

APPENDIX I

**EXCERPT FROM LETTER OF MR. L.A.W. HUNTER DATED JULY 13, 1984
TO ONTARIO SECURITIES COMMISSION RESPECTING NON-VOTING SHARES**

As Director of Investigation and Research, my main concern is the fostering of efficiency in the Canadian economy through the judicious use of competition when appropriate. I believe that competition is a powerful tool to promote efficiency in financial markets which are perhaps closer than any other markets to the ideal competitive model of economists.

I am glad to see that we share the same objective since it is stated in the March 2, 1984 position paper that the Commission's mandate is "to provide a regulatory environment in which efficient capital markets operate and develop". Consequently the key question which needs to be addressed here is whether or not the efficiency of capital markets is promoted through measures which would limit the use of restricted shares.

An important factor which affects not only this submission but also, I suspect, all other submissions is the lack of factual information and empirical work in this area up to now. This implies that any answer given to the questions you have raised can only be tentative at this stage and cannot provide a very firm basis for making a decision. This would justify, in my opinion, a great deal of caution on your part and a call for more empirical research before significant changes are made to your policies.

In the balance of this letter I shall give you my assessment of the economic significance of restricted shares as a financial instrument and whether or not it is desirable to impose limitations on their use. I shall also consider the role of restricted shares on takeover activities and their likely impact on concentration. I shall conclude the letter by suggesting to you possible areas for empirical research which could usefully be undertaken over the next few months to shed light on some of the questions you have raised.

The Economic Value of Restricted Shares

There is a widely accepted presumption supported by extensive empirical research that financial markets use information efficiently. This implies that the market price of the various financial instruments available on the market do reflect their economic value as can be determined on the basis of publicly available information. Given the set of financial instruments available this true value will take into account the present value of expected future return as well as the risk associated with any particular instrument. Any anomaly in the market (i.e., over valuation or under valuation) will rapidly be corrected through arbitrages undertaken by informed investors.

In this context, the introduction of a new financial instrument (e.g., restricted shares) should - if found acceptable by investors - improve the allocative efficiency of the capital market. The use of non-voting shares, for

example, would be beneficial to investors willing to tradeoff their right to vote for a higher dividend yield. Other investors may value the right to vote (and to participate in any premium bid for control) such that they are willing to pay a premium for common shares. In an informationally efficient market, any premium on common shares is likely to reflect the participation of such shares in any bid for control. Restricted shares are also beneficial to issuers since such shares may represent an attractive financial alternative when compared to other possibilities, such as debt or preferred shares. This will be the case in particular when interest rates are high and when the issuer does not wish to dilute control. Indeed the introduction of restricted shares has been issuer driven, with investors accepting the resulting product. Consequently, in the absence of empirical evidence to the contrary, a presumption should be made that restricted shares, like other financial instruments, do provide choice to investors and contribute to the efficient operation of financial markets. Their ban would therefore be, prima facie, contrary to the public interest.

The Imposition of Mandatory Measures in the Use of Restricted Shares

One argument that has been put forward against restricted shares is that while on balance they could contribute to the efficiency of financial markets, they may also expose investors to abuse by majority shareholders.

This possibility, however, does not arise only in the case of restricted shares. It is a general problem which is usually referred to as the "agency problem" in the economic/finance literature. It affects all classes of security holders who do not have a controlling interest in a firm, including bondholders, preferred shareholders and minority shareholders. In such situations, the majority shareholder has a clear incentive, other things being equal, to increase his or her own wealth at the expense of other security holders. The important point here is that the market has recognized this agency problem and has found acceptable solutions. First of all, the market value of securities which are vulnerable to abuse by majority shareholders will decline in relation to protected securities to reflect this risk. This will contribute to reduce the overall financial value of the firm and to increase the cost of raising new capital. In order to avoid those costs, issuers will have to alleviate the fear of potential investors by offering some guarantees in the form, for example, of restrictive covenants on bonds and preferred shares. If we trust the market to solve the agency problem in these cases, why can we not trust it to solve it in the case of restrictive shares? Indeed, there are good reasons to expect the agency problem to be no worse in the case of restricted shares than in the case of other securities since, in most instances, actions which benefit common shares will benefit as well the holders of restricted shares.

Any mandatory regulatory solution to the agency problem is unnecessary if, as argued above, the market understands fully the risks to which holders of restricted shares are exposed and reflect them in the price of these shares. This applies, in particular, to the coat tail provisions and the requirements for minority approval of capital reorganizations proposed in the

discussion paper. These measures are also likely to be too rigid and may even be harmful since they are unlikely to be suitable in all market situations. By forcing investors and issuers to abide by pre-established rules, they may indeed prevent the full exploitation by the market of the particular advantages of restricted shares.

Restricted Shares and Takeover Activities

An issue of particular importance, in this regard, is the incidence of the use of restricted shares on takeover activities. In general, such takeovers should not be discouraged since they represent a major mechanism by which resources are efficiently allocated and bad management disciplined. In the absence of any evidence to the contrary, I suspect that restrictive shares (without coat tail provisions) may - by reducing their cost - facilitate at least some takeovers. In other instances, the use of restricted shares may enable controlling interests to fend off unwanted takeover bids. However, it is important to note that the controlling interest usually has other means, including the use of preferred shares, to prevent dilution of control if they so desire. Consequently, restrictive shares should not be singled out in this regard.

The use of restricted shares is unlikely to affect the overall level of takeover activities at any point in time. This level is largely determined by the need to correct inefficiencies in the allocation of resources. The use of restricted shares may however affect the nature of the takeovers. By reducing the cost of takeovers and enhancing the position of the controlling interest, they could on balance contribute to increase the relative occurrence of "friendly" takeovers (i.e., takeovers where the controlling interest is bought off) and reduce the relative occurrence of "hostile" takeovers (takeovers where the controlling interest loses control unwillingly).

To the extent that the use of restricted shares may make some firms immune to "hostile" takeovers, they may contribute to entrench the position of majority shareholders. However, poor management will still be penalized in this case by reduction in the financial value of the company. In such a situation a "friendly" bidder may be able to make an offer which the majority shareholders may find hard to turn down. In addition, so long as competition prevails in the market for the goods and services the firm sells, traditional market forces will discipline inefficient management. Consequently, the contention that restricted shares adversely affect takeover activities and the allocative efficiency of the market is unwarranted.

In situations where takeovers do result in an improved allocation of real resources, this improvement in efficiency creates an economic rent which is normally reflected in the increase in the financial value of the company. Mandatory "coat tail" provisions will affect the distribution of the economic rent between the buyer, the majority shareholder and restricted shareholders. By making the takeover more costly to the bidder it may indeed discourage change of ownership which may be desirable from an efficiency point of view.

Restricted Shares and Corporate Concentration

In your letter you have mentioned the possible effect of restricted shares on corporate concentration. Available information, indicates clearly that the link between restricted shares and high concentration is tenuous at best. Restricted shares, like other capital market instruments, and along with internally generated funds, contribute to the financing of corporate growth. Such growth may result in high concentration. Where it does, such large size may be desirable. Where high concentration is associated with undesirable conduct, the solution lies, in the first instance in dealing with the abuse of market position, and from a broader public policy perspective, in treating the motivation that leads to unnecessarily large size. In this regard, the appropriate policy instrument is the Combines Investigation Act, not securities legislation.

Suggestions for Future Work

Many of the problems addressed above and in your position paper are largely hypothetical at this stage. In this connection empirical research would be useful to first ascertain whether there is evidence that the market valuation of voting and restrictive shares systematically reflects the presence or absence of coat tail provisions, dividends or winding up preferences and the like. The results of such analysis will shed light on the extent to which concerns expressed in regards to restrictive shares are warranted.

It would also be useful to find out why the use of restricted shares has become more widespread. To what extent, for example, are incentives or restrictions related to foreign ownership serving as a catalyst? To what extent is the high dividend yield now required on preferred shares discouraging their use because of high real interest costs? The answer to these questions must be better understood before one can determine if the recent upsurge of restricted shares is a transitory or more permanent phenomenon.

An analysis of the nature of the dividend and other preferences that are typically accorded to restricted shares also merits investigation. A more detailed analysis of the alleged cases of "abuse" (or potential for "abuse") of owners of restricted shares should also prove revealing. Additional questions include the adequacy - or lack thereof - of existing judicial remedies, and whether "informed" investors (e.g., institutional investors) are also deemed to be at risk. "Abuse" would of course need to be defined very carefully to reflect an unfavourable outcome (from the point of view of the "abused" investor) which could not reasonably be expected at the time of the original purchase of the shares and which results from the deliberate action of the owner of the controlling interest in the firm. The frequency of documented cases of abuse would then have to be compared with the frequency of such occurrence in the use of other financial instruments to ascertain whether special regulatory treatment of restricted shares is warranted, taking into consideration existing judicial remedies.

Conclusions and Recommendations

The main message I would like to leave with you in concluding this letter is that, in the absence of empirical evidence to the contrary, there is no good basis for treating, from a regulatory perspective, restricted shares differently than any other financial instrument. Indeed, there is a strong presumption, based on a priori reasoning, that the Commission's proposed policy changes may be unwarranted and could be harmful and contrary to its stated objective of promoting efficiency in capital markets. Consequently, my advice to you would be to refrain from any major policy change before an informed decision can be made on the basis of relevant empirical information.

As has been indicated in this letter, the areas where such empirical information is particularly required are:

- (a) The extent to which the differential values of restricted and common shares are systematically related to factors such as the presence or absence of coat-tail provisions, dividend or winding-up preferences, improved liquidity and so forth, to determine if there is any evidence that the market fails to understand the attributes of restricted shares.
- (b) The reasons why firms have chosen to issue restricted shares, including non-resident ownership concerns and the present high costs of issuing preferred shares; the extent to which the recent upsurge in the use of restricted shares is likely to be transitory or permanent.
- (c) The question of whether restricted shares promote or impede the takeover mechanisms, with implications for concentration and the market for corporate control.
- (d) The nature and significance of actual or potential abuse of restrictive shareholder interests and identification of changes in securities and corporate legislation that may be required.

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