note 364; although see also supra note 278 (the recession and U.S. savings and loan debacle have caused a temporary drying up of private placement capital for smaller firms).

368 Overregulation of this character will prove increasingly costly to Canada’s financial markets as international capital becomes more mobile. See J.G. MacIntosh, “Current Trends and Future Paths in Domestic and International Securities Regulation” (Faculty of Law, University of Toronto, 1992) [unpublished].
At first sight, regulators could check this tendency by the simple expedient of regulating the exempt market. However, this is likely to backfire. Given the increasing international mobility of capital, such a course is likely only to drive domestic issuers to seek out other, less costly venues for raising capital.

Although the increasing size and importance of the exempt market has greatly alarmed securities regulators, it is not cause for concern. As indicated earlier, the core of primary market regulation is the protection of the presumably gullible retail investor. The most important exemptions to the prospectus requirements are premised on the understanding that there are investors, particularly institutional buyers, who are able to protect themselves without the assistance of the state. Such investors are able to defend their own interests because of their size and bargaining power (which enables them to insist on relevant disclosures of information), and because of their relative sophistication in interpreting corporate data. The expansion of the exempt market should therefore be cause not for regulatory angst, but for regulatory celebration, since it signals a correspondingly shrinking sphere of potential advantage-taking by issuers.

The adoption of Rule 144A by the U.S. Securities and Exchange Commission is a direct product of market internationalization and the growth of the exempt market. Rule 144A provides a "safe harbour" from the registration and prospectus delivery requirements of the Securities Act of 1933 for private resales of certain securities to qualified institutional buyers (QIBs). The rule is based squarely on the presumption that QIBs are able to protect their own interests without the assistance of the regulators, and was motivated by the desire to ensure that corporate issuers and institutional buyers not by-pass U.S. private placement markets in favour of overseas markets. For similar reasons, American regulators have recently allowed foreign firms to sell

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369 The inauguration of the universal registration system appears to have been at least in part a product of the desire to staunch the flow of business to exempt markets. See infra notes 374-377 and accompanying text.

370 Supra note 368.

371 Supra notes 326-328 and accompanying text.


rights to U.S. institutional investors without the need for registration, and have also created an exemption from the application of anti-manipulation rules to facilitate such rights offerings.\[374\]

In Ontario, however, the growth of the exempt market has apparently been greeted more with a sense of consternation than jubilation.\[375\] Without feeling compelled to demonstrate any abuse of the exempt market, the Ontario Securities Commission (osc) introduced a system of universal registration (ur) in 1987 under which all securities market professionals engaging in exempt market activity were required to register with the Commission.\[376\] The ur system appears to have had much more to do with regulatory discomfiture associated with loss of turf than any genuine need to control questionable activity. In fact, ur has operated mainly as a hindrance to exempt market activity, both because of the glacial pace at which registrations have been processed and the uncertainties that the new system introduced. In 1990, in recognition of the difficulties spawned by ur and the minimal regulatory payoff, the osc floated a proposal to abandon ur.\[377\] For reasons which


375 A welcome exception is the so-called “privatization exemption,” under which the osc has in certain circumstances granted discretionary exemptions from the requirement that an offering memorandum contain a contractual right of action for rescission or damages. See Re Secretary of State for Energy of Her Majesty’s Government of the United Kingdom and the Regional Electricity Companies of England and Wales—S. 73(1) (1990), 13 O.S.C.B. 5106. See generally J.A. Connidis, “Emerging Issues in Securities Regulation,” in Rupert, ed., supra note 46 at 66-68.

376 O. Reg. 345/87, ss. 176-183. A comprehensive account of the origins of ur may be found in J.D. Scarlett, “Universal Registration Under the Securities Act (Ontario): History and Implementation,” in Special Lectures of the Law Society of Upper Canada 1989: Securities Law in the Modern Financial Marketplace (Toronto: DeBoo, 1989) at 145. The ostensible rationales for the system include the “credit ring” theory, which holds that the collapse of one player in the system might jeopardize the solvency of others, and the “level playing field” theory, under which exempt market players are said to have an unfair advantage in conducting exempt market business over their regulated counterparts. The application of “credit ring” theory to exempt market players is supported on the collapse of a single U.S. player and is questionable. The “level playing field” concern can be met by allowing non-exempt market players to place their exempt market activities in a separate, unregulated subsidiary—something the osc has declined to do.


The authors of the “Proposed Changes” laconically observe that “there have been some industry concerns that the present system contains elements of unnecessary regulation.” Ibid. at 5396. They also indicate that generally, the Commission will not impose registration where it believes that either there is minimal risk to investors or the investors are capable of protecting themselves. In
are unclear (but which almost certainly include a desire not to foresake the revenue generated by uR), this proposal has apparently been abandoned.378

Given the almost inevitable tendency of regulators to abhor a regulatory vacuum, there is no guarantee that the overweening regulatory zeal that spawned the uR system will not be repeated in the future. However, the increasing internationalization and institutionalization of securities markets means that the cost of such regulatory errors will increase over time as securities market players respond to excessive regulation by doing business in other jurisdictions.

In the long run, it can be expected that increasing market institutionalization will cause further growth in the exempt market sector and will further add to the international mobility of capital. Thus, the deregulatory pressure created by these developments will intensify.

X. THE INTERNATIONALIZATION OF CORPORATE CONTROL MARKETS

Corporate control markets are important in ensuring that managers act in the best interests of shareholders.379 Increasingly, corporate control markets have become international in scope. This is the result of developments in communications technology and information management that have allowed acquirors to obtain better information both about potential target companies in other jurisdictions and about foreign legal regimes. The trend towards international harmonization of takeover laws and the adoption of mutual recognition schemes (under which a bidder may extend a bid to foreign shareholders by complying with domestic takeover law) will only accelerate the internationalization of control markets.380 The consequences are clear: more vital control markets mean invigorated discipline of corporate managers, helping to ensure that managers act in the interests of shareholders and not themselves.

378 An added reason may be that domestic players are quite happy to support uR, given that it tends to exclude foreign competitors.

379 Supra note 197 and accompanying text.

380 See Macintosh, supra note 368.
Although most transfers of control in Canada are effected consensually rather than by means of hostile takeovers, the internationalization of control markets will greatly expand the range of potential acquirors. Since control will tend to gravitate (whether through consensual or non-consensual control transactions) towards those controlling shareholders who are the most efficient monitors, the efficiency with which Canadian managers are monitored will be improved.

XI. FINANCIAL INNOVATION AND THE DEVELOPMENT OF NEW TOOLS FOR MANAGING RISK

The past twenty years have witnessed an explosive amount of financial innovation in the form of myriad new securities and exotic hybrid combinations of securities. These innovations have included a plethora of futures, options, and swaps on a variety of underlying interests including foreign exchange rates, interest rates, commodities, and market indices. Recent innovations have also included mortgage and asset-backed securities and, in the U.S., junk bonds.

A considerable amount of financial innovation has been inspired by regulatory or tax arbitrage (i.e., the desire to circumvent or reduce regulatory or tax burden). While tax arbitrage is normally of

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381 In Canada, comparatively few control transfers are effected by way of hostile takeover. See Daniels & Macintosh, supra note 5.

382 M.J. Barclay & C.G. Holderness, “The Law and Large-Block Trades” (1992) 35 J. Law & Econ. 265, especially at 278 (“the evidence shows that block premiums facilitate the transfer of voting control to those who are more effective monitors and managers, a result that increases wealth for all shareholders”).


385 The development of a market for junk bonds, or premium yield bonds issued by comparatively high-risk issuers, has been primarily an American phenomenon. Although the market temporarily collapsed with the fall of Drexel Burnham and the most recent recession, it is now making an aggressive resurgence.

386 It may be the case, for example, that to some extent Canadian institutions have circumvented the “foreign property” rules by purchasing futures and options. See generally M.H. Miller, “Financial Innovation: The Last Twenty Years and the Next” (1986) 21 J. Fin. & Quan. Anal. 459; R.C. Merton, “Financial Innovation and Economic Performance” (1992) 4:4 J. Applied
questionable social benefit,\textsuperscript{387} regulatory arbitrage has often been a means for circumventing inefficient regulation.\textsuperscript{388} Some financial innovation has also been stimulated by a desire to "complete the market" for financial claims. A new form of claim will facilitate market completion when it affords investors the opportunity to hedge, share, or pool risks in novel ways or, more generally, to create contingent payoff structures previously unavailable to investors.\textsuperscript{389} Much financial innovation has also been directed at allowing investors to accomplish familiar financial goals, but with lower transaction costs or greater liquidity.\textsuperscript{390} Yet other forms of productive financial innovations have arisen in the form of novel contractual mechanisms for reducing agency costs. Examples include new types of managerial payoff structures designed to align managerial and shareholder interests and "event risk".

\textsuperscript{387} Tax arbitrage is generally the least socially productive form of financial innovation. While it consumes resources to conceive and to market tax avoidance instruments, the benefits are primarily redistributional in character; i.e., the purpose and effect of tax arbitrage is to transfer wealth from the public purse to private interests. Occasionally, however, even tax arbitrage can fortuitously result in social benefit. See Miller, \textit{ibid.} at 462 (tax arbitrage responsible for creation of the Eurobond market).

\textsuperscript{388} Indeed, this is a central theme of this Part. Of course, whether or not regulatory arbitrage is socially productive depends on the efficiency of the regulation being skirted. Bypassing inefficient regulation is socially productive, while bypassing efficient regulation is not. In the main, most regulatory arbitrage can probably be placed in the first category. See Merton, \textit{supra} note 386.

\textsuperscript{389} The remarkable acceleration of the pace of financial innovation in the past thirty years appears to be the product of a number of factors, aside from regulatory and tax arbitrage. One commentator has suggested that the increase in global economic activity has created a focus on financial innovation that was absent in more troubled times. See Merton, \textit{ibid.} at 17. In addition, a variety of new sources of financial risk have increased the returns from financial innovation. These include the abandonment of fixed exchange rates, accelerated and less predictable rates of inflation, wide differences in national inflation rates, and the increased volatility of interest rates and commodity prices. These increased risks have raised the demand for new financial products in order to facilitate risk management. See C.W. Smithson & D.H. Chew, "The Uses of Hybrid Debt in Managing Corporate Risk" (1992) 4:4 \textit{J. Applied Corp. Fin.} 79 at 81. The growing internationalization of business has added to the demand for protection against exchange and interest rate risks, while deregulation has facilitated the offering of novel products. See Kalymon, \textit{supra} note 383 at 1-18. Yet another factor that has given a boost to financial innovation has been the evolution of sophisticated methods for valuing complex securities, like the famous Black-Scholes option pricing model.

\textsuperscript{390} An example would be an institutional investor that wishes to alter portfolio risk. Prior to the invention of financial derivatives, the fund might have had to buy and sell many securities to accomplish its goal; now, the ability to buy or sell a market index allows it to achieve the same result at much lower cost. See Kalymon, \textit{supra} note 383 at 7. Yet another example is the liquid yield option note (LYON), which was initially designed to appeal to a specific investment strategy in the retail market. The origins of the LYON are discussed in J.J. McConnell & E.S. Schwartz, "The Origin of Lyons: A Case Study in Financial Innovation" (1992) 4:4 \textit{J. Applied Corp. Fin.} 40.
covenants designed to reduce the incentives of managers and shareholders to act opportunistically towards debt holders.  

These developments are significant to the future path of securities regulation. Futures, options, and other derivatives allow both investors and corporate issuers to manage risk more effectively. Examples include the hedging of risks arising from fluctuations in foreign exchange rates, interest rates, or commodity prices. As Merton Miller has observed:

Efficient risk-sharing is what much of the futures and options revolution has been all about ... The combined set of futures and options contracts and the markets, formal and informal, in which they are transferred has thus been likened to a gigantic insurance company—and rightly so.  

Securities regulation also has much to do with managing risk. Mandated disclosure aims at ensuring that investors are aware of various risks associated with the purchase of an investment. Merit regulation goes further and effectively forbids the creation of certain risks. However, if significant classes of risk can be managed by investors themselves through various risk hedging, sharing, and pooling strategies,

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For a pessimistic but rigorous review of the current state of the managerial remuneration market, see M.C. Jensen & K.J. Murphy, “Performance Pay and Top Management Incentives” (1990) 98 J. Pol. Econ. 225. Jensen and Murphy suggest that both regulatory and non-regulatory constraints have limited the effectiveness of managerial contracting in aligning manager and shareholder interests. Nonetheless, it would appear that there has been an increasing sensitivity in the business community to the importance of incentive-based compensation. See, for example, symposium articles on executive compensation in (1992) 5 J. Applied Corp. Fin. 99 et seq.

For a description of some recent advances in financial contracting designed to reduce the agency costs of debt, see K. Lehn & A. Poulsen, “Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts” (1991) 34 J. Law & Econ. 645.

The increasing sophistication of financial contracting in mitigating agency cost problems has a direct impact on corporate regulation, particularly in the area of fiduciary standards of conduct. For example, the evolution of market means of taming the agency costs of debt (see Lehn & Poulsen, ibid.) belies recent calls like those of McDaniel for an extension of fiduciary duties to creditors. See M.W. McDaniel, “Bondholders and Corporate Governance” (1986) 41 Bus. Law. 413; and M.W. McDaniel, “Bondholders and Stockholders” (1988) 13 J. Corp. Law 205. Canadian courts arguably have already created a fiduciary duty towards creditors under the statutory oppression remedy. See J.S. Ziegel, “Creditors as Corporate Stakeholders: The Quiet Revolution—an Anglo-Canadian Perspective” (1993) 43 U.T.L.J. 511. In my view, this is a mistake.

then the need for mandated disclosure, merit regulation, and other forms of regulatory intervention is likely to decline.393

Diversification—one of the oldest forms of risk management—furnishes an example. By purchasing a reasonably large, well-diversified selection of securities, virtually all of the "unsystematic" risk can be eliminated from an investor's portfolio. This sharply reduces the benefits of mandated disclosure of unsystematic risk factors in the prospectus.394 In an economy in which investors did not have the ability to diversify their investment portfolios, a much greater premium would be placed on information concerning company-specific risk factors.395

One can take diversification a step further: the strategy of assembling an international portfolio of securities can result in lower systematic risk than investing in a single market, since movements in national economies are far from perfectly correlated.396 The increasing popularity of international investment portfolios reduces the benefit that many investors will derive from disclosure of systematic risk factors.

There are other ways of reducing systematic risk, such as purchasing put options written on market indices,397 buying "portfolio insurance," or investing in a futures mutual fund.398 The future holds yet more promise; the development of "macro" swaps and options will

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393 The reverse side of the coin is that many of the new financial instruments are extremely risky, particularly when misunderstood or not properly hedged, increasing the potential costs of financial mismanagement. See, for example, Hazell v. London Borough Council, [1989] 2 W.L.R. 372 (H.L.), in which borough councillors racked up ruinous losses on poorly conceived swap transactions. In my view, these risks are adequately addressed in the case of institutional investors by prudent person investment standards (although it might be well to forbid some institutional investors, like municipal councils, from purchasing derivatives at all—the result effectively achieved by the Hazell holding), and, in the case of retail investors, by regulation of professional providers of investment advice. See text below.

394 Mandated disclosure enthusiasts might argue that factors that are relevant to unsystematic risks are also frequently relevant to systematic risks, and this is undoubtedly true. However, there are likely to be unsystematic risk factors that do not tell investors much about systematic risks; for example, disclosure bearing on the quality or character of management personnel (although the latter will also bear on expected returns as well as risks).

395 The fact that investors value the information does not by itself, however, justify the imposition of a scheme of mandatory disclosure. See MacIntosh, supra note 65.

396 R.R. Grauer & N.H. Khakansson, "Gains from International Diversification: 1968-85 Returns on Portfolios of Stocks and Bonds" (1987) 42 J. Fin. 721; and Speidell, supra note 305 at 84-86.


398 For a cautionary view, see "Futures Shock: Mutual Funds that Invest in Futures and Options Sound Attractive. Beware" The Economist (8 August 1992) at 69.
further increase the ability of both issuers and investors to shield themselves from systematic risks.399

The decline of the retail sector and the rise of financial intermediation helps to spread the benefits of these new technologies of risk management. This is due to the fact that institutional investors are much more likely than retail investors to be aware of, and to employ, sophisticated risk management techniques.400 By this means, the institutionalization of the market offers a further reason for shedding few tears about the decline of the retail sector. Indeed, it supplies an added reason for re-examining the current regulatory burden of mandated disclosure imposed in both primary and secondary markets.

The development of derivatives markets has also contributed to the efficiency of the stock markets. Because market prices for derivatives are more sensitive to new information than their underlying interests, the existence of derivatives markets tends to speed up the reaction of stock prices to new information.401

For all of these reasons, the further development of Canadian derivatives markets should be seen as an important regulatory priority.402 This is particularly true given that financial innovation has proceeded at a slower pace in Canada than in the U.S., and derivatives markets are still at an embryonic stage.403 To some extent, this is a product of the small size of the Canadian market; the critical mass of trading necessary to generate the liquidity demanded by many

399 See J.F. Marshall & V.K. Bansal, "Hedging Business Cycle Risk with Macro Swaps and Options" (1992) 4:4 J. Applied Corp. Fin. 103. Macro swaps and options are based on indicators of general economic performance. For example, a company whose profits are correlated with an index of consumer confidence might purchase a swap under which it would pay the swap dealer if consumer confidence is higher than expected, and be paid by the dealer if consumer confidence is lower than expected, thereby hedging its systematic risk. Ibid.

400 Some of the techniques employed by institutional investors are reviewed in Finnerty, supra note 391.

401 See Froot, Perold & Stein, supra note 94 at 47.

402 Accord, A New Frontier: Globalization and Canada's Financial Markets, supra note 1 at 41-45 (recommending that financial institution legislation be modified, where necessary, to allow explicitly for the purchase of derivative securities; that both federal and provincial crown corporations play an informational role in the development of financial innovation; that the Federal Business Development Bank directly assist in the development of a market for securitized business loans; and that provincial crown corporations that lend to businesses actively assist in the development of a market for securitized business loans).

institutional investors has been lacking.\textsuperscript{404} Added to the liquidity problem is the inevitable inertia of institutional money managers in adapting investment strategies to embrace new and often complicated derivative products.\textsuperscript{405} Legal constraints have also played a role, however, in inhibiting the development of derivatives markets. For example, the legality of institutional purchases of derivative products remains unclear under legal-for-life statutes, particularly where such statutes endow regulated institutions with limited capacity.\textsuperscript{406} While the new federal legislation, as well as some of the provincial legislation, has jettisoned legal-for-life lists in favour of the prudent person approach,\textsuperscript{407} it remains to be seen whether the courts will interpret the prudent person standard as supporting the purchase of derivative securities.\textsuperscript{408}

Recently proposed National Policy Statement No. 46 (NP46), which reflects current regulatory policy,\textsuperscript{409} regulates public prospectus offerings of derivative securities by a variety of techniques, including: mandated primary and secondary market disclosure; merit regulation; broker registration; requirements that issuers maintain liquidity in derivative securities, as well as minimum working capital and net assets; and investor eligibility criteria.\textsuperscript{410} Space limitations forbid a discussion of specific features of the proposed policy. However, while clarification of the regulatory requirements applicable to derivatives will add to market certainty, many features of the policy are questionable. Even

\textsuperscript{404} Securities trading creates liquidity that begets further trading, producing a sort of trading chain-reaction. However, absent a critical mass of trading, this chain reaction may never get started. See, for example, Kirzner, \textit{ibid.} at 77.

\textsuperscript{405} Institutional trading cultures become deeply imbedded and change only slowly, particularly given that new trading strategies require new forms of expertise that might not be immediately available. This is a key reason why many institutional traders, like private pension funds, have not yet made a serious attempt (or indeed any attempt) to enter markets for derivative securities. This obviously will change over time.

\textsuperscript{406} See P.M. Moore, "Derivative Products—Legal Powers and Investment Authority" \textit{Insight} (28 March 1991); and P.M. Moore, "Derivative Products—Legal Powers and Investment Authority Update" \textit{Insight} (31 March 1992). At the very least, legal-for-life statutes put a ceiling on the quantity of derivative products in institutional portfolios. See Part II(K)(4).

\textsuperscript{407} See Part II(K)(4).

\textsuperscript{408} See \textit{supra} note 193 and accompanying text.


more than the non-derivative primary market, the market for derivatives is an institutional market. With rare exceptions, derivative securities are tailored for and marketed to institutional investors. Institutional investors thus play a pivotal role in pricing derivative products—even when such products are offered to the public by prospectus—and retail investors are able to free-ride on the institutional investors' self-protective efforts. Given the ability of institutional investors to protect their own interests (and, indirectly, that of retail investors), the value added by many features of the proposed policy, including mandatory disclosure and merit regulation, is not readily apparent.

Indeed, even where derivative products are specifically designed for, and marketed to, retail investors, most retail investors rely on the advice of a broker in making their purchase decisions. Brokers are no less capable than institutional money managers of gauging the quality of derivative offerings, and they have a potent incentive to recommend only good buys to their retail clients. Broker registration requirements, investor suitability rules, and "know-your-client" rules thus appear to be perfectly adequate to protect retail investors.

Thus, it is not clear what constituency is served by NP46. In particular, given the often short market windows in which derivative products must be marketed (or abandoned), and the delays and direct costs occasioned by regulatory compliance, it would be better to take a hands-off approach and leave the development of derivative products to the market.

\[411\] The only exception is exchange-traded options on individual securities, which in Canada are cleared through the Trans-Canada Options Clearing Corporation (and are exempted from NP46).

\[412\] See supra note 326 (most important prospectus exemptions are based on assumption that institutional investors are able to protect own interests).

\[413\] The LYON, or liquid yield option note, is an example. See supra note 390.

\[414\] Few retail investors deal in derivative products through discount brokers, other than exchange-traded options on individual corporations (which are excluded from NP46) since it is mainly through brokers that retail clients become aware of derivative securities. Even where retail clients do use discount brokers and do not have direct access to professional advice, they still free-ride on the investigative efforts of brokers and investment analysts, whose reaction to new issues will be pivotal in pricing such issues.

\[415\] Broadly similar (but more elaborated) views are expressed in Riley & Wildeboer, supra note 410, especially at 39-44. A recent step in the right direction is the liberalization of rules relating to purchases of derivative securities by mutual funds. See "National Policy Statement No. 39: Restated to Expand the Permitted Uses of Derivatives by Mutual Funds" (1992), 15 O.S.C.B. 5645.
XII. CONCLUSION

The rapid growth of institutional investing, the decline of the retail investor, and the internationalization of securities markets are among the most significant recent developments in securities markets. I have argued that these developments have important implications for the structure of corporate and securities law in Canada.

In particular, the rise of the institutional investor is likely to improve monitoring of corporate managers, although the extent to which this will occur is highly dependent upon the extent to which policy makers recognize the salutary role that can be played by institutional investors and take appropriate steps to accommodate this role. I have recommended a number of legal changes that would facilitate more active institutional monitoring.

In addition, market institutionalization is likely to increase the efficiency and liquidity of both primary and secondary trading markets and to diminish the size of the institutionally neglected sector of the market. It will also enhance the ability of retail investors to free ride on the self-protective efforts of institutional buyers in both primary and secondary markets. These developments will create less need for regulation of securities markets through mandated disclosure and other means.

International competition between jurisdictions to attract securities business has grown tremendously in the past decade and will continue to grow into the foreseeable future. This puts an important brake on the degree to which domestic policy makers can regulate the activities of securities market actors without motivating them to do business elsewhere. It is also likely to enhance the efficacy of corporate control markets in disciplining corporate managers.

Another brake on the activities of the regulators is the increasing degree to which issuers have sought to raise funds in private, rather than public, markets. Because private and public markets are substitutes, increasing the cost of raising funds in public markets relative to that of private markets will only succeed in causing yet further expansion of the latter. Attempts to head off this development by further regulating the exempt market are likely to fail because of the international competition for securities business noted above. Indeed, I have argued that there is little reason for regulatory concern about the expanding exempt market. Exempt market purchasers are relatively sophisticated institutional investors, who are able to protect their own interests, and expansion of
the private markets is associated with a shrinking in the sphere of potential advantage-taking by corporate issuers.

The development of markets for derivative securities will assist corporate issuers and institutional investors in managing risk and will improve the efficiency of securities markets. However, there is a distinct danger that over-zealous regulation will inhibit the development of these markets. In recognition of the fact that derivative securities are primarily sold to institutional buyers who are able to protect themselves, regulators should take a hands-off approach.