Chapter 6

Mergers and Acquisitions

The subject of corporate mergers and acquisitions is obviously relevant to the task of this Commission, and indeed to any consideration of the process of corporate growth and concentration. As a result, it has been the subject of considerable research by the Commission. Our interest does not, however, imply that we consider mergers and acquisitions to be exceptional phenomena but rather that they are an integral and normal part of commercial life. In this chapter we discuss only their economic and legal aspects. The social influence of the resulting large corporate groups is dealt with later in this *Report*.

Mergers and acquisitions tend to be discussed under different names depending on the context of the discussion. In law, the name varies with the form of the transaction: takeover bid, purchase of shares, amalgamation, purchase of assets, or reorganization. In accounting, the usual term is a "business combination", while in economics the term "merger" refers to an amalgamation between firms, and "acquisition" generally refers to a takeover of one firm by another. Since these terms encompass the same general concept, any transaction as a result of which (1) two firms amalgamate into a third one either by an agreement or a reorganization defined in statutes, (2) the assets of a firm or a substantial part thereof are transferred to another firm, or (3) the voting control of a corporation is transferred to another one, will, throughout our discussion, be referred to as either a merger or acquisition.

Legal Aspects of Mergers

The concern of the law with the different methods of acquisition is based, in part, on their potential effect on the interests of minority shareholders, protection of whom is germane to our mandate. Minority shareholders enhance the liquidity and marketability of corporate shares, contribute to the vitality of secondary markets and are necessary to the financing of most public corporations. For these reasons, we consider that in a merger it is important that

minority shareholders be well informed and have a mechanism by which to participate in decisions.

There are three basic methods of effecting a merger or an acquisition:

1. by an amalgamation under the corporations acts of Canada or one of the provinces, the effect of which is to continue the merging corporations as a single new one having all the property and rights and subject to all the liabilities of the previous ones;
2. by one corporation purchasing a substantial part of the assets of another for cash or securities, following which the vendor corporation may be wound up and the consideration received distributed to its shareholders;
3. by one corporation purchasing the shares of another either by private agreement or in a takeover bid or sometimes both.

The form of the transaction is generally not determined by corporate constraints (votes required, number of meetings, approvals, etc.) but by considerations related to the state of capital markets or taxation implications (the latter are discussed in a background report commissioned by us from Stikeman, Elliott, Tamaki, Mercier & Robb, *Corporate Concentration and the Canadian Tax System*). In an amalgamation, a purchase of assets and a private agreement to purchase shares, the rules under which the transaction takes place are usually found in the statute under which the corporation has been created and the civil law of the province where the contract is made. In takeover bids, additional applicable provisions are found in the securities legislation of most of the provinces and, if the target corporation is a federal one, in the Canada Business Corporations Act.

Amalgamation

All the corporation statutes in Canada provide that any two or more corporations may amalgamate. The corporations enter into an agreement under which a new corporation emerges with a legal identity separate from the preceding ones. The agreement usually specifies the name of the proposed new corporation, its directors, share capital, the terms of the exchange of the shares of the previous corporations for shares of the new one, the bylaws, and so on. It is not effective until it has been approved by a certain majority of the shareholders of the amalgamating corporations. This majority may vary from two-thirds to three-quarters depending on the jurisdiction. Under some statutes (the federal one, for example) approval of every class of shareholder is needed. If the amalgamation changes the rights or priorities of a class of shares of one of the former corporations, the agreement must be approved by the holders of that class of shares.

One difficulty facing corporations that contemplate amalgamating is the fact that no corporation statute in Canada allows for the amalgamation of a corporation created under it with a corporation created under a different statute (e.g., a Quebec corporation with a federal one). The federal act and

some provincial statutes do provide, however, that a corporation constituted in one jurisdiction may apply to be continued in another. Through the use of these provisions an amalgamation is possible between firms in different jurisdictions. For example, an Ontario corporation could emigrate to the federal jurisdiction or a federal corporation could apply for a certificate continuing it under the Ontario act. Afterwards, as both corporations would be under the same act, the amalgamation could proceed. This procedure is based on reciprocal legislation which exists in Ontario, Manitoba, Alberta, Saskatchewan, New Brunswick and British Columbia, and in the Canada Business Corporations Act.

Takeover Bids

Takeover bids are the most dramatic form of acquisition, as illustrated by the terms employed: the acquired company is known as the target corporation; when the bid comes as a complete surprise to the management of the offeree company, it may become known as "raid". Takeover bids are most often used when a prospective purchaser seeks to acquire a controlling interest from a large number of small shareholders. In the typical case, the target company's shares are listed on a stock exchange, and the bidder offers to purchase from all holders at a stated price. Managers of corporations with many small, unrelated shareholder interests thus often fear takeover bids.

Takeovers provide the greatest source of concern about minority shareholder protection. The Commission thinks that so long as takeover legislation ensures that shareholders receive full and timely information and have a reasonable time to consider it, takeover bids encourage vitality and competition in the management of public corporations. The possibility of a takeover partly replaces shareholders' supervision and surveillance, which are often lacking.

The securities laws of Quebec, Ontario, Manitoba, Saskatchewan, Alberta and British Columbia regulate takeover bids addressed to shareholders residing in their jurisdictions. If the target corporation is federally incorporated, the takeover bid must also comply with the federal act. In most legislation a takeover bid is defined as an offer to purchase voting shares of a corporation, which together with the voting shares owned by the purchaser will, in the aggregate, exceed 20% of the outstanding voting shares of the target corporation (in several jurisdictions the figure is 10%).

Some offers are excluded from the application of the acts:

1. an offer to purchase shares by way of private agreement with fewer than 15 shareholders and which is not extended to shareholders in general;
2. an offer to be executed through a stock exchange or in the over-the-counter market;
3. an offer to purchase shares of a private company; or
4. an offer exempted by a court or the administrator of the act.

A Premium for Control Under a Private Agreement

The acquisition of control by way of private agreement with a small group of shareholders is a common occurrence, and the offer will be exempt from statutory takeover bid provisions when there are fewer than 15 solicited shareholders. For example, had Power Corporation of Canada, Limited, been able to bid for and acquire the shares of Argus Corporation Limited held by The Ravelston Corporation Limited, no public offer to the other shareholders of Argus would have been necessary, and no statutory provisions would have applied.

Often such an agreement for the acquisition of effective control of a corporation precedes a takeover bid for the remaining shares. Sometimes the price offered for the controlling shares will exceed the purchase price offered to the minority shareholders because control commands a premium. If the purchaser wants only effective control he may not make a full offer, or any offer at all, to the other shareholders. If an offer is made to them, the remaining shareholders have the choice of retaining their shares or selling them at a lower price than that paid for the controlling shares. These practices have been attacked as unfair and discriminatory.

Canadian statute law does not prohibit a control premium in a private agreement. In the United States there are no statutory provisions concerning control premiums, but courts sometimes intervene in favor of minority shareholders. The City Code, which governs takeover bids in Great Britain, requires a general offer to be made to all shareholders at the same price. Under the City Code the same requirements apply when control is acquired in a "creeping takeover" when control is bought gradually.

Concern has been expressed about the fact that a share worth one price, if it is sold by a minority shareholder, can be worth a higher price if it is sold as part of a block of shares carrying control of the corporation. Some argue that each share in a company is the same as every other share of the same class and should command the same price in a sale. The risks and burdens of corporate ownership are not always equal on a per share basis, however. Owners of controlling equity interests in corporations assume greater liquidity risks than do minority shareholders, particularly in thinly traded issues. No proposals have been made to share "blockage discounts" with minority holders. A law forcing the acquirer to make the same offer to all shareholders may reduce the number of potential buyers and the price paid for the controlling shares. It could also decrease the motivation of entrepreneurs who see the prospect of a premium for their controlling shares as a strong incentive to assume the risks of starting a business. Thus an obligation to make a general offer raises a possibility that many privately (as well as socially) beneficial reallocations of corporate equity may be thwarted.

A control premium becomes questionable if it represents the price a purchaser is prepared to pay for the opportunity to take unlawful advantage of

minority shareholders. For example, sellers of control may attempt to take all or part of a control premium in the form of an excessively favorable employment contract from the new controller or in some other "side benefit". However, the courts in the United States have been able to characterize such conduct as wrongs to the corporation or its other shareholders and to order payment to it, or them, of the benefits improperly received by the seller.

To the extent that the law provides remedies to minority shareholders against directors and others who abuse their authority, the improper component of a control premium will be minimal. We think that, for the most part, the law is already adequate to deal with whatever harm can arise out of transfers of controlling interests in corporations. More effective examination and disclosure of transactions between corporations and their directors and other insiders (such as we propose in Chapter 13) would supplement existing legal remedies significantly. For these reasons we are unwilling to endorse the idea (contemplated in Ontario) that purchasers of shares should be required either not to pay a control premium or to pay it even to those who do not have a controlling interest to sell.

Trading by Insiders

One of the preoccupations of the securities administrators has been the fact that the management and controlling interests of a corporation have access to confidential information that could be used to the detriment of the minority shareholders in connection with a trade in securities. Accordingly, directors, senior officers and those controlling over 10% of a corporation are required to report trading to the appropriate securities commission, which in turn makes the information public. Provisions have been enacted to penalize insiders who make use of pertinent confidential information to trade in securities.

Suggestions have been made that present measures are too narrow in application and too limited in scope and do not remove the possibility of abuse of minority shareholders. In our opinion there is no need for new legislation if the present requirements for timely disclosure of material facts are followed and enforced.

Takeover bids raise a special set of issues. If, for instance, an offer is for less than 10% of the voting shares, the insiders of the offerer are not considered to be insiders of the target corporation. Conversely, if there have been negotiations between the offerer and the shareholders of the target corporation, the insiders of the target corporation are not insiders of the offerer. To treat these conflicts of interest along the lines of insider liabilities, the federal act contains provisions under which the liability extends to the directors and officers of each corporation during the six months preceding the date on which a corporation acquires the shares of another. The Commission thinks that such safeguards are consistent with the rationale of insider trading provisions and that they should be available to all Canadian shareholders and incorporated in all provincial statutes.

Statistics on Mergers

Number of Mergers

The principal source of information on Canadian mergers is a study relating to the years 1945-61, which employed a questionnaire survey conducted under the Combines Investigation Act. It covered all companies subject to that Act that were known or thought to have acquired other companies. These data were analyzed by Grant L. Reuber and Frank Roseman in a study published by the Economic Council of Canada in 1969 (*The Take-Over of Canadian Firms, 1945-61: An Empirical Analysis*). Subsequent data have been collected by what is now the Bureau of Competition Policy of the Department of Consumer and Corporate Affairs. These data are compiled from published sources, principally financial newspapers and magazines in Canada. As a consequence, it is likely that unpublicized mergers are often unnoticed. These are most likely to be mergers involving small companies. On the other hand, premature reporting of merger transactions may lead to the inclusion of some acquisitions that were never, in fact, consummated. On balance, the data collection process for merger activity probably understates the number of mergers in Canada. These data have been analyzed by the research staff of this Commission. In addition, Samuel Martin, Stanley Laiken and Douglas Haslam in a study for the Canadian Institute of Chartered Accountants undertook a detailed analysis of mergers entered into by companies listed on the Toronto Stock Exchange during the years 1960-68. Their study focused primarily on the accounting and financial aspects of mergers. A related study by Laiken, which appeared in the *Antitrust Bulletin* in 1973, evaluated the financial performances of merging and non-merging companies in Canada over the period 1960-68.

The Commission's focus on merger activity in Canada after 1945 is dictated, in part, by the fact that most of the available data are for this period. In addition, conglomerate mergers, which constitute an important part of the Commission's inquiries, are primarily post-World War II phenomena. Our analysis concentrates on the number of mergers, although alternative measures of merger activity, such as the value of total assets acquired, are also relevant. Unfortunately, consistent data on measures of merger activity other than number of mergers are unavailable for the period not covered by Reuber and Roseman.

There have been distinct cycles in merger activity in Canada since 1945 (Table 6.1, Figure 6.1). The periods of relatively high activity were immediately after the war in 1945 and 1946, the boom years 1955 and 1956, the recession years 1959 to 1961, and the years 1968 to 1972, which include the final phases of the boom of the late 1960s and the recession and bear-market period of the early 1970s. The percentage of mergers that were acquisitions of Canadian businesses by foreign-controlled companies fluctuated between about 20% and 45%, being generally higher during the 1954-62 period than in the earlier or later periods. The number of mergers each year has been only a small percentage of the total number of Canadian companies. We note, however, that the number of mergers reported in Table 6.1 exclude acquisitions of service

Table 6.1

Summary* of Canadian Mergers, 1945-74

Year	Total Number of Active** Domestic Companies	Mergers			Foreign Acquisitions	
		Number	As a Percentage of Active Domestic Companies	Number of Domestic Acquisitions	Number	As a Percentage of All Mergers
1945	27,229	74	0.27	51	23	31.1
1946	30,442	79	0.26	64	15	19.0
1947	34,087	45	0.13	32	13	28.9
1948	35,960	53	0.15	39	14	26.4
1949	37,467	38	0.10	27	11	28.9
1950	40,545	45	0.11	36	9	20.0
1951	43,365	80	0.18	61	19	23.8
1952	45,777	76	0.17	59	17	22.4
1953	49,745	93	0.19	68	25	26.9
1954	54,434	104	0.19	61	43	41.3
1955	59,773	134	0.22	78	56	41.8
1956	67,480	135	0.20	81	54	40.0
1957	73,823	103	0.14	68	35	34.0
1958	80,770	140	0.17	80	60	42.9
1959	88,806	186	0.21	120	66	35.5
1960	97,549	203	0.21	110	93	45.8
1961	106,309	238	0.22	148	86	36.8
1962	115,082	185	0.16	106	79	42.7
1963	118,597	129	0.11	88	41	31.8
1964	126,813	204	0.16	124	80	39.2
1965	152,818	235	0.15	157	78	33.2
1966	164,410	203	0.12	123	80	39.4
1967	176,210	228	0.13	143	85	37.3
1968	185,816	402	0.22	239	163	40.5
1969	199,994	504	0.25	336	168	33.3
1970	212,192	427	0.20	265	162	37.9
1971	228,458	388	0.17	245	143	36.9
1972	236,431	429	0.18	302	127	29.6
1973	258,501	352	0.14	252	100	28.4
1974	276,157P	296	0.10	218	78	26.4

Sources: All data for 1945-61: G.L. Reuber and Roseman, *The Take-Over of Canadian Firms, 1945-61: An Empirical Analysis* (Ottawa, 1969), Table 3.1. Data for all other years: *Combines Investigation Report* (1976); *Corporation Taxation Statistics* (1974).

Notes: * – The merger data reported in the table do not include all mergers undertaken in Canada. Most notably, they exclude mergers among companies in service businesses, which are not covered under the provisions of the Combines Investigation Act. As a result, the percentage that total mergers represent of the total number of companies in each year is less than the percentage that would be obtained if all mergers in Canada had been reported. Furthermore, the divergence between the two percentages is probably larger for the later years, because of the relatively faster growth of the service sector since 1945.

** – Excludes Crown corporations, cooperatives and personal corporations.

P – Indicates projected value based on continuation of average annual growth rate from 1970 to 1973.

businesses. Such mergers are not included in the records compiled by the Bureau of Competition Policy, and clearly would increase the merger intensity ratios if they were included in the total number of Canadian mergers.

Canadian and U.S. merger cycles have been quite similar (Figure 6.1). One apparent difference is that the high level of merger activity reached in the late 1960s relative to base year 1955 was sustained longer in Canada than in the United States and has declined relatively less in the early 1970s. Of course, the absolute number of mergers in the United States has been consistently higher than that in Canada over the postwar period.

The broad similarity in overall merger patterns suggests that a common set of factors has influenced the pace of merger activity in the two countries.

Reuber and Roseman in their study of Canadian mergers concluded that for the 1945-61 period:

> Our "best" estimate in some respects is that variations in foreign mergers in Canada [i.e. Canadian firms coming under foreign control] can be explained by variations in the number of mergers in the United States, the number of commercial failures in Canada and the supply of internally generated funds in Canada's corporate sector. In effect, this can be interpreted as saying that foreign mergers in Canada are governed by the same factors governing domestic mergers in the United States, conditioned by the level of activity in Canada and Canadian credit conditions.
>
> Variations in the number of domestic mergers in Canada, according to our evidence, can best be explained by variations in stock market prices in Canada, reflecting business expectations, and internally generated funds in Canada's corporate sector, reflecting Canadian credit conditions.

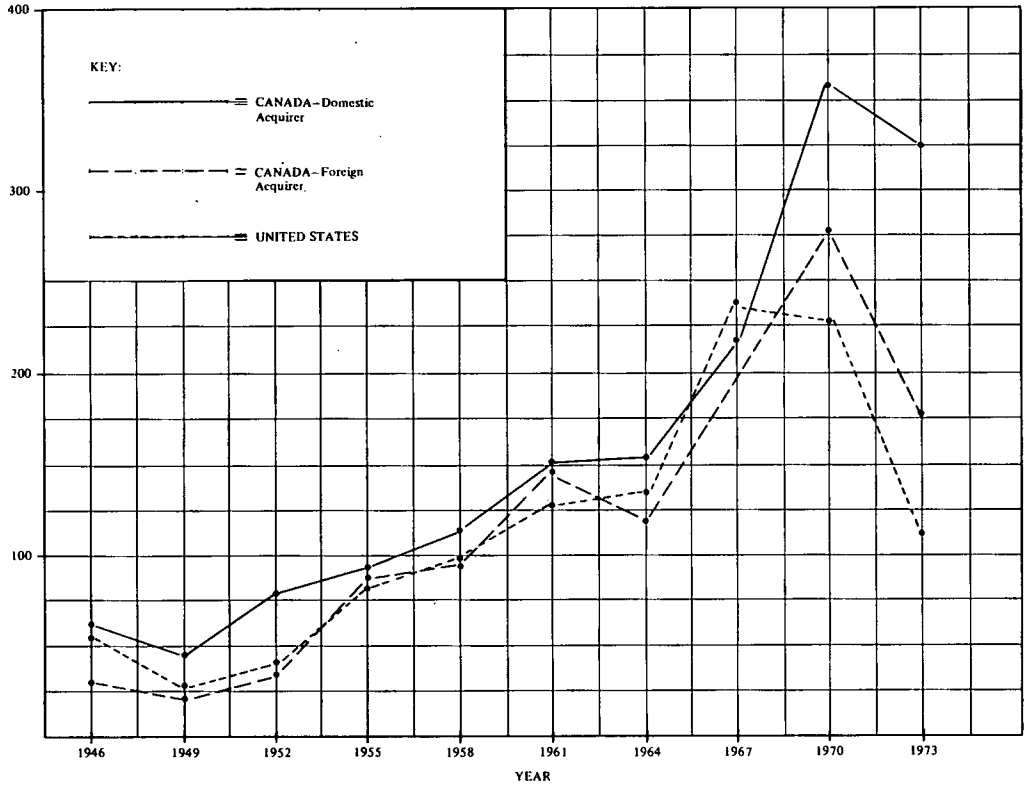

FIGURE 6.1: Variations in the Number of Mergers, Canada and the United States, 1945-74 (Three-Year Moving Average Index, 1955 = 100).

Sources: Canada: Table 6.1.
United States: 1945-70, *U.S. Historical Statistics* (1975); 1971-74.
U.S. Department of Commerce, *Statistical Abstract of the U.S.* (1976).

Commission staff found that over the entire period 1947-74, the rates of change in the number of mergers in Canada and in the United States were directly and significantly related to the rates of change in Canadian and U.S. stock prices respectively. However, the relationship between changes in merger activity and stock price changes, while still positive, was statistically insignificant for Canada during the subperiod 1947-63 and was statistically insignificant for the United States during the subperiod 1964-74. Furthermore, the overall level of real economic activity, as measured by the rate of change in industrial production, was not significantly related to merger activity in either subperiod for Canada, and was significantly (and directly) related to U.S. merger activity only for the 1947-63 subperiod.

While our results appear to differ from the findings of Reuber and Roseman, our statistical model was not identical with theirs and hence the results are not strictly comparable. It is worth noting that Christopher Maule, in an unpublished doctoral thesis, concludes that, while cyclical movement in Canadian merger activity was similar to the cyclical behavior of stock prices during the period 1948-63, after 1959 the relationship was, if anything, inverse. He further concludes, on the basis of earlier work on Canadian mergers done by J. C. Weldon, that Canadian mergers and stock prices do not show any consistent relationship with each other over the period 1900-63. Maule also found that the cyclical relationship between merger activity and industrial production is weakly inverse when both stock prices and industrial production are employed simultaneously to explain Canadian merger patterns.

The Commission concludes that, while capital market conditions are related to aggregate merger patterns in North America for specific periods after 1945, the relationship is not uniform. Furthermore, capital market conditions do not provide a satisfactory explanation of the broad similarity in merger activity patterns in Canada and the United States since 1945; nor do overall economic conditions in the two countries explain the broadly similar merger experiences of the two countries. A complete understanding of the merger process requires more than consideration of macroeconomic conditions.

Distribution of Mergers among Industries

The Commission analyzed Canadian data for 17 broad manufacturing industry groups. The distribution of acquisition activity over time and across manufacturing industries, as depicted in Table 6.2, was tested for similarity between Canada and the United States. Potential difficulties in such a comparison are introduced by the possibility that differences in the relative sizes of the various industries in the two countries will contribute to observed differences in merger intensities. Furthermore, the time periods for the Canadian and U.S. data are not identical. Comparisons of the data in Table 6.2 must, therefore, be treated with caution. The 17 industries were ranked in order of relative merger intensity, and the rank orders for the Canadian and U.S. series were compared. Statistical tests show that the rank orders for the series are quite similar, lending some support to the general conclusion that the distribution of merger activity across manufacturing industries has been quite comparable in Canada and the United States.

Table 6.2

Distribution of Manufacturing Companies Acquired by Industry of Acquired Firm, United States and Canada, Ranked by Percentage of Acquisitions

Percentage of Acquisitions in Manufacturing

United States			Canada		
Industry	1948-68	1973	Industry	1945-61	1973
1. Machinery	13.2	12.7	1. Food	26.3	8.5
2. Food	8.7	15.0	2. Paper	8.2	3.9
3. Chemicals	8.5	11.0	3. Chemicals	7.9	15.5
4. Electrical machinery	7.6	14.6	4. Fabricated metals	7.8	12.4
5. Paper	7.1	4.6	5. Printing	6.9	13.2
6. Primary metals	6.8	4.9	6. Non-metallic minerals	5.9	10.4
7. Fabricated metals	6.7	7.2	7. Electrical products	5.2	6.4
8. Textiles	5.9	3.6	8. Wood	5.1	6.2
9. Transportation equipment	5.7	7.9	9. Machinery	3.7	4.7
10. Non-metallic minerals	4.3	4.5	10. Textiles	3.5	2.4
11. Petroleum	4.2	1.7	11. Transportation equipment	3.2	3.8
12. Printing	3.1	3.8	12. Leather	3.1	0.1
13. Wood	2.6	3.1	13. Primary metals	2.5	2.3
14. Rubber	1.9	2.7	14. Petroleum	1.6	1.6
15. Furniture	1.0	1.3	15. Rubber	1.1	0.0
16. Leather	0.9	0.8	16. Furniture	0.9	7.0
17. Tobacco	0.4	0.5	17. Tobacco	0.4	0.8

Sources: Canada: for the years 1945-61, the data were derived from Tables 4-8 and A-7 of Reuber and Roseman, *op. cit.*; for 1973, Royal Commission on Corporate Concentration (RCCC) analysis of the Department of Consumer and Corporate Affairs' record of mergers.

U.S.: for the 1948-68 data, Table 1.7 of the Federal Trade Commission, *Economic Report on Corporate Mergers* (Washington, 1969); for the 1973 data, *ibid.*, *Statistical Report on Mergers and Acquisitions* (July 1974).

Note: The Spearman rank correlation coefficient for the U.S. (1948-68) and Canadian (1945-61) series is 0.67.

To investigate merger activity in Canadian manufacturing industries further, we made a statistical analysis paralleling that used for U.S. mergers and reported by Michael Gort in a 1969 article in the *Quarterly Journal of Economics*. Inter-industry differences in merger activity (measured by acquired firms as a percentage of the total number of firms, Table 6.3) were related to sectoral concentration ratios and other explanatory variables for 17 industry groups. The results indicated, among other things, that merger intensity in an industry is directly related to concentration in an industry, employment growth in an industry and growth in the average firm size in the industry. The relationship between merger rates and growth in the number of firms in the industry is inverse.

The finding that merger intensity is directly related to growth in average firm size in Canada is consistent with the notion that mergers, at least in part, are undertaken to secure real and/or pecuniary economies of scale. Further evidence is provided by the observation that mergers are undertaken relatively

Table 6.3

Merger Activity in Canadian Manufacturing Industries, 1945-61 and 1972-73

	Acquired Firms as a Percentage of Total Number of Firms		
Industry	1945-61	1972	1973
1. Food and beverages	0.88	1.27	0.37
2. Tobacco	0.85	0.00	4.76
3. Rubber	1.03	0.00	0.00
4. Leather	0.42	1.13	0.56
5. Textiles	0.40	1.31	0.29
6. Knitting mills	0.31	0.00	0.00
7. Clothing	0.07	0.23	0.58
8. Wood	0.22	0.61	0.44
9. Furniture	0.11	0.79	0.89
10. Paper	1.24	0.42	1.06
11. Printing, etc.	0.30	0.50	0.60
12. Machinery	0.26	2.16	0.65
13. Transport equipment	0.52	1.86	0.62
14. Electrical products	0.84	1.60	1.16
15. Non-metallic mineral products	0.59	0.71	1.32
16. Petroleum and coal products	1.58	4.00	4.00
17. Chemicals	0.51	2.19	2.19

Sources: Number of acquired firms: 1945-61, Reuber and Roseman, *op cit.*, Table 4A-3; 1972 and 1973, RCCC analysis of Department of Consumer and Corporate Affairs' record of mergers.

Total number of firms: *Corporation Taxation Statistics.*

more frequently in industries having above-average ratios of salaried employees to total employees. The latter ratio might be taken as a crude proxy measure of the "managerial intensity" of an industry. Many people have suggested that managers are scarce in Canada; hence firms could be expected to try to economize on managerial talent by taking advantage of available economies of scale in managerial functions. It should be acknowledged, however, that concentrated merger activity in managerially intensive industries is also consistent with the argument that mergers are undertaken to fulfill managerial objectives for firm growth.

It is difficult to place an unambiguous interpretation on the finding that merger intensity is directly related to concentration. This observation is consistent with the hypothesis that mergers are undertaken by firms in concentrated industries to acquire more market power, by both increasing their market shares and absorbing smaller firms that may have posed a threat to parallel pricing behavior in the industry. However, industry concentration may be an indirect measure of the firm-level economies of scale in an industry as well as an imperfect measure of market power. Therefore, since the empirical variables used in the research described above provide rather crude tests of the underlying theoretical relationships, interpretations of the statistical results must be tentative.

Distribution of Mergers by Type

In addition to looking at mergers in general, we also analyzed the mergers in Canada by type: horizontal, vertical and conglomerate (Table 6.4). Horizontal mergers are essentially those between businesses competing in the same industry. Vertical mergers are those between actual or potential customers and suppliers in the same industry. Conglomerate mergers are those between businesses in different industries. Horizontal mergers can be further divided to show those which involve an extension of the business after the merger into a different geographic area or into a different product within the same general industry.

Canadian data for the years 1972, 1973 and 1974 were compiled by Commission staff from information in the Department of Consumer and Corporate Affairs' record of mergers. The classification of mergers by type for those years relied for the most part on the description of merging companies in that record. If companies were producing the same or related products or services the merger was classified as horizontal. If the companies were linked by different stages in a common production process, the merger was classified as vertical. All mergers involving largely unrelated production processes or acquisitions by a holding company were classified as conglomerate. Given the imprecisions in our classification procedure, we did not attempt to distinguish different categories of broad horizontal mergers in the years 1972-74. Furthermore, the U.S. distributions are based upon large acquisitions in manufacturing and mining, while the Canadian distributions are based upon all recorded industrial mergers. Once again, comparisons must be taken to indicate general rather than exact relationships.

Table 6.4

Percentage Distribution of Types of Mergers, Canada and the United States

Country	Type of Merger	Percentage of Total Mergers 1945-61		1972	1973	1974
Canada	Broad horizontal	68.25		68.9	68.9	67.7
	Horizontal		40.23			
	Geographic market extension		12.71			
	Product extension		9.71			
	Other		5.60			
	Vertical	22.43		12.3	12.5	9.2
	Conglomerate	9.31		18.8	18.6	23.1
United States		1948-63				
	Broad horizontal	67.02		58.6	56.2	62.9
	Horizontal		23.21			
	Geographic market extension		5.64			
	Product extension		38.17			
	Vertical	19.89		17.2	11.0	4.8
	Conglomerate	12.74		24.1	32.8	32.3

Sources: Canada: 1945-61, calculations by the staff of the Commission from Table 5-3 of Reuber and Roseman, *op. cit.*, 1972, 1973 and 1973, RCCC analysis of the Department of Consumer and Corporate Affairs' record of mergers.
U.S.: 1948-68, Federal Trade Commission, *op. cit.* (1969), p. 673; 1973 and 1974, *ibid., Statistical Report on Mergers and Acquisitions* (1974).

The data show that about 68% of Canadian mergers have been of the horizontal type, both in the 1945-61 period and in recent years. In the United States, about the same proportion were horizontal in the 1948-63 period, but less so in recent years, with a substantially higher percentage of conglomerate mergers. Our classification of U.S. merger activity has been made comparable with the Canadian classifications. As a result, product extension and market extension acquisitions in the United States have been classed as horizontal mergers, whereas the U.S. Federal Trade Commission includes such acquisitions within a broader conglomerate category. In Canada the proportion of conglomerate mergers in recent years was about double the 9% that they formed in the 1945-61 period and half again as high as the 12% reported by Martin, Laiken and Haslam for the period 1960-68, but it was still significantly short of the proportion of conglomerate mergers in the United States in recent years. Similarity in the distribution of mergers by type between Canada and the United States further supports the conclusion that broadly similar factors have influenced merger patterns in the two countries.

Characteristics of Merging Firms

The size of Canadian firms acquired was studied in detail by Reuber and Roseman for the 1945-61 period, and by Statistics Canada for 1970 and 1971. It is more difficult to determine the size of an acquiring firm when it is foreign-owned. However, it is generally true that the acquiring firm is substantially larger than the firm acquired. Over the period 1945-61 as well as in the years 1970 and 1971, acquiring firms were consistently larger than acquired firms (Table 6.5).

Perhaps more surprising is that the firms acquired are usually as profitable as the firms acquiring them, although the detailed study of the 1945-61 mergers showed that a much higher proportion of the acquired firms had suffered losses. The study of 1970 and 1971 mergers showed more mixed rates of profitability, on average not differing much between acquired and acquiring firms.

Similarities in merger patterns between Canada and the United States and, in particular, the fact that merger-intensive industries tend to be the same in the two countries suggest that the underlying motives for merger activity may relate strongly to market structures and production conditions for individual industries in the two countries. More specifically, Canadian and U.S. industries tend to have similar if not identical characteristics: highly concentrated industries in Canada tend to be highly concentrated in the United States; high-technology industries in Canada are also high-technology in the United States. Similar demand conditions imply that faster growing industries in the two countries will tend to be the same. In short, the marked similarity in Canadian and U.S. merger patterns could have an explanation in common microeconomic characteristics of industrial organization and performance in the two countries.

Economics of Mergers

Motives for Merging: Theory and Evidence

The Commission received considerable information concerning mergers in the briefs submitted to it, in testimony at its public hearings and in its own studies. This material identifies numerous motives for merging, both on the part of companies acquiring control of other companies and on the part of those willing, and often seeking, to sell control of their companies. We note at the outset that a large percentage of mergers may not, in fact, live up to the expectations of the acquiring companies. Furthermore, we should not expect to find pursuit of enhanced market power cited in the public record as a merger motive. Nevertheless, the possible importance of such a motive in specific mergers must be considered in evaluating alternative policies toward mergers.

The motives of the acquiring companies or, strictly speaking, those who control them, are varied and frequently mixed. We cannot always be sure that stated motives are true motives, and we list cautiously the stated motives. Readers should note that some of the motives brought to the Commission's attention are closely related and that several motives on both buyers' and sellers' sides may be involved in any one merger transaction.

Table 6.5

Relative Size and Profitability of Acquired to Acquiring Firms before Merger, Canada, 1945-61 and 1970-71

	Average Assets		Average Sales		Profit Rate	
	Acquired	Acquiring	Acquired	Acquiring	Acquired	Acquiring
	(Millions of Dollars)		(Millions of Dollars)		(Percentage)	
1945-61	3.46	45.65	4.24	53.54		
1970	4.72	37.57	2.39	25.95	4.74	7.07
1971	3.45	91.97	3.04	40.73	5.97	4.77

Sources: Average assets and average sales, 1945-61, calculated from Reuber and Roseman, *op. cit.*, Tables 4.3, 4.4; profit rates, 1945-61, calculated from *ibid.*, Table 4.11: other calculations based on data from "Pilot Project on Statistics of Corporate Takeovers in the Canadian Economy", *Canadian Statistical Review* (Feb. 1976).

MOTIVES TO ACQUIRE

The simplest motive for acquisition is that of a holding company, or less frequently an active operating company with cash or credit to spare, which finds, or is presented with, what it considers on examination to be an attractive investment at a reasonable price. The company to be acquired may be in a business quite unrelated to that of the buyer, or it may have related production and marketing activities that make it attractive. We have encountered several instances of quick acquisition decisions apparently not part of a preconceived plan in which favorable price or prospects appeared to be the buyer's main motive.

More complex are the motives of a group that sets out to rationalize an industry, as has happened in Canada on several occasions. An acquirer may set out to achieve various economies of size or scale, or may desire to establish or extend market power. Such cases have potentially significant economic consequences and their impact may require careful appraisal to determine whether they are beneficial or harmful to the public interest. An example of a series of mergers undertaken apparently to achieve operating economies occurred when Voyageur Inc. acquired several small carriers.

Less complex but also of potential economic importance is the motive of a group (or company) that wishes to enter an industry or to expand in it, and which finds that acquiring control of an existing company is cheaper or quicker than assembling its own facilities. This is a common phenomenon in a depressed securities market, where many firms have a market value well below their asset value. The acquisition by Abitibi Paper Company Ltd. of control of The Price Company Limited was based in part upon that consideration. Such acquisitions also enable firms to acquire experienced employees and management and established relationships with customers and suppliers.

We have also encountered many vertical mergers in which an active business has acquired control of one or more of its customers or suppliers to obtain more secure markets or more reliable sources of supply or for reasons of improved product quality and scheduling. George Weston Limited is an example of a Canadian firm that has become vertically integrated to a high degree through mergers.

Another motive, which might be expected in the oligopolistic industries common in Canada, is the desire of an aggressive company to acquire one of its competitors to increase its share of the market without creating excess capacity or upsetting the established price structure. Such mergers may lead to increased concentration in the industry concerned, but may also permit greater efficiency in the use of existing plants or their ultimate replacement with more economic plants. They may also permit economies at the firm level in management, financing and various staff functions. However, such mergers may lead to greater dominance by one firm in the industry and a reduction in competition.

Some companies have acquired others that provided complementary products or services, which enabled the acquiring company to offer a more complete

line of related services or products. While this objective could be achieved partially by agreement, it was thought that control would result in better marketing. It was stated that the acquisition of a 50.1% interest in The Great-West Life Assurance Company by The Investors Group in 1969 was motivated at least in part by the marketing advantages that would result from Investors' expansion into a related service. Corporations selling products outside Canada have acquired foreign affiliates to market their exports or to produce in foreign countries behind trade barriers. Alcan and Massey-Ferguson Limited have penetrated foreign markets in this way.

There have been cases where companies seem clearly to have been acquired to use their liquid assets or borrowing capacity for the purposes of the acquiring company, including the making of further acquisitions.

Another motive is to acquire a business to use in it special technical or commercial abilities of the acquiring firm. Marketing skills appear to have led to diversified acquisitions in some conglomerate mergers, while technical expertise seems to be a more common motive in vertical or horizontal mergers. Both Imasco Limited and the Molson Companies Limited have achieved a high degree of diversification predicated on exploiting their marketing abilities more fully.

The explicit purpose of a number of Canadian corporate groups has been the acquisition of control of independent and relatively small but promising companies in order to provide financing and management that they could not otherwise obtain. Testimony given us by some of those who sold control of such independent businesses, but who continued to operate them with a considerable degree of autonomy, has led us to believe that this can be a constructive and profitable means of growth without the formation of really large corporate control groups. Canadian Corporate Management Company Limited and Hugh Russel Limited are firms that have grown in this way.

We have been told of cases of deliberate diversification by mergers to provide more stable earnings and to utilize more fully the capacity of management and other corporate level staff personnel. These hopes have not always been realized.

As mentioned in Chapter 5, we have received briefs and testimony from some who have had carefully planned programs to use profits and cash flow from profitable but relatively slowly growing operations to acquire and develop businesses in more dynamic industries. This was the motive behind Molson's several acquisitions in the latter part of the 1960s and in the 1970s, and Genstar's acquisitions as well. A related motive is to acquire controlling interests in businesses in Canada for the purposes of reinvesting in Canada funds available from operating profits or divestiture in other countries. Brascan Limited and John Labatt Limited are two examples of firms that have repatriated capital or profits.

Sometimes a greater degree of shareholding control has been acquired to rehabilitate a business in which the acquiring company already had a substantial equity, and this has on occasion involved the infusion of additional capital

and/or the replacement or reorganization of top management. Argus and Power have thus extended their share control in Standard Broadcasting Corporation Limited and Consolidated-Bathurst Limited respectively. As the history of Canadian financial institutions illustrates, mergers are often arranged to rescue a failing business. Unity Bank of Canada was a financially troubled firm when La Banque Provinciale du Canada took control of it in 1977.

Acquisitions are sometimes made by companies under the control of confident and dynamic men motivated by the desire to grow and to create a corporate empire. Indeed, given the types of men who succeed in business and the kinds of opportunities that arise, it would be surprising if there were not cases of this kind, especially when there are available businesses under the control of others who appear less dynamic and venturesome. If such acquisitions do result in transferring resources to more aggressive and innovative managers, they help to promote greater economic efficiency. On the other hand, we have seen examples where unrelated acquisitions have led to deterioration in efficiency and performance.

In concluding this list, we should mention that there are other considerations that are contributory rather than primary motivations. One of the most widespread is the exemption from taxation of dividends received by one corporation from another, while dividends going to individuals enjoy only a tax credit. This exemption encourages retention and reinvestment of earnings by the corporation as opposed to the paying out of corporate earnings for reinvestment by shareholders. While the tax treatment of dividends should not, by itself, influence the decision of a firm toward external rather than internal growth, it encourages the retention of earnings within the corporate sector, thereby facilitating corporate acquisitions.

MOTIVES TO SELL

Our investigations have revealed that the initiative for merging usually comes from those who wish to sell control of a business. There are many reasons to sell. Commonly those controlling a relatively small independent business are unable to finance its expansion without selling control. Whether this is because of some remediable gap in the capital market, other reasons relating to the behavior patterns of financial institutions, or the economics of corporate control is a subject we discuss in Chapter 11.

Frequently the motive to sell is simply a natural desire on the part of an owner-manager to retire from active business and to get the best price he can. A related motive arises from the difficulties that managers of small but growing companies may have in adjusting to the type of management functions undertaken in larger firms. Owners wishing to dispose of a business concern find that their tax burden can be substantially reduced by selling to another corporation instead of liquidating the firm's assets. Some witnesses emphasized to us the difficulties encountered by small firms in complying with the numerous government regulations affecting all businesses as a reason to sell out.

In some cases, and it is hard to judge how many, the owners of a controlling interest in a business desire to diversify their holdings into marketable assets at the time when they retire or plan their estates. The desire for a more liquid portfolio to pay estate taxes at some future date provides an incentive for owners of closely held businesses to sell. In other cases, heirs who come into possession of controlling interests in such businesses may have no taste for the risks and responsibilities of such an investment and will seek to sell.

Often those who control a losing or troublesome business decide to cut their losses and sell the business.

We have noted the sale of minority controlling shareholdings when another strong interest becomes a major shareholder with either an immediate or probable dominant position in the company. We have also seen cases in which two dominant shareholders in a number of companies will exchange holdings to give each party controlling interests in particular companies.

Finally, sometimes owners may sell simply because they believe that the offered price exceeds the underlying value of the business.

We have compared our observations on stated merger motives with other published reports on this subject. The most extensive review was made by Reuber and Roseman in their 1969 report to the Economic Council on the results of the government survey of mergers. The most common reason for merging given by the successor merged company was the desire of the owners of the acquired company to sell. The next most common reason was that it was "cheaper and less risky to buy rather than build", and in the text it is emphasized that mergers were most often favored because they were "faster". A significant number of respondents gave as a motive for merging the acquisition of something unique to the acquired firm (or to other firms like it). Other reasons included the desire to expand capacity, the desire to reduce costs, or reasons directly related to the competitive situation. The desire to diversify into new fields, or into related or complementary products, or into new territories was also frequently mentioned. Broadly speaking the reasons given in this survey taken 14 years ago were similar to those we found in the briefs presented to us, although efficiency motives for merging were more frequently cited in the briefs than in Reuber's and Roseman's survey.

Some recent evidence on the declared motives for merging is provided in annual Foreign Investment Review Agency (FIRA) reports. They apply to foreign acquisitions requiring FIRA approval and, thereby, suggest caution in using the results, since firms may provide those reasons they think are most likely to win FIRA approval. The applications for approval emphasize, on the part of the acquiring businesses, desires for horizontal integration and expansion or for vertical integration. Other mergers result from acquisitions outside Canada of foreign parents of Canadian businesses. About 8% of the total gave diversification as the primary motive. About 23% of the sellers of businesses gave the poor financial position of the business as the reason, while about 18% stated inability to finance expansion as their primary reason. Desires of the

parent company to divest itself of a Canadian subsidiary to raise capital or for other reasons was given as the cause in about 18% of the cases.

An international list of reasons for merging was given in a 1974 report of the Organisation for Economic Co-operation and Development (OECD) on mergers and competition policy. The report listed a dozen reasons, nearly all of which we also encountered in Canada. The report concludes that several motives will be present in most mergers and that there can be no overriding presumption in favor of or against mergers. Some smaller U.S. surveys found that synergy was expected in sales administration and research and development, while management considerations played an important role in a large proportion of mergers.

Economic Effects of Mergers

Mergers do not always achieve their purposes and the reasons given are not an entirely satisfactory guide to the probable effects of mergers in particular industries or cases or to their effects in general. Also, it is unrealistic to expect respondents to merger surveys to cite anticompetitive motives for undertaking mergers, although they may exist. The Commission has had an opportunity to review the financial results of many companies that have made frequent acquisitions and has set forth in Chapter 5 those results for a number of conglomerate groups; however, we have not been able to make a comprehensive survey of the effects of mergers in Canada. Because of the inadequacy of public information in this area, such a study would have necessitated fairly large-scale surveying efforts of the type undertaken by Reuber and Roseman (which took almost four years to complete).

Numerous studies in the United States have attempted to determine whether identifiable gains from mergers are realized by acquiring companies. The studies provide no unambiguous conclusions as to how acquiring firms have fared after mergers, inasmuch as some studies show that mergers apparently are not profitable, while others show that there are gains to both the acquiring and the acquired companies. The various studies, to a greater or lesser degree, are subject to the methodological reservations that the time period of analysis may not have been long enough to capture the effects of possible efficiency gains and that the procedures to hold constant all other factors besides acquisition activity were imperfect.

The major evidence for Canada is included in the Reuber and Roseman study based on a survey of mergers from 1945 to 1961. Those companies that had merged were asked to describe "the economies, if any, secured by the merger which were not otherwise obtainable". While the results of answers to such a questionnaire must be interpreted with caution, of the approximately two-thirds of the respondents who answered this question, about 46% said there were no economies or only negligible ones, about 25% cited the rather vague "administration and management" category and about 30% cited more specific economies in buying, selling, transport and production. Only about 15% of the

mergers were said to have brought economies in the integration of plants and the use of materials.

In his 1973 study, Laiken analyzed the financial performance of a sample of 369 Canadian-based firms listed on the Toronto Stock Exchange during the period 1960-70. The firms were classified into groups based on their use of mergers for expansion during the period. He concluded that a weak direct association between increased merger activity and the ratio of operating income to total income provides a very slight indication of increased efficiency in the allocation of capital funds from mergers. As well, the lack of a strong inverse association in the ratios of operating income to total capital, and of net income to common equity may be taken as some evidence that merging firms were not consistently less efficient in their use of capital. However, the available evidence on conglomerate mergers in Canada, discussed in Chapter 5, suggests that diversified mergers did not generally prove profitable for acquiring firms. Moreover, there is some evidence to support the conclusion that conglomerate acquisitions increase the variability of the earnings of acquiring firms.

The available studies indicate that there is insufficient evidence to conclude that most of the mergers taking place in Canada add very much to real efficiency in production and distribution. The evidence does suggest that productive mergers do take place, although the effects of the size of an enterprise upon its efficiency are complicated and vary with circumstances. The Commission did receive numerous briefs from companies suggesting that economies of scale, particularly in overhead, managerial functions and cash management, are attainable through the acquisition process. The managerial functions most often centralized within the head office of the acquiring company include financial management, accounting, legal and insurance services, employee benefits and public relations.

In several briefs, management of the acquired companies indicated that assistance in some of the above-mentioned functions was an important reason favoring the acquisitions. For example, the management of Progresso Foods Corp. (formerly Uddo & Taormina Corp.), acquired by Imasco, claimed that the Imasco takeover brought substantial improvements in the company's accounting techniques, legal knowledge, inventory control and management information systems. The management of another company taken over by Imasco, Grissol Foods Limited, cited improvements and cost savings in the legal counselling and insurance functions after integration of these functions into the parent's operations. In these cases, it may have been more difficult or costly to obtain assistance by alternative methods, such as hiring management consultants.

Concern about potential competitive effects of mergers has centered, in part, on the relationship between merger activity and subsequent changes in

industrial concentration. In the previously cited study, Laiken concluded that higher levels of merger activity in Canada were not associated with increases in profit margins or with increased price/earnings ratios. On this basis, he suggests that mergers did not increase the market power of acquiring companies. Recent evidence on patterns of industrial concentration in Canada was assembled for the Commission by Christian Marfels. Employing special tabulations by Statistics Canada, he constructed various measures of aggregate concentration. In one exercise, aggregate concentration ratios for the 25, 50, 100 and 200 largest non-financial corporations in Canada were compared for 1965, 1968 and 1973. Modest increases in asset concentration were evident for the first 25 and the first 200 non-financial corporations from 1965 to 1973, while sales concentration showed a slight decrease. In another exercise, a measure of industrial concentration was constructed, specifically a Herfindahl index for 129 manufacturing industries. Detailed analyses of the indices by industry group showed that concentration trends had a tendency to decline during 1965-72. Analyses of concentration trends in nine large manufacturing industries support this conclusion. Six of the nine industries showed declines in both enterprise and establishment concentration for various measures of concentration. Thus, aggregate industrial concentration in Canada did not generally increase during a period in which merger activity was quite intense.

Some admittedly rough analysis by our staff also contradicts the notion that merger activity was associated with a significant increase in concentration at the industry level. Specifically, the percentage change in the number of largest firms accounting for 80% of industry employment between two discrete years, 1948 and 1965, was calculated for a sample of 10 industries. The industries were ranked in terms of this measure and in order of their merger intensities over the period 1945-61, from highest to lowest values. The rank orders of the two series were compared and found to be unrelated; however, since complete data on which to calculate the 1948 concentration ratios were unavailable for several of the sample industries, this result might be subject to error.

Critics of the evidence cited above might argue that in merger-intensive industries (which are generally characterized by faster than average growth) concentration, rather than staying the same, might have decreased if the mergers had not taken place. On the other hand, it is also possible that market shares of acquiring companies would have been larger had they devoted their efforts to internal growth in their primary industries and diversified less. Moreover, the impact of mergers on industrial concentration will be overstated if mergers are in fact an alternative to exit for the absorbed companies.

In summary, while individual mergers may have the effect of increasing concentration in some instances, the Commission thinks that no long-run general relationship between merger activity and concentration can be identified in Canada during the period since 1945. This was also the conclusion reached by Lawrence Skeoch and Bruce McDonald in their 1976 report to the

Minister of Consumer and Corporate Affairs, *Dynamic Change and Accountability in a Canadian Market Economy*:

> To revert to the Canadian situation: in terms of (1) relative merger numbers (and their limited effect in bringing together the leading firms) in the post-war years as against the earlier merger movements, (2) the large post-war increase in the number of firms, and (3) also keeping in mind the dimensions of merger and joint venture activity in Sweden and the United States, it would appear that the *general* merger movement in Canada has not given rise to any important consequences for the economy. At the same time, there have undoubtedly been a significant number of mergers that the Canadian economy would have been better off without. It is not so much the *number* ["perhaps half a dozen mergers in the last two decades that I would rather have seen not take place," Skeoch told us] of mergers that gives cause for current concern as the nature of the comparatively small number of those that have occurred.

Competition Law and Policy Concerning Mergers

Competition Law in Canada

One of the economic implications of large corporate groups and of the mergers sometimes used in forming them are their effects, or possible effects, on competition in various Canadian industries and markets. Since 1923 there has been a section in the Combines Investigation Act that makes it an indictable offense to form a merger (or a monopoly) by which competition in an industry (or trade or profession) is lessened, or is likely to be lessened, to the detriment of or against the interests of the public, i.e. consumers, producers or others. Nevertheless, there is concern as to whether this law and its application constitute an adequate safeguard to the public interest. Two features of the law must be noted. The first is that, for constitutional reasons, it was thought in the past that Parliament could legislate in this field only by using criminal law. This requires cases to be tried in the courts and to be proven beyond a reasonable doubt under strict rules of evidence. In mergers it is important to prove conclusively that competition is likely to be lessened "in the future", and to prove this "beyond a reasonable doubt". It must also be shown that the effects of a merger in lessening competition will likely be to the detriment of or against the interest of the public, essentially a matter of economic appraisal.

The *Proposals for a New Competition Policy for Canada, Second Stage* (1977) conclude that:

> Although there has been a section in the [Combines Investigation] Act since 1923 which makes it an indictable offence to be party to a merger which has operated or is likely to operate to the detriment of the public, its enforcement has not been successful. Before World War II there was only one prosecution for a merger offence, the Western Fruits and Vegetables case, and it resulted in an acquittal. Following this, there were no further prosecutions until the *Canadian Breweries* case in 1959 and, shortly thereafter, the *Western Sugar* case. Both of these prosecutions also ended in acquittal. The Electric Reduction Company of Canada Limited pleaded guilty to a merger charge in 1970 and K.C. Irving Limited was convicted of merger charges by the trial court in 1974 but the decision was reversed

> on appeal. In another case an order was issued against Anthes Imperial Limited in 1973 which prohibited it from acquiring Associated Foundry Limited. There has never been [in Canada] a conviction after a full trial which was not reversed on appeal.

Since monopoly, monopolistic pricing, supply reduction and related practices are all violations under other sections of the Combines Investigation Act, there has been little scope for action under the merger section. The Director of Investigation and Research charged with administration of the Combines Investigation Act did, however, testify before us that the merger provisions of the Act have some deterrent value. Some parties contemplating mergers are dissuaded as a result of consulting with the Director and his staff, and it is possible that others have been deterred by advice of legal counsel. Nevertheless, the Director stated in his brief to the Commission, referring to the provisions of the law relating to mergers and monopolies, "I believe it is fair to say that these sections of the competition law have not been effective enforcement tools to date, and thus competition policy in Canada has not been as effective as might otherwise have been the case".

It is difficult to assess how much the public interest in Canada has been harmed by the weakness of the Act in regard to mergers. In Chapter 2 we presented statistics suggesting that concentration in specific Canadian industries did not generally increase from 1965 to 1972. Of course, evidence gathered for such a short period must be treated with caution. Furthermore, one can point to periods of merger activity in the early part of this century when concentration increased substantially across a broad range of industries. In Chapter 4 we examined the nature of competition in relatively concentrated industries and markets and concluded that while a significant amount of "conscious parallelism" exists with respect to pricing decisions, competition frequently occurs along non-price dimensions in these industries. In Chapter 5 we examined some competitive practices of diversified "conglomerate" corporations and found no evidence of serious anticompetitive practices. In this chapter we have seen that the overall postwar merger movement in Canada does not appear to have given rise to widespread anticompetitive consequences for the economy.

However, we are aware that many observers, including Skeoch and McDonald, believe that the anticompetitive effects of a small number of mergers have indeed been significant. William Stanbury, in a paper prepared for the Commission, argues that several acquisitions provided acquiring companies with substantial positions of market power in relevant markets. The Commission agrees with the view that for a small number of mergers in Canada, there may be reasonable cause for concern that harm might occur to competition and to the public interest.

Considerations Regarding the Application of Law to Mergers

The Commission's responsibility regarding competition law and its administration is to assess to what degree it represents an adequate safeguard

to the public interest. Before attempting an assessment, we briefly outline the relevant considerations in framing merger policy.

On competition policy generally we agree with those who say that competition law should not be framed as criminal law if it is constitutionally possible to express it otherwise. We also agree with Skeoch and McDonald that the proper focus of concern of a competition law should be on the misuse of dominant market power or the attempt to increase or entrench a dominant position by anticompetitive means. Examples of such abuses, according to Skeoch and McDonald, are:

> preclusive acquisiting [*sic*] or ownership of resources and facilities; deliberated exclusion; reinforcing a dominant position by exclusive dealing and tying arrangements, or by refusal to deal; predatory discrimination; a design to forestall competition and to hold its monopoly position by other than the achievement of real-cost economies; the use of reciprocal buying-selling advantages, and the like.

Under existing competition law a corporate merger is not in itself an abuse of market power; it is only a technique by which two or more firms can become, in effect, one. However, a merger could create a situation in which the merged firm may acquire and abuse market power. As well, a merger can in some circumstances reduce competition even if the merged firm does not actively engage in anticompetitive conduct.

Few would disagree that a competition law must deal with mergers or their consequences in some way. The difficult question is how far a competition law should seek to go in preventing the consummation of mergers that may threaten competition, and to what extent the law should operate, after the fact, against whatever anticompetitive consequences are seen to flow from a completed merger.

The question is essentially one of emphasis, but the decision as to where to put the emphasis is a matter of judgment on which reasonable people may legitimately differ. To the extent that the law is left to operate after the fact, dealing with traceable consequences, there is a risk that the law may not be able to apply effective sanctions against the parties to a completed merger, since it is not always possible to assign to a particular merger any deterioration of competition that may occur. Even if the anticompetitive effects of a completed merger can eventually be traced and stopped, an unacceptable amount of damage may have been suffered in the meantime by customers or suppliers of the merged firm. On the other hand, if the law scrutinizes all proposed mergers so as to stop those that may be competitively harmful, it may have such unsettling effects on normal commercial activity that beneficial mergers may be deterred.

In addition to the cost of maintaining an agency to screen potential mergers there are the out-of-pocket costs and the costs of uncertainty and delay that will be imposed on the parties to a proposed merger. Moreover, a law that requires some form of official consent or permission before people may do something (in this case complete a corporate merger) raises an important philosophical question. The matter is not simply one of economics.

We think there should be a high burden of proof on those who advocate a law requiring official or even quasi-judicial consent before a particular course of action is undertaken. There should be several essential preconditions to justify any law that is permissive instead of prohibitory. Foremost among these would be a high probability of substantial and irreversible harm to the community. Also, the standards upon which the permission will be granted or withheld should be clear and capable of being related to facts that can be determined and demonstrated at the time permission is sought. Permission should not depend on unverifiable predictions of what the applicant might or might not be able to do at some time in the future nor should it be conditional on future events beyond an applicant's control.

The evidence that we have seen does not suggest that industrial concentration has increased significantly even during a period of high merger activity. In our view the law should not be biased against mergers because their benefits cannot be clearly and indisputably demonstrated in a pre-merger screening procedure. The law should act preventively only when there is a clear likelihood that harm will result if it does not. The evidence does not suggest that corporate mergers generally tend to be harmful in competitive terms; rather it suggests that the danger is slight. In our opinion, therefore, there is no justification for an elaborate preventive law and a correspondingly expensive screening apparatus with which to enforce it. If it is difficult to assess the economic consequences of a completed merger, it is far more difficult to predict the outcome of a proposed one. Any mechanism designed to predict which mergers will be beneficial and which harmful will be enormously cumbersome and prone to error.

Finally, there is the question of timing. There is a marked lack of confidence today in at least the short-term economic future of Canada. It does not seem prudent at this time to launch new and untried schemes of general economic regulation of the kind that would be implicit in a preventive merger law. The risk that a new merger law might further depress business confidence might be worth taking if there were strong evidence of harmful anticompetitive practices and if there were a reasonable prospect that the law could improve conditions significantly at an acceptable cost. Neither of these conditions obtain.

For all these reasons, we think that the competition law should deal in a prohibitory way with proven anticompetitive conduct and, correspondingly, that corporate mergers should not be subject to a review process or require official approval or consent before they are completed. Our conclusion carries with it a risk that, if there is a merger that has a significantly harmful effect on competition, the law will be able to deal with it only after the fact. We think this risk is slight. We recognize, however, that some people are not willing to accept this risk and demand, instead, a preventive measure. The government, implicitly, has acceded to this view by introducing Bill C-13. We think it is right, therefore, for us to expand on our argument by reference to this Bill so that people will be better able to judge the merits of the two opposing points of views.

BILL C-13

THRESHOLD STANDARDS

Assuming that a preventive merger law should not reach all mergers, but only those that may have significant implications for competition, the statute should first establish criteria by which the mergers most likely to be harmful can be identified.

The criteria set out in subsection 31.71(2) of Bill C-13 do not meet these standards because they are too vague and because they seem likely to subject far too many potential mergers to review. If a review process is desirable at all, we should prefer a threshold that uses the size of the merging firms (measured, for example, by assets or sales). A threshold of this kind can be criticized for arbitrariness, but it does bring certainty into the law, and that is an important consideration. We suggest the following criteria, which combine a size standard with a market-share test:

horizontal mergers: a horizontal merger between parties who sell in the same market, in which the parties would have at least a 50% share of the relevant market after the merger, and where each party has at least $50 million of sales or assets before the merger, would be subject to review and could not be completed without the approval of the reviewing tribunal;

vertical mergers: a vertical merger where one party is a customer of the second, in which one party has at least a 50% share of a relevant market, and where each party has at least $50 million of sales or assets before the merger, would be subject to review and could not be completed without the approval of the reviewing tribunal;

conglomerate mergers: a conglomerate merger with horizontal or vertical market dimensions should be reviewed against the criteria above; a conglomerate merger where there is no horizontal or vertical aspect raises few issues relevant to a competition law and should be treated in the way we recommend in Chapter 7 for a merger like the proposed Power-Argus one.

REVIEW STANDARDS (COMPETITION BOARD)

If a proposed merger does exceed the threshold limits, so that it must then be examined and approved before the parties are allowed to complete it, the next question is by what standard is it to be judged? Bill C-13 sets out an elaborate list of factors in subsections 31.71(4) and (5) against which a proposed merger could be tested. Many of these factors are disturbingly vague, but our chief criticism is that too many of them depend on the "likelihood" of future events.

In an advance appraisal process the decision-maker is necessarily examining promise, not performance. It is difficult enough for anyone to identify, isolate and weigh the consequences (to the public as well as to the parties) of a completed merger several years after it has occurred. It is far more difficult to

do so when the merger is merely a prospect, at the point where its consequences are in the indeterminate future. Any judgment of a proposed merger against standards like those described in Bill C-13 will be at best an inspired guess.

It would be possible to test proposed mergers against standards less elaborate than those contained in Bill C-13. In the United States, for example, proposed mergers are examined in terms of the merged firm's resulting market share. The U.S. Department of Justice has published specific guidelines indicating market shares that will ordinarily be challenged. Courts in the United States have generally refused to consider offsetting benefits that arise from reduced costs, increased efficiency and the like when deciding whether a proposed merger should be approved.

In *Dynamic Change and Accountability in a Canadian Market Economy,* Skeoch and McDonald criticize this exclusive concern with market share and say that, whatever its suitability in the United States, it would be inappropriate in Canada:

> A small economy does not enjoy the same elbow-room in policy making. A few bad merger decisions may strengthen monopolistic elements unduly or they may inhibit the development of firms of sufficient size to undertake production and marketing effectively in a world context, and to participate, at least as a partner, in the complex process of innovation.

They urge that mergers should be evaluated against broader criteria.

We acknowledge the force of this criticism, but it does not follow that Canada should therefore subject proposed mergers to a more sophisticated examination than that attempted in the United States. In our opinion, the ideal described by Skeoch and McDonald and carried into Bill C-13 is simply not practical in this country. The criteria set out in the Bill are far too complicated to interpret and time-consuming to apply. The tangible and intangible costs, including risk and uncertainty, of the examination they would require would far outweigh the benefits.

We suspect that the merger law in the United States works as well as it does because the courts in that country have tested mergers largely by reference to anticipated market shares. They have recognized that any other consequences are too speculative, especially if those other factors pull in opposite directions and the judge has to consider how far one unmeasured and unmeasurable factor offsets another. An appraisal process operating on this basis is a chimera, creating an illusion of profundity.

In sum, although it should be relatively easy to establish a threshold by which to select those mergers that should be reviewed in advance, we are not convinced that any review process would produce results reliable enough to justify the costs of the review. The forecasting process is the Achilles heel of a merger law.

APPEALS

The extensive powers to be vested in the proposed Competition Board quite naturally give rise to a feeling that there should be some right of appeal so that mistaken decisions can be corrected. We assume that the decisions of the Competition Board, like those of other regulatory tribunals, would be appealable to the ordinary courts on questions of jurisdiction and procedural fairness. The more difficult question, however, is whether there should be a right to appeal on the merits, that is should the substantive decisions of the regulatory tribunal be reviewable by the courts.

Regulatory tribunals, like the proposed Competition Board, are usually created because of an understandable belief that the ordinary courts are not equipped to handle the kind of questions that arise under "economic" laws. If that is true, it would be pointless to allow the decisions of the Board to be reviewed, on their merits, in the courts. In addition, the long time that would elapse if decisions of the Competition Board could be carried through the courts might weaken the competition law fatally.

Although we can agree with the drafters of Bill C-13 that the substantive decisions of the Competition Board should not be appealable to the courts, we cannot agree with section 31.91, which gives the federal Cabinet power to annul the Board's orders. If anything, this alternative is worse because it displaces open standards with hidden discretion. It will stultify the development of the law and it will create suspicion about the integrity with which it is administered.

There is a valid case for government intervention to vary or rescind regulatory decisions that go contrary to decided government policy. The dangers of this kind of lawmaking are so great, however, that some kind of parliamentary supervision should come into play when government uses such a power.

In our opinion, the concern about appeals, and the mistaken response to that concern in Bill C-13, stem from a fundamental misconception of what a tribunal like the Competition Board should be. The Competition Board should be more of a legislative body than an adjudicatory one. A broad regulatory scheme like that foreshadowed in the Competition Bill is a complex area in which Parliament cannot be expected to legislate in detail. The Competition Board's primary function should be to create the necessary legislative infill, using all the techniques of what in the United States is called "rule-making". It will not be enough to leave this task to case-by-case adjudication. That is only one rule-making technique, and not the most useful one. In the merger area particularly, history suggests that there will be few cases indeed and, as we have said, there should be especially few involving an advance assessment of proposed mergers. This means that the inescapable uncertainty in even the best-drafted statutory provisions will not be clarified in a reasonable time by case decisions.

We resist the temptation to digress to a more extensive discussion of the lawmaking functions of the Competition Board or regulatory tribunals generally, because that raises other important questions of accountability and parlia-

mentary control, which go beyond our terms of reference. We wish only to make the observation that we think Bill C-13 places too much emphasis on the Competition Board as an adjudicatory body, and to record a doubt about the usefulness of trial-like proceedings in the development of economic policy.

CLEARANCE PROCEDURE (COMPETITION POLICY ADVOCATE)

Bill C-13 provides for another kind of review process, which may have been designed to resolve some of the problems we have raised above. The parties to a proposed merger can inform the Competition Policy Advocate (the official who is given a kind of prosecutorial function in Bill C-13) of their plans. If the Advocate is satisfied that the merger would not be an undesirable one he can issue a certificate to that effect, and he is thereafter barred from attacking the merger before the Competition Board. This could be a useful procedure in many cases, particularly if the Advocate takes advantage of the opportunity given him in section 27.2 to issue interpretative opinions. These interpretative opinions would be a form of rule-making.

The other consequences of the Competition Policy Advocate's "clearance procedure" are less easy to predict. On the one hand, the availability of the clearance procedure may mean that few corporations will be content to act on the advice of legal counsel as to whether any merger being contemplated will be subject to the statute. The Advocate's certificate could become an item on the checklist of every corporate solicitor. If that were so, the Competition Policy Advocate could be asked to rule on almost every proposed merger in Canada, including those that would have no conceivable effect on competition. It is impossible to tell how much of a burden this might impose on the Competition Policy Advocate, and what staff he will need to discharge this "insurance" function for the private sector.

On the other hand, the Advocate's examination may be seen as a further impediment to corporate mergers. Often it will take a considerable time to collect and explain the "material facts" the Competition Policy Advocate will need to study before he can issue a certificate. Section 31.71(22) of Bill C-13 obliges the Advocate to give his decision within six months after he receives the information, although he can ask a member of the Competition Board to extend this time to twelve months. These time limits are deceptive, however, because they do not start to run until the Competition Policy Advocate has received *all* the necessary information, and many months could pass during which the parties will be responding to requests from the Competition Policy Advocate for information additional to that supplied initially. The parties may not have all the information relevant to the Advocate's examination and may have to do research of their own to obtain it. Information supplied may suggest the need for additional information; the Competition Policy Advocate may feel obliged to verify some of the information he receives, and so on.

It would be impossible, of course, to specify completely and precisely in the statute the information the Competition Policy Advocate should have before he makes his decision. Presumably the information would be broadly that which would be put before the Competition Board if the merger were to be

reviewed by the Board. The Advocate will be doing informally essentially what the Board would do formally.

It is important to the integrity of the competition law that the Competition Policy Advocate's examination be thorough, but it is only reasonable to expect the Advocate to be cautious before issuing clearance certificates. The potential embarrassment to him and to the government if he approves a merger that experience later shows to be competitively damaging will always be present in his mind. However unconsciously, the Advocate's bias will be to deny approval and thus keep open the opportunity to attack the merger later before the Competition Board.

A clearance procedure of the kind contemplated in Bill C-13 requires an escape provision, if only to deal with situations in which the Competition Policy Advocate's certificate may have been based on incomplete, incorrect or misleading information. Thus, Bill C-13 provides that, if the Competition Policy Advocate can convince a member of the Competition Board that he was not given all the relevant information, then, notwithstanding his clearance certificate, the merger is not immune from later attack. However, the Bill also provides that any six people can apply for, and the Minister of Consumer and Corporate Affairs may direct, the Competition Policy Advocate to carry out an "inquiry" into the merger, whether or not it has already been approved by the Advocate. On the conclusion of the inquiry the Advocate can decide that there are grounds to attack the merger after all, and there is apparently no way in which his determination could be challenged, notwithstanding that it was inconsistent with his earlier decision and the clearance certificate.

However justified these "let out" provisions may be, the point for our purposes is that they qualify the finality of any clearance certificate issued by the Competition Policy Advocate in respect of a proposed merger. The usefulness of the advance review procedure by the Advocate is correspondingly qualified.

The Competition Policy Advocate's responsibility under the merger clearance procedure of Bill C-13 is heavy, especially where the merger is an important one. It is only right that he has all the available relevant evidence before him, and that he has adequate time to study it before he makes his decision. Although we are sympathetic to the idea behind the clearance procedure, which we think is intended to facilitate desirable mergers, we fear that the unavoidable costs and delays in that procedure, the possibility that the Competition Policy Advocate may give an unfavorable ruling at the end of it and the uncertainty overhanging even a favorable ruling may destroy much of its value in the minds of corporate executives.

CONSENT ORDERS

Section 31.79.1 of Bill C-13 provides for "consent orders" where the Competition Policy Advocate and the parties can agree on the disposition of a case without a hearing before the Competition Board. If the competition law is to include a preventive provision of the kind set out in Bill C-13, we think the consent order provision will be useful. But it should be accompanied by some safeguards.

In some of the more serious matters with which the competition law is concerned, little can be expected from case-by-case adjudication by the Competition Board. In cases involving mergers and joint monopolization, for example, the relative weight of the several factors is so uncertain, the circumstances so complex and the nature of the Board's orders so unconfined that few businesses will be able to bear the uncertainty (to say nothing of the delay and cost) of a hearing before the Board. These and many other possible cases will almost always be settled by consent between the Competition Policy Advocate and the parties.

The consent order provisions of Bill C-13 therefore invite a kind of plea bargaining on an unprecedented scale. Plea bargaining is coming to be recognized as a problem in the administration of the criminal law, but it is more serious in regulatory law because its direct consequences reach far beyond the interests of the immediate parties. It is not clear from section 31.79.1 that the Competition Board will review and approve all case settlements; it should have this duty and power because of the overwhelming power of the Competition Policy Advocate to put pressure on businessmen who cannot afford to fight. Moreover, these settlements should be fully reported by the Board, so that everyone will be able to see how the law is working in practice. The process of review, approval and publication will serve as a check on the Competition Policy Advocate and it will also tend to allay suspicions about secret and perhaps politically inspired "deals".

Conclusions

We expressed the opinion earlier that competition was not seriously threatened by corporate mergers, and also that the costs of a review process by the Competition Board were not justified by the unsatisfactory results that may be expected from it. Our examination of Bill C-13, including the provisions for advance clearance by the Competition Policy Advocate, Cabinet appeals and consent orders, has not caused us to alter that conclusion. It is not that a process requiring a prediction of the economic effects of mergers cannot be made to work; it is that the process can operate only at what we think will be a prohibitive cost and that the results of the process will not be sufficiently worthwhile.

This conclusion reinforces the view we stated earlier: that competition law should deal with abuses or further entrenchment of market power. The law should act in the traditional prohibitory fashion: if facts are established showing that a firm is guilty of proscribed conduct, the court or responsible tribunal makes an order designed to stop the practice and, possibly, to compensate those who have been injured by it. In extreme cases, the tribunal could of course order dissolution of the offending firm or divestiture of some of its assets and operations. Indeed, the law should make it abundantly clear that sanctions as severe as dissolution and divestiture will be applied, where necessary, to companies who abuse market power. Ideally, the responsible tribunal should have a rule-making function under which, among other things, it could indicate the circumstances in which such severe remedies would

probably be applied. This would do much to ensure that objectionable practices did not occur. In particular, it would impel parties to a merger to make sure that the new firm did not take improper advantage of increased market power resulting from the merger.

Chapter 7

Power/Argus

Introduction

In the spring of 1975, Power Corporation of Canada, Limited, launched a bid to acquire control of Argus Corporation Limited. Power's attempt to take over Argus prompted considerable comment in business and other circles and, although it is not mentioned specifically in our terms of reference, it led directly to the establishment of this Commission.

While we are examining and appraising a number of issues from a broad perspective, we have also studied many specific cases, of which Power's attempted takeover of Argus is the most prominent. As a general rule we have looked at these cases only to improve our understanding of corporate activity, to apply theories and concepts to real situations, and to determine whether, or to what extent, patterns of behavior occur. To some extent, our consideration of the Power bid for Argus is an exception. Because the takeover bid was the reason for this Commission, and because it is quite clear from questions asked in the House of Commons that Parliament wishes our views on it, we decided to examine Power and Argus in particular and to assess the implications of a possible merging of control of the two firms. We also thought it might be useful to have a fairly detailed analysis of this case when our general conclusions of wider application are being considered.

We received detailed submissions from both Power and Argus, and also conducted public hearings at which their chief executive officers gave evidence. In addition, we received submissions and oral testimony from several of the companies affiliated with the two corporations. We also commissioned studies of each corporation and its major affiliates. These studies, which are published concurrently with this *Report*, focus on the financial affairs of the two companies and contain considerable historical and topical detail. Readers who are interested in more information about Power and Argus than is found in this chapter should refer to the studies.

Power Corporation of Canada, Limited

Power Corporation was founded in 1925 by members of the investment firm Nesbitt, Thomson & Company Limited. For many years its holdings were

largely in the electrical generating industry, but in the early 1960s most of its assets were either sold or expropriated. Over the next decade it made investments in transport, pulp and paper, financial services, and communications. In 1968 control of Power was effectively acquired by Paul Desmarais and his associate, the late Jean Parisien. As of June 30, 1977, Desmarais and the Parisien family interests owned about 18% of the equity stock of Power (through their holding company, Gelco Enterprises Ltd., in which Desmarais has a 75% and the Parisien family a 25% interest). This holding includes 97.6% of those shares carrying multiple voting rights, so that in the aggregate they have about 53% of the total votes that can be cast at a Power shareholders meeting. They have both effective and legal control of Power.

Power has controlling positions in a number of large and important Canadian companies (the most significant of which are the subject of separate sections within the study on Power Corporation referred to above). Its ownership and degree of control of the major investments it held at the time of the takeover bid are shown in Figure 7.1.

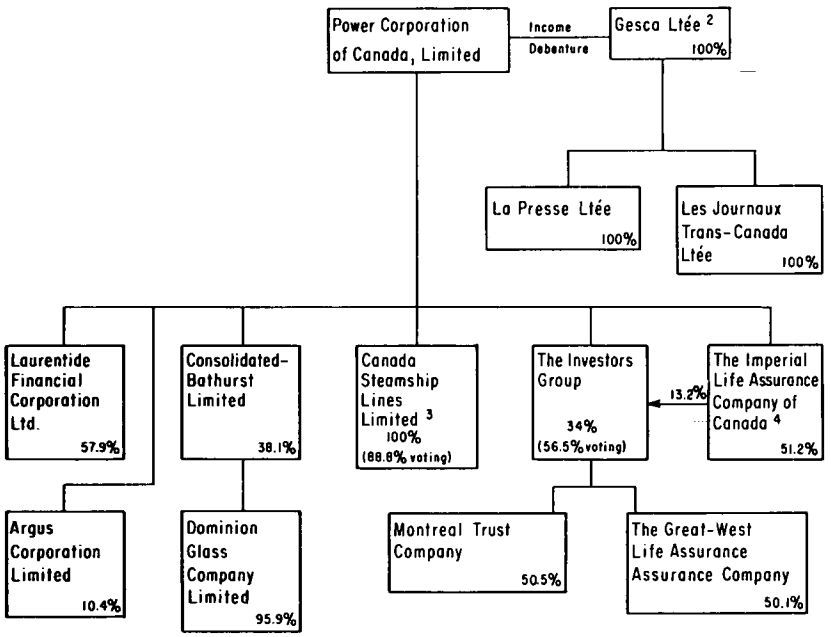

FIGURE 7.1. Power Corporation of Canada, Limited. Major Investments, March 25, 1975.[1] Common shares.

Source: Royal Commission on Corporate Concentration (RCCC) research.

Notes

1. This table illustrates the size and diversity of the Power interests on the date Power announced its intention to take over Argus. There have been changes since then but none are significant for the purposes of this *Report*.
2. The shares of Gesca are owned by Gelco Enterprises (the Desmarais-Parisien holding company).
3. Subsequent to March 25, 1975, Power increased its ownership of Canada Steamship Lines to 100% voting. As a result of its bid for Argus, and subsequent thereto, it increased its interest in Argus to 25.3% voting and 52.9% equity.
4. In 1977 Power sold its holdings in Imperial Life to a life insurance company based in Quebec City, for about $10 million, and it has since purchased, through its wholly owned subsidiary, TransCanada Corporation Fund, Imperial's 13.2% interest in Investors.

The relationship between Power and the companies in which it has interests (with the exception of Argus) is one of active and interested supervision over broad policy matters and of important activities such as the selection of a chief executive officer and board nominees. While Power is represented on the executive committees of these affiliates, the committees are not crucial to the maintenance of its control. Representation on the boards of the affiliates is important, and Power influences them mainly in this way. Except for Consolidated-Bathurst Limited, over which it has effective (but not legal) control, and Argus, over which it has no control whatsoever, Power owns (or controls through other affiliates) sufficient shares to give it over 50% of the votes in all its affiliates.

Power is a large company, at least by Canadian standards. In our list of Canada's largest non-financial firms for 1975, Power ranked 98th by sales ($293 million), 45th by assets ($579 million) and 38th by net income ($32 million). Its financial affiliates administer billions of dollars of assets, some of which are owned by the companies in question and some of which they merely administer. Whether the assets are owned, as by life insurance companies, or are merely administered, as by trust companies, Power's ability to deal with them is carefully limited and constrained by law.

Argus Corporation Limited

Argus Corporation was founded in 1945 by a group of Toronto business and investment men led by E. P. Taylor and the late W. Eric Phillips. Its original philosophy, stated in the 1946 annual report, was to invest in a relatively few enterprises, mainly for long-term growth, and it has adhered to this approach. It is a closed-end investment company, which has been controlled since its inception by a small group of people, the composition of which has occasionally changed. This group now holds its interests through The Ravelston Corporation Limited, a holding company. Since 1971 J. A. McDougald has been Chairman and President of Argus.

At the end of 1977, McDougald and his associates, through Ravelston, owned or controlled, directly or indirectly, about 61.5% of the common (voting) shares of Argus, giving them legal control. They also owned or controlled about 23% of the Class C (non-voting) shares which were distributed to the common shareholders on a 4-for-1 basis in May 1962. They had in the aggregate about 31% of the equity stock of Argus. Power in mid-1977 held about 25% of the common shares and sufficient Class C shares to give it almost 53% of the equity stock of Argus, apart from the senior Class A and Class B preferred shares. The Jackman interests (who have an informal arrangement with the Ravelston group) hold 8.6% of the common shares and the remaining 5% is in the hands of the public.

At the time of Power's bid for control, Argus held (and still holds) large, but minority, positions in five major Canadian companies in the following industries: merchandising; pulp, paper and packaging; mining; manufacturing; and communications. Its major investments as at March 25, 1975, are shown in Figure 7.2.

Several of these companies are important in the Canadian economy in their own right. For example, in our list of large Canadian non-financial firms, Dominion Stores ranked 10th by sales ($1.9 billion), and Domtar ranked 36th by sales ($815 million). In addition Massey-Ferguson, which ranked 7th by sales, is a multinational corporation of significant stature, with sales outside Canada of over $2 billion.

Argus has held its investment in these companies for many years (on a weighted basis, the average time that each investment has been held ranges from about 12 years to about 29 years). This factor, among others, has permitted Argus to play a significant role in their affairs while holding only a minority interest. Argus representatives constitute a majority on each executive committee (Standard Broadcasting Corporation Limited does not have such a committee), and these committees do, in fact, have and exercise power. Argus is also represented on the boards of all five companies, its representatives constituting from one-third to one-half of the membership. No other shareholder holds as much as 10% of the voting shares of these companies.

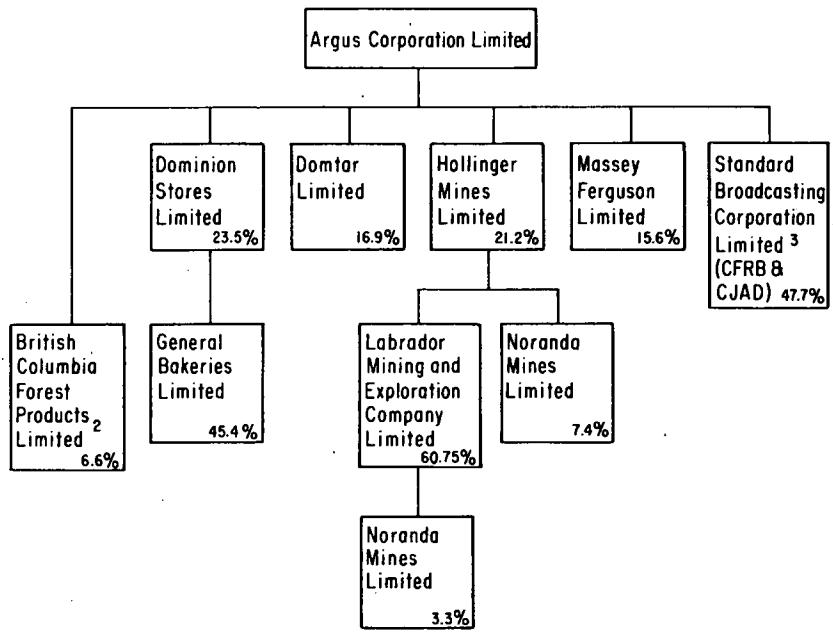

FIGURE 7.2. Argus Corporation Limited. Major Investments, March 25, 1975.[1]

Source: RCCC research.

Notes

1. This table illustrates the size and diversity of the Argus interests on the date Power announced its intention to take over Argus. There have been some changes since then but none that are significant for purposes of this *Report*.
2. Interest disposed of July 5, 1976.
3. On March 13, 1975, Standard Broadcasting received approval from the CRTC to purchase a 52% interest in Bushnell Communications Limited. The purchase became effective April 28, 1975. In October 1976 it increased its interest to 62.2%.

Argus is careful to say that it does not "control" these companies. It readily acknowledges, however, that it influences their affairs. The influence is such that no major transaction is undertaken by any of the companies without the approval of the Argus representatives on the boards. Because Argus does not have legal control, its investments in the companies are carried on the Argus balance sheet at quoted market value. Power carries its Argus investment on a cost basis (with market value indicated), but its wholly owned subsidiaries are consolidated, and other subsidiary and affiliated companies are accounted for on an equity basis.

Argus, like Power, is an important company that influences the affairs of other major corporations. Because it has less than a 50% interest in, and therefore does not legally control, its associated companies, it is not included in most lists of Canadian firm rankings by size. However, its 1975 balance sheet indicated assets of $204 million and net income of $12.1 million.

Relationships with Affiliates and Associated Companies

From the foregoing, it will be apparent that there are some significant differences between Power and Argus. Certainly their origins and their business activities and strategies seem to be sufficiently divergent to limit the usefulness of comparisons between them. One of the most striking differences is the perception each corporation has of its relationships with its affiliated companies. Power monitors the performance of its affiliates and, because of its legal control, seems to accept some degree of residual responsibility for them. Power considers that having a controlling interest is good for its own shareholders. Desmarais told us, "If you have control of something, it is usually worth more than just a passive investment."

Argus is adamant on its interpretation of the question of control of its associated companies. Argus has a large, but minority, interest in the five companies and has always taken the position that it does not control them and cannot speak for them. McDougald told us that "Argus Corporation is not a conglomerate. Argus has not subsidiaries and does not manage any other companies in which it holds shares. . .and does not advance funds to or purchase debt instruments of the companies in which it holds shares."

These may not be real differences between the two firms, however, only differences in style or perception. Desmarais, when asked, thought that "They [Argus] probably have the same amount of direction, and the same amount of control that we have, but that is an historical control and was spelled over a period of time. . . ." Recognizing, and subject to, the very important constraints upon Argus that might arise in some circumstances where it does not have over 50% of the votes in a company, we are inclined to agree that, as a practical matter, there is no important difference in the influence exercised by Power over its affiliates and that exercised by Argus over its associated companies.

The Takeover Bid

In the spring of 1969, Power acquired about 10.4% of the Argus common shares. Most of these were bought from Gelco (Messrs. Desmarais and Parisien) and the rest were bought in the open market. Power has subsequently stated that this original acquisition was made because of the strength of Argus and its importance as a pool of capital. In June 1969, two Argus shareholders, Ravelston and Windfields Farm Limited, pooled the voting power of their combined shares, for a minimum of five years. Between the time of its original purchase and the spring of 1975, Power did not increase its investment in Argus.

On March 25, 1975, Power announced that it proposed to make a bid to acquire all Argus common and Class C (non-voting) shares. The offer was $22 for each common share and $17 for each Class C share. In the six preceding months the common shares had traded within a range of $13 to $17, and the Class C shares had traded within a range of $8.25 to $13. The offer, made on April 3, was more successful in obtaining Class C shares than in obtaining common shares.

Argus shareholders were informed that Ravelston would not accept the Power offer. Because Ravelston held 50.9% of the common stock, this meant that the Power bid for control had failed. Although the Power offer for common stock was conditional upon an 80% or greater acceptance by Argus shareholders, Power accepted all shares tendered. Shortly after the offer closed Ravelston increased its holdings in Argus to 61%. Although control of Argus did not change hands, Power has continued to buy common shares of Argus whenever they become available. At the end of 1977 it held about 53% of the Argus equity stock and about 25% of the votes.

Power has stated that it attempted to buy control of Argus because "it was considered to be a good investment opportunity" for Power's shareholders, and because Power could then broaden its earnings and assets base and expand into new areas. The study commissioned by us refers to the bid as "mystifying" and suggests that, had Power acquired control of Argus, some or all of Argus' investments would likely have been sold, and the proceeds used to acquire control of other companies. Desmarais has indicated that if the Argus controlling stock becomes available, Power would still like to acquire it, although at the present time it seems clear that, as he told us, "the doors have been slammed pretty firmly."

If the takeover bid had been totally successful the cost to Power would have been about $148.5 million. This sum was committed to Power by The Royal Bank of Canada and the Canadian Imperial Bank of Commerce, on a temporary basis. The amount that had to be provided to Power to pay for the shares that were tendered was about $70 million, which was raised by Power through its sale to three banks of income debentures of varying maturities.

The Commission's Assessment

In the Canadian context a merged Power-Argus would be prominent among major concentrations of corporate power. Even though Power does not at the present time control Argus, we offer our comments on the implications for Canadians of a successful takeover of Argus by Power.

Financial Aspects

While a change in control of Argus would not immediately alter the size or composition of companies in the merged group, it is nevertheless useful to draw a picture of what a Power-Argus corporation would look like. After the acquisition was completed, and before any disposition of assets, the combined firm would have had assets (at balance sheet values) of $783 million. This would have placed it about 37th (in terms of assets) in our 1975 list of large non-financial firms. On an earnings basis it would have ranked about 24th. In these calculations we are not including the assets administered by the financial companies in the Power group.

Dollars alone may not be an adequate measure or satisfactory indicator for a complete evaluation of potential impact. A Power-Argus corporation would have a substantial influence over major firms in many important industries (see Table 7.1). Except for the interests in pulp and paper, and

Table 7.1

Power and Argus,

Combined Major Investments, March 25, 1975
(Common Shares)

Financial Services		*Pulp, Paper and Packaging*	
Investors Group	34.9% (56.5% voting)	Consolidated-Bathurst[3]	38.1%
Great-West Life[1]	50.1%	Domtar	16.9%
Montreal Trust	50.5%	British Columbia Forest Products	6.6%
		Communications	
Imperial Life[2]	51.2%	Standard Broadcasting	47.7%
Laurentide	57.9%	La Presse[4]	100%
		Les Journaux Trans-Canada[4]	100%
Manufacturing		*Mining*	
Massey-Ferguson	15.6%	Hollinger Mines[5]	21.2%
Transport		*Merchandising*	
Canada Steamship	100% (88.8% voting)	Dominion Stores[6]	23.5%

Source: RCCC research.

Notes

1. Owns 9.5% Investors voting shares.
2. Owns 13.2% Investors voting shares and 7% equity.
3. Owns 95.9% Dominion Glass.
4. Owned by Gesca Ltée. All income and gains accrue to Power until 2020.
5. Owns or controls directly or indirectly, 10.7% Noranda Mines.
6. Owns 45.4% General Bakeries.

possibly communications, a joining of the two firms would produce essentially a conglomerate merger. As we said in Chapter 5, our research indicates that firms that have diversified into unrelated industries have decreased their return on investment, return to their shareholders and growth in sales per share. We assume for these purposes that, while a merger of Power and Argus would create a single large enterprise there would not be any material increase in the size of its component economic and technological units. We see nothing to indicate that a merged Power-Argus would be an exception to the general conclusion drawn from our research, although the merged firm might realize gains in financial flexibility, an increased ability to raise capital in international markets and returns to scale in management. Although the probable financial performance of the merged firm does not raise issues of important public interest, it might well be of considerable importance to shareholders.

The possibility of a Power-Argus combination does, however, raise some issues that touch upon the public interest more directly. These issues arise within the context of competition policy and the broad social impact of such a merger.

Competition Policy Aspects

Canadian competition policy is found in the Combines Investigation Act. If Power and Argus controlled, directly or indirectly, or had significant interests in, corporations that competed with one another in particular product markets in Canada, and in addition jointly accounted for a substantial proportion of those markets (i.e. in the range of 60%), then their merger might violate the Act. A possible violation of the Act would also occur if any of the firms were significant actual or potential customers or suppliers of one another and if there were serious doubt as to whether firms outside their group would be hampered in selling to or buying from firms within the group.

In the Power-Argus situation such questions do not generally arise. Only with Consolidated-Bathurst and Domtar, and then only in the pulp and paper sector, would there be any reason to consider whether competition law might be violated by the merger. We have reviewed this part of the hypothetical transaction, and in doing so have focused on the structural impact of the joining together of Consolidated-Bathurst and Domtar under the Power-Argus parentage. We assume here that Argus' direct holdings in British Columbia Forest Products Limited at the time of the bid would have been sold, as was Argus' intention at the time.

The nature of the pulp and paper industry requires that competitive impact be assessed within the context of individual product markets and carefully defined geographic markets. Our review, based on a market share evaluation, indicates that in the product categories of paperboard and corrugated boxes, and possibly fine papers, the merged organization could have a significant impact. In the areas mentioned, but probably in no others, the joining of Consolidated-Bathurst and Domtar would, we believe, have an impact significant enough to warrant those responsible for the administration of the Combines Investigation Act investigating the facts.

The only other field where there might be issues relevant to competition policy is communications. Standard Broadcasting cannot be said to compete in any significant way with either the newspapers or the broadcasting companies in the Power group. Even if it did, there is little likelihood that the merger would lessen competition to the detriment of the public. While other issues are raised by this aspect of the merger (and we shall refer to them below), there is no reason to think that it would offend competition law.

It is our conclusion that, judged according to our view of the general effects of conglomerate mergers, there is no reason to think that the Power bid for Argus, had it been successful, would have resulted in a situation adverse to the public interest because of a lessening of competition.

Other Aspects

Shortly after the takeover bid was announced, the *Financial Post* referred to the combined firm as one that would comprise "a dazzling collection of some of the country's largest companies". Certainly a successful bid would have seen a number of very significant companies in some major industries fall within the control of one parent company (and ultimately one individual). Even though competition law might not be violated, would this accumulation of corporations within one group constitute a danger to the public interest? Should this concentration of ownership, which was probably at the root of most public apprehension regarding the takeover, be a matter requiring public action?

INTERNATIONAL TRADE

Power has suggested that the takeover would be beneficial, since a combined Power-Argus would "create a Canadian company of size capable of operating more effectively on a world scale". McDougald commented, regarding this statement, that "Most of (our companies) are. . .fairly good on the world scale as it is and we don't need anyone to help us."

We have seen nothing to suggest that the present affiliates of Power or the associated companies of Argus are too small to function effectively. It is likely that the individual companies would not benefit in the way suggested from the change of ownership and control resulting from the merger, unless there were significant divestment of some companies and subsequent investment of the proceeds in assets capable of being profitably used by the companies still held.

On the evidence we have heard, the Commission accepts that in some international markets, large corporate size may be of some assistance in doing business successfully. A successful takeover of Argus might therefore improve some customers' perceptions of Power's ability to participate in world-scale transactions. Canada certainly needs firms that can mobilize the capital and other resources required to do business in competition with foreign corporations. A Power-Argus merger holds out to some observers the prospect of increased Canadian investments abroad, or greater exports by the merged enterprise. After reviewing the probable consequences of a merger, we conclude that any benefits to the Canadian public in increased international trade from a combination of the two enterprises are likely to be negligible.

FINANCIAL INSTITUTIONS

The presence in a merged Power-Argus of some large financial institutions is not, of itself, a matter of concern. The common ownership of Investors, Great-West Life, Imperial Life, Montreal Trust and Laurentide has had little observable effect on the operations or performance of those companies, or of their competitors. Even if they were part of a larger group and related to other major firms, they would still be governed by laws that effectively eliminate any significant risk of misuse of funds.

COMMUNICATIONS

We have said that the merging of the communications interests of Argus and Power would not appear to violate the Combines Investigation Act. Because of the relationship between Desmarais and Power, however, it would certainly constitute a significant concentration of ownership of media interests. As of mid-1976, Gesca (owned by Gelco, but with income accruing to Power) owned five daily newspapers in Quebec, which accounted for over 50% of the circulation of French-language dailies in the province. Of the five, *La Presse* was the most important and had the largest circulation of any French-language daily newspaper in Canada. Three of the others are the only daily papers published in their respective cities (Sherbrooke, Trois-Rivières and Granby). Gesca also owned indirectly a radio station in Granby. Power Corporation held a $7.25 million debenture of, and 2.1 million participating, non-voting preferred shares in, Beau-dem Ltée. Beau-dem owned three television stations, seven AM radio stations and three FM radio stations. Of these CKAC, Montreal, is the largest French-language radio station in the province. Desmarais (who indirectly owns 75% of Gelco) also has a 33.3% interest in Prades Ltd., which operates a small radio station in Shawinigan and a television station in Carleton, Quebec, which in turn has a number of rebroadcast stations.

Standard Broadcasting, controlled by Argus, operates CFRB, Toronto, the radio station with the largest audience in Canada, and CJAD, Montreal, which has the largest English-language radio station audience in Quebec. Since the Power Corporation offer, Standard has acquired a 62.2% interest in Bushnell Communications Limited. Bushnell operates CJOH-TV, the largest television station in Ottawa, and has 75% of one Ottawa cablevision company and 44% of another. Approval for the purchase by Standard of a 52% interest in Bushnell was given by the then Canadian Radio-Television Commission on March 13, 1975.

A takeover by Power of Argus would constitute a change in effective control of Standard Broadcasting. That aspect of the transaction would have to be specifically approved by the Canadian Radio-Television and Telecommunications Commission (CRTC), which has authority to revoke a broadcast licence if it does not approve a change in effective control of a broadcast licensee. The CRTC has in the past expressed concern about the accumulation of significant ownership interests in broadcasting (especially where ownership

of newspapers may also be involved), because of the potential influence of owners of communications interests. For example, in January 1977, the Chairman of the CRTC said that it "has no real hang-ups about size of broadcasting undertakings. Its concerns are rather that there should be no undue concentration of media control, particularly in any given location. . . ." We understand and share that concern.

We see no advantage to the public interest in the common ownership of the Power-Argus communications interests, and there is a potential detriment to the public interest if enough important instruments of communication, in different media fields, are owned or controlled by one person or group.

SIZE AND INFLUENCE

Among the factors that should be considered in evaluating the contemplated takeover from a more general perspective are the merged firm's overall size, probable behavior and likely degree of influence. Of course, it is difficult to measure such implications of corporate size as impact upon the public or ability to influence various kinds of actions. The activities of large companies may have positive effects, negative effects, or a complex mixture of both. To the extent that large corporations do have them, such impact and ability (actual or potential) probably increase (although probably not proportionately) with size. This is so whether the measurement is the greater number of employees in the merged group, the greater opportunities for contact with government representatives at many levels or any one of a number of other possible factors.

Desmarais himself (with the Parisien family interests) would effectively control many important firms. We know of no standards by which to state that this would be "excessive power", but it would certainly be substantial. It is true, however, as the Power brief indicated, that ownership or control is only one of a number of "levers of power that are used to influence decisions and shape events". Yet because it is such an important factor, Desmarais would be able, potentially, to exercise, or to attempt to exercise, very considerable influence, even with the many legal and other constraints that would be present. We must ask whether such potential influence is harmful to the Canadian public interest.

That question requires a difficult and delicate judgment of public policy. We do not think there would be substantial economic gains or losses from a Power-Argus merger. The social costs are probably minimal. Since Argus has not been active in acquiring other companies, its absorption into Power would have no effect on the market in the buying and selling of businesses. In our view, the overall consequences of such a merger are relatively neutral. In such circumstances, should the paramount consideration be one of maximizing the decentralization and diffusion of whatever power exists in corporations and corporate groups, or should we tolerate whatever happens in this particular market unless, according to legislated standards (such as those expressed in competition law), the public interest is harmed?

As we indicated in Chapter 6, it is our view that there is probably some point between these two positions at which Parliament should intervene to review an acquisition or merger. It is, of course, impossible to specify precisely where that point lies. Threshold limits, beyond which a person or group would be prevented from proceeding, should be avoided, because they would inevitably be arbitrary and would be a serious damper on initiative and action. The possibility of intervention could arise only in rare situations like the present one involving several very large and important firms with many interests in several significant and sensitive sectors of the economy. Canada does not have many firms like Power and Argus. In most acquisitions, competition law would protect most aspects of the public interest.

In those few instances where undesirable concentration of ownership, influence, or control would arise, the Cabinet should undertake an appraisal of that specific case. Ultimately, the decision whether or not to intervene will have to be made by Parliament, and it will reflect political and social concerns. Because of the implications of intervention, or non-intervention, we think it is appropriate that the responsibility for these judgments be placed with the Cabinet.

Conclusion

Our analysis of the Power-Argus situation leads us to think that the power resulting from a merger of the two firms is not likely to have an adverse effect upon the public interest. Had Power acquired Argus, it would not thereby have significantly increased its market power in any industry. There are no other factors in the Power-Argus situation that lead us to conclude that the merged firm or those controlling it would act in a way that would be detrimental to the public interest.

Chapter 8

Foreign Direct Investment

Long-term foreign direct investment has an important impact on the structure and behavior of Canadian industry and hence on the economic power exercised by large firms in Canada. An understanding of this impact requires a brief review of the size, nature and causes of foreign direct investment in Canada, but, since the impact of foreign direct investment is manifested in social as well as economic activities, a wider framework encompassing its social and political as well as economic consequences must be used.

Long-term foreign direct investment is basically the transfer of a package of assets from a foreign-domiciled corporation through corporate channels into an enterprise in Canada, either by acquisition of an existing firm or the creation of a new enterprise, which thereafter becomes a subsidiary of the foreign corporation and subject to its control. The assets transferred in the package may include capital, a licence to use a brand name and preferred access to markets and sources of raw materials. The most important part of the package, however, is usually a distinctive technology, the "core skill" of the parent corporation. This core skill, as defined by Leonard Wrigley, is the "collective knowledge, skills, and habits of working together . . . required to enable the firm to survive and grow in a competitive market." The core skill (or know-how) is "information not just of a technology or of a market, but of one in relation to the other", and, because it is a collective skill, it can usually be transferred most efficiently within the administrative channels of the corporation, rather than between corporations through the market by arm's length transactions between independent firms. In making investments outside their base countries, multinational enterprises are maximizing the rent they can obtain from their core skills. This process has the potential for increasing the economic growth of the host country, but it may also lead to a different level and diversity of output both within the host country and across the countries in which the multinational enterprise operates.

This raises a fundamental dilemma for Canadian society. Although it is difficult to quantify its social, political and economic impact on Canada,

foreign direct investment, by bringing into Canada technology, management skills and capital, raises the productivity of Canadian industry, accelerates the rate of industrial growth and promotes economic prosperity. In the longer run, however, it may atrophy or limit the ability of Canadian firms to develop indigenous research and development, entrepreneurial expertise or export capacity, decrease the amount of upgrading of Canada's natural resources before export and cause a reverse flow of dividends, interest and capital. In addition to these potential economic problems, foreign ownership may not be compatible with Canadian political sovereignty. Foreign laws and directives reach into Canada through multinational enterprises. For example, in the case of the uranium cartel, the Canadian subsidiary of a U.S. firm was reluctant to comply with the wishes of the Canadian government for fear of U.S. antitrust laws.

Before World War II, direct investment by foreigners represented only 33% of total foreign investment in Canada. The remaining 67% was portfolio investment in the stocks and bonds of Canadian companies and governments. There was little public awareness of attempts by foreign governments to apply their legislation in Canada along with direct investment originating in their country.

Since the 1950s there has been growing concern in Canada about the political, social and economic implications of direct foreign investment. In part, this concern arose because of the increasing amounts of such investment after the war. By 1950, direct foreign investment in Canada amounted to $3,975 million, or 45.9% of total foreign capital invested in Canada. By 1960, it amounted to $12,872 million, or 57.9% of such foreign capital. About 1960, the U.S. government began to pass and implement legislation that applied to the activities of Canadian subsidiaries of U.S. firms. Such legislation restricted the application of Canadian public policies in respect of Canadian subsidiaries of foreign companies. Also, during this period Canadian nationalism began to emerge as a political and social force. The dilemma of how to reconcile prosperity and sovereignty thus became acute.

It is clear from the briefs and oral evidence submitted to us that there is concern about long-term foreign direct investment in Canada. It is also clear that while many people hold strong views on the subject there is no unanimity among them. The subject presents a problem for which the solution under present circumstances can be only an untidy, flexible and ambiguous compromise.

This chapter describes the historical dimensions of foreign direct investment in Canada, the public issues it has raised and the government's responses to these issues. We then present a number of ideas originating with our briefs and hearings on the effect of foreign investment on corporate concentration and conclude with suggestions for alternative ways to resolve the Canadian problem of foreign investment.

The Nature and Level of Foreign Investment in Canada

Over the past 100 years Canada's major economic goal has been to develop its economy through broadly based industrialization covering a wide range of manufacturing and resource development activities. To achieve this Canada has looked to foreign direct, portfolio and debt investment for about 30% of the capital required. From 1900 to 1914, two-thirds, on average, of foreign investment in Canada came from Britain although the British share was declining. From 1918 to 1939 the United States was the major source of foreign capital. The total amount of foreign capital rose over the years from $1.2 billion in 1900 to $3.8 billion in 1914, and $7.6 billion in 1930. Portfolio investment constituted about two-thirds of total foreign investment in Canada in 1926 and continued to make up over 60% of the total until World War II. This investment was mostly in the form of non-resident holdings of railway securities and government bonds.

Since the end of World War II, foreign investment in Canada has undergone two major changes (see Table 8.1). The first was a great increase in total amount from $8.7 billion in 1950 to $68.6 billion in 1975. Even allowing for inflation of 140%, an increase of that amount is without precedent in any major industrial country, with the possible exception of Australia. The change in the nature of foreign investment from portfolio to direct investment was equally important. The direct investment component (comprising the total of equity investments, undistributed retained earnings and long-term debt owed to the parent firm) of foreign capital invested in Canada rose from 39% in 1946 to 46% in 1950 and to 58% in 1960. Since 1966 it has hovered between 58% and 61% with no particular trend. (By contrast, in the past most Canadian investment abroad has been portfolio rather than direct investment.) This change in the nature of the major proportion of foreign investment corresponded with a change in source. Since World War II the major source of foreign investment has been corporations, primarily the 500 largest U.S. industrial corporations. Of the $39.8 billion of direct foreign investment in Canada by 1975, $32.2 billion had been invested by U.S. corporations. The impact of this change toward direct investment by the largest corporations can be seen in the ownership of the 200 largest Canadian industrial corporations: 91 are the subsidiaries of firms numbered among the 500 largest U.S. corporations.

Before proceeding, it should be mentioned that direct investment is a two-way flow. Some Canadian firms (for example, Moore Corporation Limited, Massey-Ferguson Limited and Inco Limited) have made extensive overseas investments. This flow has increased in the last few years until in 1976 the outflow of funds for Canadian direct investment abroad was greater than the flow of foreign direct investment into this country.

Foreign Direct Investment

Foreign direct investment tends to be one of two quite different kinds: either an investment made to take advantage of opportunities in the market of the host country or an investment made to exploit resources available in the

Table 8.1

Contributors to Change in Book Value of Foreign Direct and Long-Term Investment[1] in Canada, 1945-75
(Billions of Dollars and Percentages)

Foreign Direct Investment Flows	1946-50	1951-55	1956-60	1961-65	1966-70	1971-75
Net capital inflow for direct investment	0.49	2.00	2.86	2.15	3.63	3.55
Net increase in undistributed earnings	0.71	1.40	1.69	2.21	4.24	10.63
Other factors[2]	0.06	0.35	0.59	0.12	1.13	0.70
Net increase in book value	1.26	3.75	5.14	4.48	9.00	13.48

	1945		1950		1955		1960		1965		1970		1975	
Stock of Foreign Direct Investment by Source	$	%	$	%	$	%	$	%	$	%	$	%	$	%
U.S.	2.30	84.9	3.43	86.2	6.51	84.3	10.55	82.0	14.06	81.0	21.40	81.2	32.19	80.8
U.K.	0.35	12.8	0.47	11.8	0.89	11.5	1.53	11.9	2.03	11.7	2.50	9.5	3.72	9.3
Other countries	0.06	2.3	0.08	2.0	0.33	4.2	0.79	6.1	1.26	7.3	2.45	9.3	3.93	9.9
All countries	2.71	100.0	3.98	100.0	7.73	100.0	12.87	100.0	17.36	100.0	26.36	100.0	39.84	100.0
Total Foreign Long-Term Investment, by Source														
U.S.	4.99	70.3	6.55	75.6	10.30	76.1	16.72	75.3	23.39	79.0	34.91	79.3	52.94	77.1
U.K.	1.75	24.7	1.75	20.2	2.38	17.6	3.36	15.1	3.51	11.9	4.02	9.1	5.67	8.3
Other countries	0.35	5.0	0.36	4.2	0.85	6.3	2.13	9.6	2.70	9.1	5.10	11.6	10.04	14.6
All countries	7.09	100.0	8.66	100.0	13.53	100.0	22.21	100.0	29.60	100.0	44.04	100.0	68.65	100.0

Foreign Direct Investment as a Percentage of Total Investment in Canada by Source							
U.S.	46.2	52.3	63.3	63.1	60.1	61.3	60.8
U.K.	19.9	26.7	37.3	45.7	57.9	62.3	65.5
Other countries	17.3	22.2	38.3	36.9	46.8	48.1	39.1
All countries	38.3	45.9	57.1	58.0	58.6	59.8	58.0

[1] Foreign long-term investment as recorded in these series consists of all long-term claims on residents of Canada held by non-residents, except for investments in Canadian companies reinvested abroad. This net stock of foreign-owned long-term capital employed in Canada comprises direct investment, portfolio investment (including foreign investment in Canadian government securities) and miscellaneous investment. Foreign direct investment comprises equity, retained earnings and long-term debt.

[2] New issues, retirements, borrowing, investment abroad, etc., affecting the total value of foreign direct investment in Canada, and other factors including revaluations, reclassifications and similar accounting adjustments.

Source: *Canada's International Investment Position 1971-1973*, Statistics Canada Cat. No. 67-202, pp. 86-89 and 103, and *Statistics Canada Daily* of January 10 and 30, 1978.

host country. The nature of the assets transferred from the parent corporation to the subsidiary varies accordingly.

When an investment is made to exploit the market of the host country, the distinctive core skill of the foreign-domiciled corporation is transferred to the subsidiary. In addition to the core skill, there is the right to use the corporate name, which can be a valuable asset both to raise capital in the host country and to secure consumer acceptance of products. These two assets, core skill and corporate name, are such that their use abroad need not again require the same costs associated with their original development, while their use by the corporation in its home market is not appreciably reduced.

Resources acquired in the host country are usually either raw materials or labor (but in some instances they include technology and other core skills). Investments to exploit raw materials may represent no more than backward integration of a foreign corporation anxious for assured raw material supplies. Exploitation of a raw material such as oil is likely to represent an extension of a multinational enterprise's core skills to a new geographic region. Firms also make direct investments in exploration, development and marketing in countries to obtain access to cheap factors of production (for example, cheap labor). Investments to exploit both material and labor resources tend to be made in countries where capital is costly, and usually the investment package has to contain the necessary capital as well as the firm's core skills.

In industries characterized by rapid change and advancement in the level of core skills such as marketing, production, technology, research and development (R&D), finance and management, the market for these core skills is often imperfect and inefficient, so that they will only rarely be transferred from firm to firm by a sale of licensing rights, management consulting, or "turnkey" projects. Instead a firm will have to make a direct investment to maximize the profit deriving from its core skills. In stable industries, competition reduces these profits from direct investment and makes the external market for core skills more efficient and thus reduces the incentives to make direct foreign investment. The present level of world-wide direct foreign investment may indeed represent the peak of multinational enterprise because many of the industries (for example, processed foods) in which it has occurred in the past are becoming more stable. We expect that where continuous technological innovation is important transfer of the core skill will be largely within the corporation and that industries reflecting these conditions will tend to be characterized by direct foreign investment.

Firms whose core skills include product differentiation by branding and associated marketing expertise also have a high propensity to make direct foreign investments. They often erect substantial barriers to entry to new, local firms because of the scale of marketing efforts necessary to obtain a viable market share and the uncertainty of the success of such an effort. Unlike technological skills these skills in marketing are difficult to duplicate or erode by potential competitors.

The core skills of a multinational enterprise often give it a competitive advantage over those domestically owned firms that have no foreign operations

themselves. In addition, the subsidiary of a multinational enterprise often also has greater access to both international and local capital markets than have domestically owned firms of similar size. A multinational enterprise may invest in a country to obtain economies of scale or a reduction of risk for the firm as a whole, which are not available for a domestic firm operating in only one market. Thus it can make new investments or sustain previously established positions under conditions that would be unattractive to domestically owned firms.

Analysis of the characteristics of foreign-domiciled corporations that make direct investments abroad must begin with reference to the characteristics of the 500 largest industrial corporations in the United States ("Fortune 500"), because this group is responsible for $140-$150 billion, or about 60%, of total, world-wide, direct foreign investment outside the Communist countries. Corporations in the "Fortune 500" tend to be in industries characterized by continuous technological innovation, capital intensity, product differentiation and income-elasticity of demand (for example, automobiles, chemicals, electronics, petroleum and convenience goods).

It has been said that these large U.S. firms are extremely profit-oriented and seek their profits by exploiting those of their core skills that cannot easily be duplicated by other firms. From that view, growth and diversification are incidental by-products of the pursuit for profits. Such firms also tend to withdraw quickly through divestiture of tangible assets when markets prove unprofitable or when a government demands access to their core skills for local investors through joint ownership.

To the extent that the economic activity in different national markets is uncorrelated, direct investment can reduce variations in a firm's income stream. Multinational enterprises also try to invest in several markets to ensure that they have operations in whichever market grows the most quickly. Risk reduction as well as profits can therefore motivate international diversification.

Until the mid 1960s, the largest U.S. corporations had a comparative advantage over firms from other developed countries because of their size, which allowed them to enjoy the large economies of scale available in generating core skills in finance, management, R&D and marketing and in their access to the largest, highest income market in the world. But a comparison of the 100 largest U.S. corporations with the 100 largest non-U.S. corporations suggests that the relative size advantage, while still great in 1965, has been gradually eroded from 1965 onwards until by 1975 there was no significant size difference: in 1975 the average sales of the 100 largest industrial corporations were $5,600 million while those of the 100 largest non-U.S. corporations were $4,900 million. Robert Rowthorn and Hymer Stephen in *International Big Business* have concluded that the growth of large multinational corporations is linked to the growth of their base national markets. As the growth of the U.S. economy has fallen relative to that in some other developed countries, U.S. multinational corporations have begun to lose their dominant international position. Robert B. Stobaugh in an article in the *Journal of International Business* (1977) observed that U.S. multinationals are facing increasing com-

petition from larger multinationals domiciled in other countries. This comparison of changes in relative size is significant because foreign direct investment in Canada tends to be made by large corporations. In the decade ahead the relative U.S. presence in Canada probably will not be so large as in the past decade; non-U.S. corporations will form a higher proportion of the foreign direct investment in Canada than they have in the past.

The probability of a decline in the level of U.S. foreign direct investment is strengthened by recent data on divestitures by U.S. corporations that in the past have made large foreign direct investments. Of the 500 largest U.S. corporations, some 180 have been classified as multinational enterprises, in that they have subsidiaries in six or more foreign countries, or have obtained 25% or more of their sales from foreign subsidiaries. Some of these U.S.-based multinational enterprises have recently been withdrawing their direct investment at about the same rate as others have been making it. A 1977 unpublished study undertaken by Brent Wilson at the University of Virginia found that complete divestitures of U.S. overseas subsidiaries totalled 1,459 during the 1971-75 period, nearly four times the number divested from 1961 through 1965, and that the increase in the number of divestitures coincided with a decline in the number of new foreign subsidiaries being formed. In 1971, there were 3.3 new investments for each disinvestment; by 1975, that ratio was 1.4 new investments for each disinvestment. According to *Fortune,* most of the disinvestments were motivated by inadequate earnings rather than by pressures from the host countries.

In research for the Commission, Richard Caves found evidence that foreign firms make direct investments in Canadian industries with both high concentration and moderately high barriers to entry. When attention is focused on disinvestments, Caves' conclusion seems to be reinforced. Comparatively few divestitures have taken place in highly concentrated industries like automobiles, tobacco products, office equipment, chemicals and pharmaceuticals. By contrast, a relatively high percentage of disinvestments has occurred in such unconcentrated industries as apparel, beverages, furniture and leather goods. Multinational enterprises divest their holdings in these unconcentrated industries because of low profits caused by local and international competition.

In considering the degree of foreign ownership and control of Canadian industry, however, it is important to begin with aggregate data. From 1954 to 1974 the total capital employed in Canada in the non-financial sectors increased from $28.2 billion to $129.7 billion (Table 8.2). Of this, the proportion under domestic control throughout the entire period varied between 64% and 72%. The degree of foreign ownership and control of economic activity in Canada throughout the 15 years 1960-1974 has been high but quite stable (33%-36%). The indications are that this degree of overall stability has continued to the present.

However, important structural changes did take place from 1954 to 1972. The degree of U.S. control rose slightly while that of non-U.S. foreign control rose more significantly. Non-U.S. foreign control was 4% in 1954, 8% in 1969, and 9% in 1971 and 1972. It should be noted, however, that these are

Table 8.2

Estimated Book Value,[1] Ownership and Control[2] of Capital Employed in Non-Financial Industries,[3] Canada, 1954-74

Year	Total Capital Employed	Percentage of Capital Employed Owned in		Percentage of Capital Employed Controlled in		
		All Foreign Countries	U.S.A.	Canada	U.S.A.	Other Foreign Countries
	(Billions of Dollars)					
1954	28.2	33	25	72	24	4
1955	30.4	33	25	69	26	5
1956	34.0	34	26	69	26	5
1957	37.6	34	26	68	27	5
1958	40.5	34	26	68	26	6
1959	43.6	34	26	68	26	6
1960	45.6	34	27	67	26	7
1961	47.6	35	27	67	26	7
1962	49.2	35	28	66	27	7
1963	51.8	35	29	66	27	7
1964	55.3	35	29	66	27	7
1965	60.0	35	29	66	27	7
1966	65.7	35	29	66	27	7
1967	71.6	35	29	65	28	7
1968	77.5	35	29	65	28	7
1969	85.2	35	29	64	28	8
1970	90.9	35	29	64	28	8
1971	98.0	34	28	64	27	9
1972	104.9	34	28	65	26	9
1973	115.9	34	28	66	26	8
1974	129.7	34	27	67	25	8

Source: Statistics Canada, *Canada's International Investment Position, 1926-27* Cat. 67-202, pp. 148-49; *Statistics Canada Daily*, Cat. 11-001E (Aug. 27, 1976, and Dec. 16, 1977).

Notes:

[1] The book value of long-term debt and equity (including retained earnings) employed in enterprises in Canada.

[2] The ownership series measures the proportion of foreign-owned capital (both portfolio holdings of non-residents and direct investment) to total long-term capital employed. The control series classifies enterprises by country of control by majority ownership of voting rights, i.e. data on "foreign-controlled investments" may include de investments by Canadians and investors from third countries in enterprises controlled abroad.

[3] Non-financial industries include manufacturing, petroleum and natural gas, mining and smelting, railways, other utilities, merchandising and construction.

book-value figures, which may understate the size of the older U.S. investments. The change has been gradual; the trend for both U.S. ownership and U.S. control of the total capital employed in the non-financial industries of Canada reached its peak during the late sixties. A comparison of the increase in foreign investment (debt, equity and retained earnings) from U.S. and non-U.S. sources (Table 8.3) confirms the dominant U.S. investment presence over this long-term period.

Table 8.3

Source of Net New Investment* in Non-Financial Industries, Canada, 1955-74
(Billions of Dollars)

Year	Net New Investment		
	By Residents	By All Non-Residents	By U.S. Residents As A Percentage of Total Non-Resident Investment
1955	1.5	0.8	62
1956	2.1	1.6	69
1957	2.2	1.4	86
1958	1.9	0.9	89
1959	2.1	1.0	80
1960	1.1	0.9	67
1961	1.2	0.8	100
1962	0.7	0.9	78
1963	1.7	0.9	100
1964	2.3	1.3	92
1965	3.0	1.6	87
1966	3.5	2.2	95
1967	4.0	1.9	89
1968	3.8	2.1	81
1969	5.2	2.5	80
1970	3.9	1.8	78
1971	5.4	1.8	67
1972	4.6	2.3	74
1973	7.3	3.7	81
1974	9.5	4.2	76

Source: Statistics Canada, *Canada's International Investment Position, 1926-67* and *1971-73*; *Statistics Canada Daily* (Dec. 16, 1977).

Note: *Though representing changes in foreign investment, this figure does not reflect actual capital inflows because of the role of retained earnings arising from Canadian operations, and capital outflows of foreign interests.

Significant sectoral changes in the degree of foreign ownership have taken place over the period 1967-74 (Table 8.3). There have been increases in the mining and service sectors, and in the tobacco, textile, paper, food, beverage, furniture and non-metallic industries within the manufacturing sector. But decreases were recorded in utilities, finance, wholesale and retail trade sectors and for the petroleum and coal products, chemicals and chemical products, transport equipment, primary metals, metal fabricating and machinery industries in the manufacturing sector.

Foreign direct investment in Canada has not been spread evenly or randomly across all industrial sectors. It is especially low and a decreasing percentage in those sectors that, under law, hold large elements of public enterprise, such as public utilities and transport, or where foreign ownership is restricted, as in the communications and financial industries. It is also low in sectors characterized by many small firms, such as construction, wholesale trade and retail trade, in which the scope for transferring unique core skills is

low. In general, the industry segments with a very high degree of foreign ownership in 1967 were the same in 1974. Correspondingly, those with a low degree in 1967 tended to be low in 1974.

Foreign ownership is particularly high in manufacturing and non-renewable resources (petroleum and mining). In 1974, the total capital employed in these two major sectors was $62 billion, nearly half of the $129.7 billion of capital employed in the major industrial sectors of Canada. Of the $44.1 billion in foreign-owned investment in the non-financial sectors in Canada in 1974, $33.6 billion (76%) was in manufacturing and non-renewable resources. Over the period 1967-74 the foreign-owned share of these sectors has been quite stable. (See Tables 8.4 and 8.5.)

Table 8.4

Degree of Non-Resident Majority Ownership
of Corporations* in Canada as Measured by Assets,
1967 and 1974

	Assets of Foreign-Controlled Corporations as a Percentage of Industry Assets	
Industry	1967	1974
Agriculture, forestry and fishing	8.2	9.8
Mining		
Metal mining	42.0	55.1
Mineral fuels	81.7	74.0
Other mining	50.0	58.4
Total mining	60.0	63.0
Manufacturing		
Food	35.7	38.8
Beverages	17.6	21.9
Tobacco products	83.6	99.8
Rubber products	92.4	93.7
Leather products	21.9	22.6
Textile mills	49.6	60.2
Knitting mills	18.8	23.5
Clothing	12.0	15.5
Wood industries	25.8	27.0
Furniture industries	15.8	18.5
Paper and allied industries	38.8	43.7
Printing, publishing and allied industries	11.6	11.5
Primary metals	55.6	37.9
Metal fabricating	44.4	38.3
Machinery	71.9	67.6
Transport equipment	86.2	79.6
Electrical products	65.7	65.1
Non-metallic mineral products	47.1	62.4
Petroleum and coal products	99.6	94.4
Chemicals and chemical products	83.0	76.6
Miscellaneous manufacturing	48.7	47.1
Total manufacturing	56.7	56.6

Table 8.4—Continued

Industry	Assets of Foreign-Controlled Corporations as a Percentage of Industry Assets	
	1967	1974
Construction	14.0	12.6
Utilities		
Transportation	–	8.5
Storage	6.0	3.7
Communication	–	0.5
Public utilities	7.3	2.4
Total utilities	6.2	4.3
Wholesale trade	28.5	27.8
Retail trade	20.4	18.2
Finance	12.1	10.7
Services	17.3	23.4
Total all industries	26.0	22.1
Total non-financial industries	38.0	32.8

Source: Statistics Canada, *Corporations and Labour Unions Returns Act*, Annual Report, 1967, pp. 50-103, and 1974, pp. 116-17.

Note:

*Assets of corporations having 50% or more of their voting rights owned by non-residents as a percentage of total assets in the industry. A corporation is considered to be foreign-controlled if 50% or more of its voting rights are known to be held outside Canada or are held by one or more Canadian corporations that are themselves foreign-controlled.
Also included are corporations that are exempt from the provisions of the Corporations and Labour Unions Returns Act (CALURA) but that report under other federal legislation.

To determine whether the level and direction of change for foreign ownership for each segment was random or the outcome of economic forces in the market, the four-firm concentration ratio for 1972 and the average size of the firms accounting for 50% of the output of the industry were noted for each industry segment (to the extent the classification system matched). There was a strong direct correlation between the degree of foreign ownership and the degree of concentration and the presence of large firms. The degree of foreign ownership is very high in those industry segments where an oligopoly of three or four firms account for a high proportion of total sales in the industry. By contrast, the degree of foreign ownership is low in those industry segments where there are many small firms in the industry and no firm has a significant share of the market. The direction of change in the degree of foreign ownership from 1967 to 1973 is directly related to the concentration ratios of 1972. There have been, on the one hand, divestitures by foreign corporations in those industries marked by low concentration and strong competition and, on the other hand, increased direct investments in industries marked by high concentration or oligopoly. Changes in degree of foreign ownership within industry segments were not random and are related to the advantages such investments have in oligopolistic industries and the advantage of possessing core skills that

Table 8.5

Estimated Book Value and Ownership of Total Capital Employed in Manufacturing and Non-Renewable Resources,* Canada, 1967 and 1974 (Billions of Dollars)

	Book Value						Percentage of Total Capital Employed in Manufacturing and Non-Renewable Resources	
	Manufacturing		Non-Renewable Resources		Total Amount			
Ownership	1967	1974	1967	1974	1967	1974	1967	1974
Canadian	9.8	16.8	5.7	11.5	15.5	28.4	44	46
Foreign	10.7	18.4	9.1	15.2	19.8	33.6	56	54
Total	20.5	35.2	14.9	26.8	35.4	62.0	100	100

Source: Statistics Canada, *Canada's International Investment Position, 1971-73; Statistics Canada Daily* (Dec. 16, 1977).

Note: *Petroleum and natural gas, plus mining and smelting.

could be developed only with large expenditures. The difficulties new firms face in acquiring these core skills, especially brand names, marketing skills and R&D, contributed to the high concentration in these industries and the high level of foreign investment. This analysis is supported by Thomas Horst who found that the larger firms in an industry in the United States had higher propensities to invest abroad than did their smaller competitors.

The high degree of foreign control of non-government-owned manufacturing industry (59% in 1975) can be partially explained by economic factors. The manufacturing industry of most other advanced, industrial countries has access to a market of at least 100 million people. The United States has a free trade area of over 200 million people, and the same is true of Western Europe. By contrast, tariff walls abroad seriously reduce the incentive for Canada's manufacturing industry to be scale-efficient and largely confine it to a domestic market of 23 million people. Foreign firms are encouraged to invest in Canada to overcome the Canadian tariff walls and often construct small, scale-inefficient plants to serve only the domestic market.

Multinational enterprises based in the United Kingdom or the United States also have had easy access to large pools of capital, which was available at much lower cost than capital in Canada. When the Canadian subsidiary of a multinational firm chooses to raise its capital in Canada, Canadian financial institutions are more willing to make loans to it than to domestic firms of similar size and often at more attractive rates.

Domestic manufacturers, both Canadian and foreign-owned, in many Canadian industries do not have the promise of high sales to justify the costs of developing new process or product technology to match that in the foreign

corporations. Foreign subsidiaries have access to their parents' technology, however. Domestically owned manufacturers often cannot compete against foreign subsidiaries in that part of the domestic market where continuous technological innovation is essential for success. In many industries, Canada's domestic market is too small to enable Canadian-controlled firms to be efficient and to compete against foreign subsidiaries who have access to their parents' core skills. Because of this access foreign subsidiaries often enjoy a significant competitive advantage over Canadian-owned firms. In research done for the Commission, Caves concluded that although there was no systematic decrease in the proportion of value added accounted for by Canadian controlled establishments in large size classes, their productivity was 19% below that of foreign-controlled subsidiaries, mainly because of this technological gap.

Effect on Industrial Structure and Behavior

Often the oligopolistic market structure developed abroad has been transplanted to Canada by the direct investments of firms involved in the oligopoly. When a dominant firm in an oligopolistic industry makes a direct investment abroad, it is common for other firms in the oligopoly to follow it to protect their market share and market power and to reduce the risk that the foreign operation of one of their competitors will give it a competitive advantage. It is this propensity by firms in oligopolistic industry to "follow the leader" that has been a major factor in the creation of the "miniature replica" effect that characterizes so many Canadian industries. In addition, many of the same underlying economic factors (economies of scale, advertising, R&D, productivity, capital costs, etc.) that influence the degree of concentration in other countries also exist in Canada. Some countries have encouraged foreign investment to increase exports and to have world-scale plants. Except in a few instances, Canada is not one of them. Indeed, the foreign direct investment that has come to Canada did not come to "look outward" through exports. Once such an inward looking industry has been developed, it is difficult to reorient it, but success is possible, as is demonstrated by such firms as Dominion Engineering Works Ltd. and the diesel operation of General Motors of Canada Limited, which compete with their parents in export markets.

Foreign direct investment does not seem to have increased the concentration of industries in Canada. No general relation has been observed between inbound foreign direct investment and changes in the level of concentration, nor are Canadian industries with high foreign ownership relatively more concentrated than industries in other countries with lower foreign ownership. In fact, when a follow-the-leader oligopolistic response prompts foreign direct investment, it often has lead to an overpopulation of both foreign-controlled and domestic firms in the particular industry in Canada, all of which operate below efficient world scale and have excess capacity. In such industries, foreign subsidiaries are at a competitive advantage since they have access to their parents' technology and marketing skills. Several authors have concluded that foreign direct investment increases product differentiation and promotional

behavior in host countries and thereby increases barriers to entry by domestic firms. On the other hand, it may decrease the market imperfections in the movement of capital and core skills and may make an industry more competitive and progressive. John Dunning, in an article in the *Journal of World Trade Law* (1974), concluded that if foreign direct investment is undertaken to secure sources of raw materials for a vertically integrated multinational enterprise, it will become more difficult for new investments to take place in downstream industries because new firms will be excluded from those sources of raw material.

Foreign direct investment can also affect the behavior of firms in Canada even when it does not affect the level of concentration or average size of the firms in the industry: the size of any one foreign-owned subsidiary will be an understated measure of its competitive strength if there are any economies associated with multiplant, multimarket operation or the acquisition and utilization of core skills. A multinational enterprise can smooth its sales and profit streams by taking advantage of different cost and demand structures in the countries in which it operates. If a subsidiary in one country runs into difficulties from competitive pressures or inadequate demand, its operations can be sustained by other units of the multinational either by transfers of funds and by diverting production to it. A multinational enterprise will therefore be better able to deal with risk than will domestic firms operating in a single market and hence it will be in a better competitive position. The subsidiary of a multinational enterprise may also gain an advantage by engaging in a number of anticompetitive practices that have little to do with its relative efficiency: predatory pricing, use of its "deep pocket" in finance, technology and marketing, and manipulation of transfer pricing. Some of these practices can be employed by a domestic conglomerate firm, although they may be illegal under the Combines Investigation Act, but they are harder to identify and prosecute when undertaken by a multinational enterprise. Others, such as transfer pricing to reduce taxes, are possible only for a multinational enterprise. Transfer pricing is monitored and regulated by the Department of National Revenue (Revenue Canada) under the Income Tax Act. Nevertheless, multinational enterprises still have considerable latitude in setting transfer prices to enable their subsidiaries to compete effectively, to transfer money in and out of Canada and to reduce their total corporate taxes.

The firms in an industry with high foreign ownership are aware of the resources behind foreign subsidiaries. This awareness may increase the effectiveness of price discipline and parallel pricing and discourage price competition through price cutting. Even in industries largely populated by Canadian-owned firms, the incentive to engage in price wars is decreased by the real possibility of foreign takeovers of firms weakened by the price war. The classic example of such a chain of events was the takeover of the Canada & Dominion Sugar Company, Limited (now Redpath Industries Limited) by Tate and Lyle Ltd. in 1959. For the same reasons, new domestic firms may be deterred from entering an industry in the face of competition from firms having access to resources and competitive techniques unavailable to themselves.

Public Concern

Since the 1950s, there has been widespread concern in Canada about the immediate and long-term social and economic implications for the public interest of the high degree of foreign ownership and of the potential foreign control of Canadian economic activity. This concern increased in intensity during the 1960s, with the belief that foreign control of economic activity was increasing and the identification in the public mind of foreign subsidiaries with both big business and U.S. foreign policy. (There is, however, considerable variation in the attitudes among the provincial governments toward foreign direct investment. Some have been far more eager to have foreign direct investment and far more hospitable toward it than others have been.) In this period as well a rising standard of living and a rising level of education combined to promote greater public concern over social issues. One of these was the threat to national sovereignty posed by foreign direct investment. Interdependence in political and economic matters between Canada and other countries, therefore, was more likely to be interpreted as infringement of Canadian sovereignty.

Over the years, the Gallup Poll has asked the question: "Do you think there is enough United States capital in Canada now, or would you like to see more United States capital invested in Canada"? The responses over the nine years 1964-72 show a strong shift of opinion toward the belief that increased United States investment in Canada should be discouraged (Table 8.6).

Table 8.6

Canadian Public Attitudes toward
U.S. Investment in Canada
(Percentages)

	Attitude		
Year	Enough Now	Like More	Undecided
1964	46	33	21
1967	60	24	16
1970	62	25	13
1972	67	22	11

Source: *Gallup Report* (Feb. 12, 1972).

At the same time, the significance of this shift of opinion can easily be exaggerated. When Canadians have been polled over the last decade to determine the issues of greatest concern to them, unemployment, inflation and other economic issues always topped the list, while foreign control ranked quite low.

The federal government responded to this concern in part through a number of investigations and reports, including the *Final Report* of the Royal

Commission on Canada's Economic Prospects (the Gordon Commission, 1957); the Report on *Foreign Ownership and the Structure of Canadian Industry* (the Watkins *Report*, 1968); the *Report* of the House of Commons Standing Committee on External Affairs and National Defence (the Wahn Committee, 1970; and *Foreign Direct Investment in Canada* (the Gray *Report*, 1972). It also increased the required reporting of foreign ownership under the Corporations and Labour Unions Returns act (CALURA) in 1962. In addition, there have been several investigations of foreign ownership at the provincial level.

A central finding of these reports was that foreign direct investment in Canada was increasing, and that this increase was leading to increasing foreign control over Canadian industry. The reports treated foreign direct investment as a problem of how to "maximize the benefits or minimize the costs" of such investment, that is as a problem solvable at least in principle by a set of plans and regulations. Since each report focused on a different aspect of the problem, the dilemma posed by the existence of conflicting economic, social and political goals was avoided.

While there were differences in focus and coverage between the various reports, there were also similarities, particularly as regards the following two areas:

1. administrative relationships between a Canadian subsidiary and its foreign-domiciled parent, which raised the issues of non-disclosure of financial and operating information by the subsidiary; determination of taxable profits in Canada, associated with the problem of transfer prices on intercompany sales and purchases; location of research and development facilities, and the development of indigenous technology; and the autonomy and nationality of the managers of subsidiaries in Canada;
2. political affiliation of the foreign-owned subsidiary, which raised the issues of the extraterritorial application of foreign antitrust, labor and securities law and laws relating to exports to particular countries and application of balance-of-payments guidelines to the financial operations of subsidiaries in Canada.

In addition, the reports were concerned with the sale of equity shares in a foreign-owned subsidiary to the Canadian public, corporate citizenship in terms of social responsibility of the subsidiary, and the marketing and purchasing policies of the subsidiary that discriminated against exports and in favor of imports from the foreign parent corporation. A summary of the more important ideas in these reports follows.

The Gordon Commission (1957)

The mandate of the Gordon Commission was the economic development of Canada, but its *Report* highlighted the nature and degree of foreign control of Canadian industry. After enumerating the benefits to Canada of foreign investment, the *Report* stated:

> The benefits of foreign investment that we have mentioned are very real and tangible. It is more difficult to state in similarly precise terms what the dangers are

in the present situation and what conflicts might occur between the interest of Canadians and the interests of the foreign owners of wholly-owned subsidiaries of foreign companies operating in Canada.

The *Report* was especially concerned with the possibility that the managers of U.S. subsidiaries in Canada, if faced with a conflict between U.S. and Canadian interests, would elect to support the U.S. position. The major recommendations included the issuing of a sizable minority of equity stock in foreign-controlled subsidiaries to Canadians; appointment of Canadians to boards of directors; disclosure of financial data on the operations of subsidiaries in Canada; staffing of senior positions with Canadians; purchasing supplies from local firms; and increased attention to export markets. A key recommendation, subsequently implemented, of the Gordon Commission was that financial intermediation (banks, trust companies, insurance companies, etc.) should be in Canadian hands.

The Watkins Report (1968)

The next major investigation into foreign ownership was made by a task force headed by Melvin Watkins. The task force originated in friction between the U.S. and Canadian governments over the extraterritorial application of U.S. laws to U.S.-owned subsidiaries in Canada. The specific instance was the publication by the U.S. government of its guidelines for U.S. direct investment abroad in 1965 and 1966 to encourage the repatriation of foreign earnings to improve the U.S. balance of payments. As a result, Canadians who previously had seen foreign direct investment in Canada as a major economic benefit became concerned that U.S. subsidiaries would have to make their decisions in the light of official government policies to the detriment of Canada.

However, the Watkins *Report* was concerned also with other instances of extraterritoriality: application of U.S. legislation on trading with Communist countries, U.S. antitr" law and U.S. labor law. Central to the *Report* was the idea that "The maj. eficiency in Canadian policy has been not its liberality towards foreign investment *per se* but the absence of an integrated set of policies, partly with respect to both foreign and domestic firms, partly with respect only to foreign firms, to ensure higher benefit and smaller costs for Canadians from the operations of multinational corporations."

The major recommendations of the Watkins *Report* were to create a government agency to survey multinational activities in Canada; to compel foreign subsidiaries to disclose more of their activities in Canada; to encourage rationalization of Canadian industry; to subsidize research and development and management education in Canada; to form the Canada Development Corporation; and to forbid the application of foreign laws in Canada.

In contrast to the Gordon Commission, which sought to alter the ownership of subsidiaries, the Watkins Task Force sought to alter their behavior. The question of whether it is better to reduce the degree of foreign ownership or to "improve" the behavior of foreign subsidiaries is of great importance.

The Wahn Committee (1970)

The third major investigation of foreign control of Canadian economic activity was conducted in 1970 by a Parliamentary Standing Committee chaired by Ian Wahn. This committee had as its terms of reference the examination of "Canada-United States" relations. U.S. direct investment in Canada became a central element in its *Report*. The Wahn Committee based its views on the work done by the Watkins group, some of whom testified before the Committee. However, a distinctive recommendation of the Wahn Committee was that, over a reasonable period of time, all foreign-owned firms in Canada would allow for at least 51% of their voting shares to be owned by Canadian citizens, and that the Canadian share of members on the board of directors should reflect the Canadian share of equity participation.

The Gray Report (1972)

The fourth investigation of foreign control of Canadian economic activity was *Foreign Direct Investment in Canada* (the Gray *Report*) in 1972. This report sought to determine both the economic forces that promoted this foreign investment and to measure its benefits and costs. Although the *Report* covered a wide range of topics, it gave the greatest attention to the factors affecting the development and transfer of technology for Canadian industry.

The *Report* saw the major benefit of foreign direct investment as access to foreign technology, with resultant increased productivity in Canada and the introduction of new or improved products to the Canadian market. A close relationship was seen between technology and economic progress. Technology itself was treated as the outcome of corporate research and development. Hence, the question of where this research and development was conducted was viewed as important.

The fact that most of the technology used by foreign subsidiaries in Canada was developed abroad in the research and development facilities of the parent corporation led the Gray *Report* to use the term "truncation" to describe the situation and condition of the subsidiary as a business enterprise. The assumption was that the functions conducted by a national firm would cover a wide range, including research and development. Since subsidiaries in Canada did not cover such a range, they were seen as truncated. This situation is illustrated by the fact that over 90% of all patents in use in Canada are held by foreign corporations or individuals. The Gray *Report* raised a host of other issues, including taxation, transfer prices, "stultification" of Canadian entrepreneurship and extraterritoriality.

Three policy alternatives were considered: Canadianization (in the sense of 51% of equity being held by Canadians), exclusion of foreign subsidiaries from "key sectors" of the economy and a foreign investment review agency to maximize the net benefits to Canada from foreign direct investment. The Gray *Report* recommended the third alternative and listed six categories of investments that could be reviewed.

Debate on the Issues

These reports have been criticized both for their analysis and conclusions on the economic issues and for the narrowness of the viewpoint taken. It has been argued for example, that the differences among foreign-owned subsidiaries in Canada are so great that it is not possible to make valid generalizations for the total population. It has also been said that the reports were relevant to only one segment of the total population (and not necessarily the largest or most important one), that where the subsidiary followed exactly the strategy of the parent corporation.

Another critic attacked the reports from quite a different direction. He examined the uses of licence agreements by Canadian-owned firms to determine whether manufacturing under licence was a sound corporate strategy, as had been suggested in the Gray *Report*. He found that it was sound for firms licensing to strengthen existing areas of business and those carrying out a program of closely related diversification. For a sizable number of firms trying to enter an area of business not closely related to existing businesses the use of licensing agreements was judged to be entirely unsuitable. Licensing by Canadian firms on a broad scale was not considered to be a reasonable alternative to direct foreign investment, which may, therefore, be the only way to gain access to new technology.

Harry Johnson made a more general attack. He argued that the nation-state has no necessary enduring value and that it exists for the convenience of the people. He stated: "The subsidiaries of foreign based corporations tend to be viewed with considerable suspicion...just as the local branches of national corporations were viewed with considerable suspicion in an earlier era which witnessed the rise of the national corporation in competition with the local corporation or family business."

Other, more broadly based criticisms of the reports concluded that they were overly concerned with the behavior of foreign-owned subsidiaries in Canada and not sufficiently concerned with the impact of the visibility and magnitude of the presence of these subsidiaries on the development of all aspects of Canadian society, social and political as well as economic. Such investment it is argued "dwarfs the people, and stunts and distorts the development of distinctive Canadian identity". The problem is stated to be that, in relation to the magnitude of foreign direct investment in Canada, there is not enough domestic-controlled enterprise, not sufficient "champions of industry", to enable Canadians to develop a sense of participation and to have confidence in themselves. This has in turn contributed to the inward-looking nature of much of Canadian manufacturing industry and its deep-seated pessimism about its ability to compete on an international scale.

Government Responses

Since the 1950s, the federal government has responded in a variety of ways to public concerns about the social and economic implications for the public interest of foreign direct investment in Canada. At the same time

provincial governments have responded to concerns particular to the provinces. As a result, by 1977 the powers available to government to control foreign direct investment appear to us adequate in the light of the concerns articulated:

1. key sector policy and public ownership: the exclusion of foreign direct investment from or the limitation of the activities of foreign subsidiaries in sectors of the economy deemed critical in relation to Canadian public policies or the development of a distinctive Canadian culture;
2. significant benefit to Canada: the establishment of the Foreign Investment Review Agency to encourage significant benefit to Canada from new foreign direct investment; and
3. political sovereignty: the establishment of machinery to provide countervailing power to attempts of foreign governments to apply their laws in Canada.

Key Sector Policy

Federal and provincial governments have passed legislation excluding or limiting foreign ownership in certain industries deemed "key sectors" in the economy: transport, finance and communications. Foreign ownership and control is effectively excluded or sharply restricted in Canada in the airline, railroad, commercial banking, radio, television and other industries.

In addition to these "key sectors", the federal and provincial governments have, since the mid 1970s, come to the view that some "non-renewable" or "exhaustible" resources should also be protected one way or another from foreign control. This has led to the creation of federal and provincial Crown corporations to undertake new investments in the natural resources sectors, the nationalization of some potash firms in Saskatchewan and the formation of a variety of agencies to monitor and control exploration, extraction and marketing of many resource products.

Significant Benefit to Canada

The concept of significant benefit to Canada underlies measures recognizing that a foreign subsidiary in Canada has an administrative relationship with its parent corporation abroad and that therefore market relations and market forces do not operate to differentiate the economic activities of the subsidiary from that of its parent. Although there is a general consensus that multinational enterprises increase the efficiency of resource allocation and increase world output, they can and do make decisions that adversely affect the interests of a particular country in the interests of the system as a whole. Naturally each nation wants to maximize the benefits to itself of any foreign subsidiaries operating within its borders. This goal may place it in direct conflict with other countries over the diversion of the benefits that accrue to a multinational enterprise as a whole. The multinational enterprise is often caught in the middle in these conflicts. In an attempt to increase the benefits flowing to it

from the substantial foreign presence in its economy, Canada set up the Foreign Investment Review Agency (FIRA) to screen new foreign investment in Canada.

FIRA is supposed to ensure that significant benefits accrue to Canada from "new foreign direct investment." It screens two forms of foreign investment:

(1) most acquisitions of control of Canadian businesses by non-Canadians, and
(2) the establishment of new Canadian businesses by non-Canadians who either do not already have any business in Canada, or do not have any business in Canada to which the new business is or would be related.

Five general criteria are employed to assess a reviewable investment:

1. the effect of the level and nature of economic activity in Canada, including employment, processing of resources, reduction of imports and increase in exports, purchasing of Canadian goods, and other such "spillovers";
2. the level of participation by Canadians as managers, shareholders, and directors;
3. the effect on industrial efficiency, technological development, and product innovation and variety;
4. the effect on the competitive behaviour of firms already in the industry; and
5. the compatibility of the investment or acquisition with government industrial and economic policies.

FIRA then attempts to increase the net benefits that Canada receives from foreign direct investment (rather than attempting to exclude or limit it). FIRA's role is more than a screening agency that simply accepts or rejects applications placed before it. It bargains with the foreign firms or their subsidiaries who have made an application before it to increase the benefits and decrease the costs that Canada will realize from each new investment or takeover.

FIRA itself is not directly concerned that proper taxation is paid on income generated in Canada. The issue is extremely complex in relation to subsidiary operations, but it is also extremely important, and hence must be considered here if only in summary fashion.

When a subsidiary of a foreign multinational enterprise buys or sells goods or services with its parent or another unit of the enterprise, the potential for manipulation of the transfer price of these goods and services is always present. Firms will try to set transfer prices to reduce their burden of taxes and tariffs in one country or systemwide, to transfer money out of a country or to gain a competitive advantage in a particular market. Such motivation exists for all multinational enterprises in all countries.

For the subsidiaries of foreign-based multinational enterprises in Canada, Revenue Canada requires that transfer prices for goods be at "fair market value". Some internal transfer prices can be checked against external market prices for comparable goods, or at least against internal data on direct costs

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and allowance for overhead, even though checks are difficult in a complex multinational system. Cooperation between U.S. and Canadian tax authorities has reduced the latitude for manipulation of transfer pricing, but it is still an important problem. It is even more difficult for Revenue Canada to check that licence fees royalties and management fees reflect the real costs of transferring technology into Canada: such royalties can be above or below the real costs depending on the strategy of the firm. Of the $2.1 billion dollars that U.S. firms received in total fees and royalties in 1972, only $0.7 billion was received from unaffiliated foreigners. The opportunity for manipulation is thus substantial. Royalties can be a method of transferring taxable income out of Canada into another country, either to be taxed in that country or "stored" in a tax haven for several years. Thus, multinational corporations have a definite advantage over purely domestic corporations in regard to taxation of income generated by technology. The motivation of foreign firms to manipulate transfer prices may be reduced by several factors, however: the similarity of business tax rates in the United States and Canada, the credit of foreign income taxes against U.S. tax liabilities, and the distortions that artificial transfer prices build into a firm's information and control systems. G. F. Kopits in an article in the *Economic Journal* (1976) concluded that the tax incentive to manipulate transfer prices has decreased for firms in Canada. Nonetheless, multinational enterprises in Canada still have considerable latitude and incentive to manipulate transfer pricing to reduce reported profits in Canada. More study of transfer pricing is necessary to identify more exactly where the problems lie, their magnitude and how they can be minimized.

Multinational enterprises may transfer to their foreign subsidiaries components of the core skills they have developed in their home markets at prices based on anticompetitive considerations: low prices to allow the subsidiary to capture market share; high prices to keep profits low and thereby to discourage potential entrants. The profit element in licence fees and royalties and the potential for anticompetitive behavior using technology developed by the parent were not seriously explored in the three major reports mentioned above.

Political Sovereignty

To provide some offset to the application of foreign laws in Canada, the federal government has undertaken a number of specific measures, each related to specific instances of extraterritoriality.

Section 31.6 of the Combines Investigation Act prohibits any restriction of exports in compliance with the laws of foreign governments. The United States (under the Trading with the Enemy Act) has in the past attempted to ensure that U.S.-controlled subsidiaries in Canada did not export goods to specified Communist countries. Under section 31.6, subsidiaries are not allowed to restrict exports solely because of U.S. legislation. The impact of the section is to attempt to allow the manager of subsidiaries in Canada greater autonomy vis-à-vis the government of the country in which the parent corporation resides. Similarly the Canadian government through an Order in Council has prohibited subsidiaries of foreign firms from supplying additional information to the

U.S. government concerning the uranium cartel that was in operation during the early 1970s.

In addition to these measures, in 1975 the government of Canada tabled a set of "Principles of International Business Conduct", which replaced earlier guidelines introduced in 1967. Fourteen principles were enumerated, which were intended to have the effect of fostering in the foreign-owned subsidiary in Canada a measure of independence in decision-making in relation to its foreign parent and also to encourage the subsidiaries to be "good corporate citizens".

Development of Domestic Enterprises

Foreign direct investment has often been achieved by acquisition of an existing domestically owned business. It has been stated to us that many of these foreign acquisitions of Canadian-owned companies occurred because there is a lack of large Canadian diversified firms with a specific interest in acquiring existing domestic firms. In part to deal with this concern, the government established the Canada Development Corporation (CDC) in 1971. Over the long run, CDC is intended to be mainly a widely owned corporation, with government ownership limited to 10% of equity shares. CDC has a threefold objective: (a) to develop and maintain strong, Canadian-controlled corporations in the private sector of the economy; (b) to widen the investment opportunities open to Canadians; and (c) to operate at a profit. The management of CDC has inferred from these objectives that it should compete with foreign corporations for the acquisition of Canadian firms and, through share purchases, establish a Canadian interest in foreign firms with subsidiaries in Canada. For example, CDC has acquired a 30% interest in Texasgulf Inc.

Current Issues and Policies

We now turn to several current issues and policies raised by witnesses who appeared before us during our hearings and by others in briefs submitted to the Commission. The following seem to us particularly relevant: the buying and selling of companies in Canada; Canadian technological capability; and the performance of foreign-controlled subsidiaries. The issue here is twofold, the reduction in competition for corporate assets and the lower income-generating potential of these assets.

The Market for Firms in Canada

Hugh Russel Limited told us that because of the existence of FIRA it was able to buy two domestic firms at a discount below the price that would have existed prior to FIRA, because FIRA had greatly reduced competition from foreign-owned companies. While this discount probably applies to a limited number of firms, it indicates that FIRA has a potentially significant impact on the value of small Canadian firms.

Canada is not alone in requiring a review of foreign investment. Many other developed countries, with the notable exception of the United States, do so too, either explicitly through a review process or local equity participation

requirements or implicitly through work permits, exchange controls on foreign capital or government purchasing policies.

In Canada, the market for corporate assets is far from perfect in any segment of industry. The existence of FIRA serves as a restriction of entry to the market for foreign firms. Under the Act, the government has turned down about 10% of the applications that were submitted to it and not withdrawn. Approximately another 10% of the initial applications were withdrawn before a decision was handed down. It is impossible to know how many applications were never made. The existence of FIRA has introduced uncertainty into the market for firms. As a result, the seller of a business has faced a buyer who was in a stronger position to drive down the price. This effect was particularly evident during the first year of FIRA's operation and has decreased as potential foreign investors (and foreign subsidiaries) have learned more about FIRA's procedures and operations, and as FIRA has increased the speed of its processing and become more lenient toward foreign investment during 1977.

With transfer of an appropriate core skill from another enterprise, income-generating potential of an existing business may be increased without adding to the cost (since the cost to transfer the core skill is usually very low). The skills required to effect this potential increase in income often exist in a foreign-controlled rather than in a domestically owned firm. Under ideal conditions the assets required from abroad could be transferred via the market. But, as already described, the market for these assets is highly imperfect. FIRA may have impeded the transfer into Canada of core skills that could improve the productivity of existing assets.

The mobility of multinational corporations in their investment and production decisions also poses a difficult problem for Canada. A cyclical downturn or a change in tax rates may lead a multinational to shift its investment or operations elsewhere, whereas a locally owned firm without subsidiaries in other countries would be less mobile and more likely to continue investing in Canada. The very efficiency with which multinational corporations transfer capital to the area of highest return and production to the area of lowest cost may have severe negative effects on the countries in which they operate if the economic environment reduces profits or raises costs.

Canadian Technological Capability

Many firms compete on the basis of continuous technological innovation requiring costly research and engineering facilities. While costs may be low at the early stages of new product or process innovation, expenditures tend to increase substantially as a new product approaches the stage of test marketing. Canadian firms with a domestic market of 23 million people find it difficult to spread costs over enough sales to undertake such expenditures and, given their generally inward-looking nature, many of them do not consider export markets.

There have been suggestions that Canada should seek "technological sovereignty" in certain key sectors so that all the technology required by Canadian firms in those sectors is developed in the country. Once produced, however, technology is not costly to transfer, at least within the administrative

channels of a multinational enterprise. To replicate in Canada the technology developed abroad would waste resources, the more so because of the small size of the Canadian market where such technology could be exploited and the difficulty many Canadian firms find in going abroad through trade and investment. Some Canadian firms, however, such as Northern Telecom, have been highly successful in developing technology in Canada and exporting and investing abroad.

Attempts by the Canadian government in the past to foster domestic R&D, either by private firms or by the government itself for eventual transfer to industry, have been generally unsuccessful. U.S. firms, because of their access to a large, high-income market are organized to develop and transfer technology; most Canadian firms are not. There may be some scope for the government to foster the development of new technology in Canada through incentives aimed at specific sectors to increase the amount of R&D undertaken by firms in those sectors. Often the subsidiaries of foreign firms have been able to take advantage of Canadian government programs to develop R&D while their domestically owned competitors have not.

Performance of Foreign-Controlled Subsidiaries

There have been several studies on the performance of subsidiaries in Canada relative to their parent corporations abroad and to domestically owned firms in Canada. Such studies have focused on labor or capital productivity, costs, the range or type of output, exports and technological innovation.

Obviously, if a subsidiary is established in Canada merely for domestic production of goods previously imported across tariff barriers, its labor and capital productivity is likely to be lower and its costs higher than in the parent corporation established in a larger market. Although Caves in his research for the Commission found that labor productivity was 19% lower in domestically owned firms than in foreign-owned subsidiaries, when other variables such as capital intensity, size, factor costs, technological opportunities and industry mix are taken into account, this productivity differential disappears. That is Canadian-owned firms as such are not less productive; however, they do not have easy access to the core skills such as technology and marketing and hence are generally less productive than foreign-owned subsidiaries in the same industry.

D. G. McFetridge in his work for the Commission concluded that subsidiaries of foreign firms export slightly more than domestically owned firms, but that a large percentage of their exports goes to other units of the multinational at the direction of the head office. Even exports by foreign-owned subsidiaries to unrelated firms abroad are often at the direction of the multinational's head office and not at the initiative of the local subsidiary. Many foreign-owned subsidiaries thus fail to develop export potential or expertise in exporting, since either they are restricted to the Canadian market or their export activities are handled by their parent or at its direction. This type of extraterritoriality is much more difficult to deal with than that imposed by foreign law. On the other hand, Caves concluded that subsidiaries of multinational firms exported

more than similar domestically owned firms because of economies of scale in international transactions and the informational economies available to multinational firms. Foreign ownership, by providing efficient access to the expertise of the parent firm, enables small subsidiaries in some industries in Canada to export even though they are not themselves large enough to mount an export effort.

Conclusions

Most public concern about the social and economic implications for the public interest of foreign direct investment in Canada was predicated on the belief that such investment was leading to an increasing degree of foreign ownership and control of economic activity in Canada. In fact, the overall degree of such foreign ownership and control in the non-financial sectors has been fairly stable at about 34% since 1960. Part of the dilemma posed by foreign direct investment is the location in foreign-domiciled corporations of economic power over Canadian affairs. Over the years, the government of Canada has taken a number of steps to reduce the dimensions of the problem of extraterritoriality.

There is no irreconcilable conflict between the desirability of foreign direct investment as a vehicle for prosperity and the impact of such investment on the social, economic and political milieux in Canada. In considering how to resolve this conflict four alternative sets of action have been suggested:

1. buy back control over the presently foreign-owned subsidiaries;
2. increase the number of key sectors, and buy back control of foreign-owned subsidiaries in them;
3. develop criteria for FIRA that would extend its scope to include the expansion of established foreign-controlled business within their existing or related lines of activity; or
4. retain the system of government responses as it has developed but improve the method of administering them.

In considering each of these alternatives, it is necessary to bear in mind the fact that, historically, foreign direct investment has brought major economic benefits to Canada as well as some economic and social costs. The benefits include the acquisition of technology, capital, access to markets, employment and increased levels of competition among firms. In addition, the major part of the profits of foreign-controlled subsidiaries has not been remitted abroad, but has been reinvested in the country.

The costs include truncation of our export and R&D capability and strengthened oligopolistic structure and behavior in many industries. On balance, however, the economic benefits seem to outweigh the economic and social costs, especially in the short run. There is cause to be concerned about the economic performance of enterprises in the manufacturing sector, but the concern, we believe, should relate to the question of the appropriate commercial policy for all firms in Canada not to new policies designed to place further constraints on foreign investment.

Our argument against the first alternative is threefold:

1. capital needs: to buy back the subsidiaries would require the export of Canadian wealth abroad for years and preempt the capital market for new domestically owned firms;
2. acquisition of technology: subsidiaries operate on the basis of open-door access to the technology of their parent corporation; if subsidiaries become Canadian-owned, such access may be denied them or would be much more costly; and
3. national sovereignty: the challenge is for Canadians to develop their own industrial corporations using national savings and, if necessary, foreign borrowing to enter new sectors and new ventures.

We believe that the second alternative, the "key sector" concept, has been pressed as far as it should go. We have the same objection to any extension of that idea as we have toward the "buy back Canada" concept.

In rejecting the first two alternatives we recognize that foreign ownership may prevent Canada from following a strategy of rationalization and technological advance in some of its industries. At present, there are many disincentives to prevent firms from rationalizing their production by mergers or by production-sharing agreements. As tariffs are reduced and as foreign competition, especially from low-wage countries increases, there will be greater pressure toward rationalization. However, rather than buying back foreign-owned companies, it would be preferable to provide incentives for the merger of both foreign and domestically owned firms in an industry into larger, more efficient units and to use laws that will override any antitrust objections in the United States and other countries.

The argument for the extension of FIRA's scope to all foreign-owned firms is that at present a large percentage of the investment of foreign-owned and controlled subsidiaries does not come before FIRA because these firms do not try to expand into new areas or to acquire other firms. An expansion of FIRA's jurisdiction to cover all expansion would require a substantial increase in its size to administer this screening. More important, it would put Canadian industry in a turmoil at a time when it is already in a troubled state. Given this, we set aside the third alternative.

We think the fourth alternative is the best, that is to keep the system of government responses as it has developed but to improve the method of administering them. Canada now has enough laws relating to foreign control of various types of enterprises. These laws arm the government with adequate powers to deal with foreign direct investment in Canada. We do not see the need for additional regulations to deal with existing firms and we cannot justify a case for new laws to deal with hypothetical issues that might or might not arise in the future. What seems to us essential at this time is efficient, sophisticated and firm administration of existing laws. Special attention should be directed by the Department of Consumer and Corporate Affairs toward the subsidiaries of multinational enterprises to ensure that they do not misuse their competitive powers to the detriment of Canadian-owned industry. Bill C-13 will permit the competition Policy Advocate to bring foreign investment

proposals before the Competition Board to assess their competitive implications. Presumably FIRA and the Cabinet will take the Board's decision into account when considering the overall effect of an investment. Revenue Canada can also have a substantial impact on both the level of taxes collected on profits made by multinational enterprises in Canada and on their competitive tactics.

The objective of the system should be first to attract, retain, and expand beneficial foreign-controlled enterprises willing to compete and operate in the marketplace within the framework of Canadian laws and policies; and second to secure from these enterprises a significant benefit for Canada. Over the past decade multinational enterprises have become increasingly subject to pressures from the governments in the countries in which they operate. Each country wants to extract "fair" (which they often equate with the maximum) benefits from the multinational. These goals place countries in direct conflict with each other and the multinationals in the middle. More local processing, exports and R&D in one country often mean less in another. The most demanding countries can often extract the greatest benefits to the detriment of others. This lesson is learned quickly and the demands on the multinationals are increased. Two examples are illustrative of these problems: (1) pressure is developing in the United States to restrict multinationals from transferring "U.S." technology abroad; (2) when Inco announced in late 1977 that it planned to lay off a large number of workers in Canada, a cry was raised to lay off Inco workers abroad first. Since Canada has such a high level of foreign investment, it is particularly exposed to these pressures. For this reason, Canada must formulate policies to work with multinational corporations and the countries in which they operate to achieve an equitable distribution of the benefits they generate.

Chapter 9

Workable Competition: An Approach to the Economic Implications of Corporate Concentration

Observers of the Canadian economy over the past few years have described many of its deficiencies, from inflation and unemployment to an apparent failure to be competitive and efficient, which is reflected in high domestic production costs and weak export performance. Many people have concluded that the private sector of the economy is not working effectively to deliver goods and services in a manner consistent with the public interest. The most severe critics say that we require substantially more government intervention to correct market and other imperfections.

We do not agree that further intervention in the economy by government would help any of these problems or that major rearrangements of the economy are necessary. Certainly problems exist, but we think that under certain circumstances, which we discuss below, the performance of the private sector can be improved.

In this chapter we briefly review the characteristics of Canadian markets, and the organization and strategy of firms in those markets. We discuss a proposal for progress toward a goal of greater competition in sectors of the Canadian economy and outline a framework of conditions that seem to us necessary to achieve that goal.

Characteristics of Canadian Markets

As we showed in earlier chapters, the structure and conduct of firms and industries in Canada differ greatly from the assumptions of the economic models of pure competition. The Canadian economy is not composed of industries in which there are large numbers of competitors in a laissez-faire marketplace with price as the only significant competitive variable. Rather it is characterized by a mixture of sizes of enterprises, substantial foreign ownership with Canadian competitors fearing the "deep pockets" of foreign parent

companies, barriers to import competition in some industries and an openness to imports in others (sometimes in spite of tariff barriers). In many industries, the market is dominated by a single large firm or has an oligopolistic structure in which prices and other terms of sale are arrived at through consciously parallel behavior.

Substantial barriers to both entry and exit are widespread in the economy. These are of three kinds: natural barriers stemming from economies of scale and the cost penalties of operating below minimum efficient scale (MES) in the small Canadian market; artificial barriers erected by firms already established in an industry, such as product differentiation through heavy advertising; and legislative, regulatory or traditional barriers erected by government with the intent or effect of limiting entry to an industry. While these barriers tend to restrain potential entrants to an industry, they are particularly effective against small and medium-sized firms whose management generally lacks the knowledge, expertise or money to overcome them. Research based on Statistics Canada data and comparable figures for other countries suggests that in many industries Canada has a lower proportion of small firms and, particularly, medium-sized firms relative to larger firms, than most other western industrial countries (this conclusion is supported whether measurement is by asset size or by size relative to the leading firms in the industry). In part, because they do not have competitive stimulus from small and medium-sized firms, larger firms in our economy in general have poorer economic performance in many areas, including innovation and cost reduction, than do firms in other industrial countries.

Canada's small and geographically fragmented domestic markets help to inhibit potential competition, especially when there is only enough demand to justify a small number of plants. The few firms that do build efficient-scale plants may behave as classic oligopolists, limiting entry by setting prices that are high in relation to their own costs but not high enough to cover the costs of a new entrant at below minimum efficient scale or to permit import competition over existing tariff barriers. Such oligopolists may make it known that they are willing to drive out new entrants (even those who may wish to construct MES plants), by cutting prices in the short run so that the new entrant is unable to attain a breakeven level of sales. As part of their recognition of interdependence with competitors, oligopolists may collectively accept market shares that do not justify construction of MES plants for any firm in the industry. A firm wishing to build a larger, more efficient plant cannot do so without infringing on the market shares of fellow oligopolists and risking either a price war or other forms of retaliation. In sum, our small domestic markets may simultaneously foster oligopolistic behavior, deter firms from growing to more efficient size and, as we saw in Chapter 3, discourage firms from specializing their production. The historically high effective tariff in manufacturing and the geographic dispersion of the Canadian market have also encouraged inward-looking industries that tend to perceive market size as being restricted to national or regional areas.

Over the past 15 years Canada's largest corporations have declined in size relative to those in the same industries in other countries. Even in export-oriented industries, or industries with substantial import competition, Canada has never had more than a few companies ranking among the largest in their respective world industries, and our representation is declining. A study done initially for the U.S. Department of Commerce and extended by this Commission compared 13 different industries in 15 industrial countries. Canadian membership among the 10 largest companies (measured by sales) in the 13 industries dropped from 7 in 1960, to 2 in 1974. Neither of the latter (Massey-Ferguson Limited in the general machinery industry and Alcan Aluminium Limited in mining and metals) was in the largest 5 in its industry. From 1960 to 1975 Japanese and European companies grew about two and a half times faster than comparable large Canadian companies.

From 1960 to 1974 no new Canadian company reached the top-ten rank in any of the 13 industries examined, and these included industries with substantial firm-level economies such as aerospace, pulp and paper, chemicals and commercial banking. The five companies that dropped out of the top ten in their respective industries were Canada Packers Limited, International Nickel Company of Canada, Limited, The Royal Bank of Canada, Canadian Imperial Bank of Commerce and Bank of Montreal. While the comparison does not imply that big is automatically better, there is some evidence that Canadian firms have been characterized by inadequate research and development, innovation, export performance and perhaps risk-taking compared with firms in the same industries in other countries, and that this poorer performance may be related to an inability to achieve firm-level economies of scale.

Characteristics of the Canadian economy such as high concentration, small market size and high effective tariffs produce a series of basic dilemmas in the formation of public policy. Even without consciously parallel oligopolistic behavior, solutions to problems of efficiency would be difficult in a small domestic market. Efficiency in many industries could be improved by permitting or encouraging firms to expand their operations to more efficient size or to merge, but this might also result in higher industry concentration or, in some industries, absolute monopoly control. If larger size and higher concentration levels occurred in markets with tariff or other barriers to entry, most cost savings from improved efficiency would probably not be passed along to consumers either through lower prices or through higher-quality products or improved service. Similarly, if firms were encouraged to become more efficient through specialization arrangements, but the entry of new competitors was constrained, consumers might end up with a narrower range of products from which to choose, without any cost savings passed on to them.

Workable Competition

The oligopolistic nature of many industries leads to competition among large firms based not on price alone but on a complex mixture of price, product

quality, service, technology and innovation and the promotion of real and artificial product differences. Smaller firms within these oligopolistic industries are generally unable to match their larger rivals in terms of advertising and product proliferation or to innovate or copy innovations quickly. Instead they compete on price or on the basis of a narrow product line, geographic coverage, or expert service. Of these, the major differentiating factor available to smaller firms is price. In competing in this way the smaller firms help to "fill in" the principal missing variable in competition among large, interdependent oligopolists. Recent U.S. research by Howard Newman suggests that price-cost margins and profits tend to decrease (a sign of competition) as the heterogeneity of size of firms in an industry increases.

In Canada, with the dual problem of a relative lack of small firms and the existence of major firms perhaps not large enough or sufficiently specialized to compete internationally, a realistic goal may be an economy many of whose industries are composed of firms of different sizes and following different corporate strategies, with law and enforcement adequate to prevent overt restrictive trade practices or the building of artificial barriers to entry in concentrated industries. In a mixed-size, mixed-strategy industry, leading firms might be able to expand to MES through internal growth and through mergers and acquisitions, even if this expansion resulted in higher concentration levels. Existing smaller and medium-sized firms in each industry might be able to compete on bases different from those of the leading firms (primarily price and specialized market segments) and would have the opportunity to expand and profit if successful. Smaller and medium-sized firms in each industry, plus import competition, might then intensify competition and keep larger or dominant firms from abusing market power or denying consumers the benefits of competition.

The question arising from this discussion is how a small or medium-sized firm operating below conventional MES, or at MES but without all firm-level economies, can compete on price with larger firms. It is done by specializing narrowly in a technology or production process with different MES characteristics, competing in specialized markets or competing with unique skills but without the full range of functions or support services of larger firms. Examples of smaller-scale firms are cited in Rein Peterson's *Small Business: Building a Balanced Economy* (1977).

Our concept of a workably competitive Canadian economy depends on the deliberate encouragement of mixed-size, mixed-strategy industries to move economic performance in the direction of the efficiency and range of price-service-quality-promotion values that are generally seen to flow from a competitive economy. There are, of course, no guarantees that this would happen in all industries. In some industries, economies of scale occur at such large volumes, and costs for below-MES operation are so great, that small firms cannot survive. Even a large number of small competitors in a given industry might choose not to compete aggressively on price or service. However, it appears to us that, if restrictive trade practices and behavior that maintain and build barriers to entry can be minimized, the incentives to competition will be substantial.

Conditions for Workable Competition

The following pages describe the more important conditions necessary to promote workable competition in Canada. Many of them are discussed in more detail in later chapters of this *Report*.

The first and probably most important condition is that small and medium-sized firms must not be unfairly prevented from operating and expanding and must not face artificial barriers in entering new industries. New entrants must have the opportunity to get into a market without handicaps other than the normal ones arising from the fact that existing competitors will have well-established ties with customers or a stable technology and skilled employees. A major impediment to this degree of "ease of entry", and thus to a viable mixed-size business sector, is that most new and growing Canadian firms are effectively excluded from access to equity and debt markets and to medium-term lending. These problems are discussed at length in Chapter 11 and to a lesser extent in Chapter 10 of this *Report*.

Also, to lower barriers to entry dominant firms holding patent and trademark rights must not be allowed to foreclose whole markets to new entrants. While we have done no research and heard little testimony on patent and trademark policy, this requirement follows from our general assumption that new entrants must face no artificial impediments to entering a market. Several suggestions have been put forward in the literature on this problem, usually in the form of conditions for compulsory negotiated entry to existing patent pools where such access is essential to operation in a particular industry. The federal Department of Consumer and Corporate Affairs published a major discussion paper on the subject of the revision of the patent law in June 1976 and has indicated that further material will be forthcoming.

A second condition necessary for workable competition is selective reductions in the tariff and non-tariff barriers that protect most Canadian manufacturing industries. In small markets, firms must be encouraged to expand to efficient scale and to specialize, and to pass the benefits of greater efficiency on to consumers. The need to achieve economies of scale is particularly important in industries having potential export markets. The necessary encouragement could be provided by lowering tariff barriers, as advocated by recent studies such as the Economic Council of Canada's *Looking Outward: A New Trade Strategy for Canada* (1975). This study argues that there are greater economic benefits to free trade than to a high tariff policy in some if not all industries and that on balance Canada would gain from a move toward free trade.

We would certainly support tariff reduction if it were accompanied by government sanction of specialization agreements. Under a specialization agreement competitors in a market would be allowed to allocate production among themselves to achieve longer production runs and resulting economies, but with the *quid pro quo* of progressive lowering of Canadian tariff levels to ensure that savings are passed on to the public by way of lowered prices. While it is usually argued that tariff reductions should follow specialization agreements, the opposite sequence also has much to be said for it. As a response to an industry which is fragmented in structure and operating behind high tariff

barriers, a negotiated or unilateral reduction in those barriers might be accompanied by an invitation to the firms affected to initiate specialization agreements, or to consider mergers as a way of achieving economies of scale. Caution would have to be used when moving toward free trade to ensure that the social costs of such a policy are not so high that they outweigh the economic benefits. In any policy of negotiated or unilateral tariff reductions the government would have to stand prepared to assist injured industries and workers in reallocating capital and manpower to newly vigorous and efficient sectors.

A third condition is that there must be disclosure of accounting and profit information such that it is more difficult for conglomerate firms to hide areas of rapid growth or high profitability behind a protective shield of consolidated reporting. This is a central consideration in reducing barriers to entry. The basic force attracting new investment into an industry is the promise of economic profits, i.e. profits higher than those offered by alternative investment possibilities of similar risk. Consolidated accounting procedures permit corporations to hide areas of high profitability over extended periods so as not to encourage new competing investment. Corporate disclosure is discussed in Chapter 13 of this *Report* and in a study by John Kazanjian published as part of our research series.

The fourth condition is that competition policy must be strong and vigorously enforced, particularly in the areas of restrictive trade practices, attempts to build or maintain barriers to entry and attempts by dominant firms in mature industries to monopolize markets. We emphasize the need for an approach to conscious parallelism such as that of "parallelism-plus" (see Chapter 4). Elsewhere in this *Report* we have been critical of some of the proposed amendments to the Combines Investigation Act. These represent specific concerns, however, and should in no way be taken to indicate that we think competition policy is unimportant. On the contrary, a strong and vigorously enforced competition law is necessary to prevent dominant firms from entrenching a monopoly or quasi-monopoly position or exploiting tariff protection, to provide a check on abuses of market power, and to increase the likelihood of entry and competition from small and medium-sized firms. In this context particular attention should be paid to the competitive practices of the subsidiaries of foreign multinationals since, potentially, they can exercise a disproportionate influence on the competitive environment in Canada.

A final possible condition necessary for workable competition is that the proportion of the Canadian economy constrained by government regulation or ownership should be reviewed and possibly reduced.

We are not opposed in principle to government ownership or regulation of business, and we recognize that it is often necessary and beneficial. We do think, however, that in a significant number of cases government intervention may have created and sustained inefficiencies in the economy and monopoly profits by some firms, and that government ownership or regulation has either prevented or deterred competition.

Once established, there is typically little or no government review of the regulatory process itself. We know of no case since 1950 of any Canadian regulated industry ever being completely deregulated as conditions changed, or of any major Crown corporation being returned to private ownership. We discuss the regulated sector at greater length in Chapter 17 of this *Report*, and recommend that a critical study of that sector be undertaken.

For a workably competitive society, we thus conclude that at a minimum the necessary conditions comprise active encouragement of small and medium-sized firms, minimizing of existing barriers to entry, a review of the utility of government regulation, reconsideration of tariff and non-tariff barriers to import competition, disclosure of accounting and profit information, and vigorous enforcement of competition law against restrictive trade practices and attempts to build artificial entry barriers. This set of conditions may well be incomplete, but it encompasses those requirements that we think are most basic and necessary to reduce the detriment to the public interest that may result from concentrations of corporate power in Canada.

As well as being necessary conditions for workable competition in the economy as a whole, these may also be viewed as potential remedies when there are extended signs of poor economic performance in a single concentrated sector vis-à-vis observed performance in comparable sectors in Canada or in the same sector in other countries. For example, one indication of poor performance (or lack of workable competition) might be prices in Canada that were persistently higher than prices for similar or identical products in the United States, when price differentials were not justified by differences in federal and provincial taxes, freight and insurance, the exchange rate or additional costs of raw materials or labor.

A similar indicator of poor performance might be continued lack of new entry in an industry dominated by one or more very large enterprises, where long-term profits were substantially above the rate of return earned by firms in industries with similar risk characteristics, and where production or other economies of scale were not sufficient to deter entry. However, above-average, short-term profit levels in themselves should not be taken as sufficient evidence of lack of competition or of poor performance. Other indicators of poor performance would include evidence of the systematic maintenance of excess capacity not justified by seasonable fluctuations or reasonable standby needs, a persistent lag by firms in adopting cost-reducing technological changes or the suppression of product changes.

Discussions of the conditions under which workable competition can exist have appeared in the economic literature for many years beginning with the writing of J. M. Clark in the late 1930s. Since that time the concept of workable competition has developed in a number of directions in attempts to provide appropriate leads for policy to help society attain the substance of the advantages promised in more traditional economic models, but as attainable, performance-oriented goals.

We have not cited or attempted to summarize this literature here. While the objective of attaining workable competition is common to all discussions,

the means suggested differ markedly from one to the other and, in some, from our own discussion. We have attempted only to outline the most important areas. The focus of our recommendations is on increasing dynamic market forces in the economy such that industries move toward greater efficiency, greater specialization, and concentration levels that are determined by market forces. These are the same objectives sought in the Skeoch-McDonald *Report* (*Dynamic Change and Accountability in a Canadian Market Economy,* 1976), which we have cited in several earlier chapters. We think the concept of workable competition is one that is sufficiently flexible to meet the many economic constraints peculiar to the Canadian economy and that recognizes the myriad business organizational forms and characteristics of firms and markets found in our economy.

Chapter 10

The Banks and Other Financial Institutions

Introduction

It was recognized in Parliament at the time this Commission was established that the larger chartered banks were "major concentrations of corporate power" within the mandate of this Commission. They are familiar institutions, known at first hand to most Canadians, and were a principal subject of the massive *Report* of the Royal Commission on Banking and Finance (the Porter Commission) in 1964. Most recently they have been the focus of a 1976 study by the Economic Council of Canada on deposit institutions. We have received substantial briefs from four of the five largest banks and from the Canadian Bankers' Association, and senior officers of these banks appeared at our hearings. We have also heard and read a number of criticisms of these banks' operations. As well we have reviewed many of the briefs submitted to the Minister of Finance concerning the revision of the Bank Act. We have studied a number of aspects of the operation of the banks, including the banks' role in the financing of new and expanding medium-sized business and the structure of their interest and other charges. We have also studied carefully the proposals made by the Government in August 1976 in the *White Paper on the Revision of Canadian Banking Legislation* (the *White Paper*). In view of the extensive material on Canadian chartered banking already available, we have not contracted outside research studies on matters relating specifically to the banks.

In this chapter we consider first the legislation governing the banks and the substantial changes made in the Bank Act in 1967. Then we present some background material on the banks, their sources of funds and the ways they use them, with some comments on their profits and efficiency. We go on to describe the principal institutions that compete with the banks, the markets in which they compete, and the nature of the competition among banks themselves. This leads us to certain conclusions about this competition and how it might be increased. We also make some observations about the boards of directors of the banks and make some recommendations about directors.

Banking Legislation

The British North America Act gives to the federal Parliament exclusive power to legislate in regard to "Banking, Incorporation of Banks, and the Issue of Paper Money" as well as "Savings Banks". The essential legal meaning of "banking", as we have been told, and the *White Paper* confirms by implication, is the acceptance of deposits that are transferable to third parties by cheque or similar instrument. Parliament has not permitted any companies other than those incorporated by Parliament to call themselves banks. However it has not interfered with, or as yet sought to regulate, activities of other companies or cooperatives (e.g., trust companies and *caisses populaires*) that carry on banking services in the constitutional sense. The proposal in the *White Paper* to require such institutions to be members of the "Canadian Payments Association" and to be subject to certain obligations as such is the first proposal to exercise this broader power of Parliament over "banking", whether carried out by banks or by other institutions created under either federal or provincial law.

It has been the practice in the past for Parliament to incorporate new banks by a separate act for each. Existing banks are "rechartered" by the decennial bill to amend the Bank Act. With occasional exceptions of detail, all banks are required to conform to the terms of the Bank Act, which governs in great detail the powers, organization and obligations of the chartered banks, taking the place of the general corporations acts and also providing the essential elements of regulation of their activities. While the Bank Act governs most of the powers of the banks, they are responsible to provincial legislation for matters under provincial jurisdiction so long as there is no conflict with the Bank Act.

The 1967 Revision of the Bank Act

The last revision of the Bank Act was passed by Parliament early in 1967 and came into effect (with some lags in certain provisions) on May 1 of that year. This revision was a very important one, following consideration of the *Report* of the Porter Commission, one of the most comprehensive reviews ever made of any industry and field of policy in Canada. The basic thrust of the legislation was to try to make banking business more competitive and to reduce the degree of regulation and restraint upon its operations. The banks were prohibited from entering into agreements concerning the interest rates they charged or paid (as they had been free to do and had done in the past) unless these were specifically requested or approved by the Minister of Finance. The statutory ceiling of 6% on the interest rates they could charge was also removed. The banks were also permitted to make conventional mortgage loans on real property up to a gradually increasing limit and, in addition, unlimited mortgage loans under the National Housing Act (NHA).

In keeping with earlier federal legislation in 1965 affecting trust and loan and insurance companies, the 1967 Bank Act limited ownership of chartered

banks in order to prevent or remove foreign control. In the case of banks the general limitation of ownership by one person or group of associated persons (or corporations) of not more than 10% applied to Canadian as well as to foreign shareholders, both because this appeared feasible (with one notable exception) and because a general discrimination against foreign control was felt potentially to endanger the position of Canadian banks in foreign countries. There was also introduced a general 10% limitation (with minor exceptions) on the voting shares of other Canadian corporations that a bank might own. If the value of the bank's holding did not exceed $5 million, the permissible limitation was as high as 50%. These restrictions on share ownership of banks and by banks have meant that a bank could not be part of a group of affiliated companies subject to a single control, nor could it form such a group itself (except for some defined types of subsidiary companies in related activities in Canada or subsidiaries in other countries).

There were several clauses in the 1967 Act relating to directors of banks. No one was to be appointed or elected a director who was a director of another bank or of a trust or loan company that accepts deposits, or who was a director of another Canadian company of which other directors of the bank already constituted one-fifth or more of the directors of that corporation.

The 1967 revision of the Bank Act did not implement all the proposals of the Porter Commission. In particular, it did not authorize, and regulate the operation of, agencies of foreign banks in Canada as banks. It did not, however, prevent subsidiaries of foreign banks in Canada from engaging in certain types of business that Canadian banks are not allowed to undertake, as well as business normally done by Canadian banks. Moreover there was no legislation, such as the Commission had recommended, to bring within federal control the activities of other institutions carrying out functions that the Commission considered to be essentially the business of banking.

The Business of the Banks

The leading Canadian banks are large by any standard: large in Canada, large in terms of their international reputations and operations, large in the number of their branches throughout the country, and large in their physical presence in the buildings with which they are identified in major Canadian cities. The salient facts about the size of each of the chartered banks (except the most recent, which have only just commenced operations) are given in Table 10.1. Total assets (the usual measure of size) are also given for December 1967 for comparison. In 1976 the five largest banks had about 90% of the assets of all the banks, compared with 93% in 1967. The share of the five largest has been in the 80–90% range since the late twenties.

The five largest banks, with Canadian branches ranging from 891 to 1,660 in number in 1975 (Table 10.1), all provide retail banking services in urban

Table 10.1

Characteristics of Chartered Banks in Canada

	Assets		Revenue	Balance of Revenue (Deficit) 1976*		Branches in Canada	Canadian Employees
	1967	Oct. 1976	1976	Before Tax	After Tax	1975	1975
	(Millions of dollars)						
The Royal Bank of Canada	7,810	28,832	2,437	267.4	157.4	1,432	28,655
Canadian Imperial Bank of Commerce	7,516	26,104	2,208	273.9	145.9	1,660	27,855
Bank of Montreal	6,345	20,492	1,799	174.8	95.9	1,243	25,770
Bank of Nova Scotia	4,303	18,181	1,508	213.5	116.9	924	18,430
The Toronto Dominion Bank	3,568	16,192	1,298	170.3	92.2	891	14,766
Banque Canadienne Nationale	1,281	5,675	498	45.1	24.5	479	7,304
La Banque Provinciale du Canada	627	3,624	316	31.8	17.0	324	4,573
The Mercantile Bank of Canada	198	1,708	150	20.6	13.9	12	483
Bank of British Columbia	**	844	77	5.9	3.1	30	888
Unity Bank of Canada	**	180	18	(3.5)	(3.5)	23	303
Canadian Commercial & Industrial Bank	**	16	–	–	–	–	–
Total	31,648	121,848	10,309	1,199.8	663.3	7,018	129,027

Sources: Brief submitted by Canadian Bankers' Association (December 1975); *Canada Gazette*; Royal Commission on Corporate Concentration (RCCC) research.

Notes: *Before appropriation for losses.
**Chartered subsequent to 1967.

and suburban, country and frontier areas, as well as wholesale banking services for large businesses and governments in the major cities and in many centres outside Canada. They are heavily involved in both domestic and foreign banking. Below the biggest five, the banks tend either to do retail business like the major banks but on a regional basis, or else to concentrate on wholesale transactions. The focus of wholesale operations is to obtain funds by securing large term deposits or selling short- and medium-term paper in money markets and to lend to large or medium-sized businesses without incurring the costs of operating branches.

Sources of Funds

More specific information about the role of the banks is summarized in Table 10.2 which sets forth details of the Canadian assets and liabilities of the banks collectively. The banks secure their funds primarily by way of deposits from their customers, for which they provide services, interest, or a combination of both. Demand deposits (lines 18 and 19) typically carry no interest but involve considerable personal service in handling transactions, for which some service charges are levied. Demand deposits are held by businesses and individuals for carrying out transactions and to have immediately available working balances. The banks compete for these largely by the convenience of the branch location, but also by the extent and quality of services offered, including financial services to businesses (for example, automated cash management and payroll handling).

The second item to note is chequable personal savings deposits (line 20), on which some interest is paid and some free services rendered. These are the working accounts of many individual Canadians. The third item is non-chequable savings deposits and term deposits of individuals (lines 21 and 22). These are pure savings accounts on which the banks pay interest in competition with one another and with other institutions. Other, "non-personal" deposits are mainly fixed-term deposits held by businesses, on which interest is paid, generally at publicly posted rates, or, when large sums are involved, at negotiated and highly competitive rates. The Government of Canada deposits are shown separately in line 24. These are the government's working balances, and are distributed among the banks by a formula. Most carry a rate of interest just below the market rate on treasury bills.

We shall not endeavor to comment on all the other items, but would note the figure of $1,169 million for debentures (line 28). These are the banks' means of supplementing their own capital funds by borrowing in the form of medium-term debentures, which are subordinate to deposits as claims on the bank and are sold in the bond market. Line 31 shows the shareholders' equity in the banks, including paid-up capital and accumulated profits. Line 32 is the accumulated total of appropriations for losses. It is a part of the past revenues of each bank set aside as a prudent estimate of what may be expected by way

Table 10.2

Assets and Liabilities of Chartered Banks in Canada, 1967 and 1976
(Millions of Dollars)

Line No.		December 1967	October 1976
	ASSETS		
	Liquid assets		
1	Bank of Canada deposits and notes	1,547	3,893
2	Canadian day-to-day loans	306	344
3	Treasury bills	1,725	4,177
4	Government of Canada direct and guaranteed bonds	2,904	4,349
5	Call and short term loans	336	1,273
	Loans in Canadian dollars		
6	Business loans	6,929	27,553
7	Personal loans	3,594	16,834
8	Other loans	3,327	6,987
9	Mortgages insured under NHA	749	4,954
10	Other residential mortgages	91	3,727
	Canadian securities		
11	Corporate	554	2,602
12	Provincial and municipal	646	1,135
13	Canadian dollar items in transit	1,190	1,630
14	Customers' liabilities under acceptances, guarantees and letters of credit	819	5,006
15	All other Canadian currency assets	484	1,968
16	Total foreign currency	6,470	35,417
17	Total[1]	31,669	121,849
	LIABILITIES AND SHAREHOLDERS' EQUITY		
	Canadian dollar deposits		
	Demand deposits		
18	Personal deposits	366	2,761
19	Other deposits	6,120	10,031
	Personal savings		
20	Chequable	}	6,679
21	Non-chequable	} 11,760	18,579
22	Fixed	}	14,184
23	Other notice deposits	3,255	18,005
24	Government of Canada	618	1,934
25	Provincial governments	309	986
26	Other banks	235	1,015
27	Acceptances, guarantees and letters of credit	819	5,006
28	Debentures	40	1,169
29	Other Canadian liabilities	106	304
30	Foreign liabilities	6,309	36,135
31	Shareholders' equity	1,310	3,332
32	Appropriation for losses	424	1,090
34	Accounting adjustment[2]		639
	Total[1]	31,669	121,849

Source: Bank of Canada *Review*.

Notes: 1. Totals may not add exactly because of rounding.

2. Accounting adjustment is added because in the 1976 personal savings figures are understated by $639 million because the breakdown was available only in the weekly rather than in the monthly series.

of losses on the loans and securities carried on the bank's books. How, and indeed whether, this should be shown in the bank's accounts has been a controversial issue in past revisions of the Bank Act, as have the limits on what may be added to such reserves as a deductible expense for tax purposes. The present Bank Act does not require that annual loan losses be reported to shareholders. However, for the year 1976, most banks made this information available by reporting both their average five-year losses and the difference between actual 1976 losses and their five-year averages. We expect this practice to continue.

In addition to accepting and managing deposits and making loans and investments, the banks perform a variety of services for businesses and individuals, including the sale or purchase of foreign exchange, the acquisition and sale of securities for their customers and the provision of safekeeping and some accounting services. It does not seem necessary to go into these for the purpose of this *Report*.

Uses of Funds

What the banks do with the funds they borrow as deposits or otherwise is illustrated by their Canadian asset items in Table 10.2. The biggest item is business loans (line 6), details of which are published monthly by size and quarterly by industry and region. These extend all the way from the smallest business loans right up to the largest loans to the biggest business enterprises. The next category (line 7) is personal loans, including those secured by claims on various types of assets (for example, automobiles) as well as unsecured loans and certain guaranteed loans (notably student loans). The "other loans" (line 8) include Canada Savings Bonds and loans to governments, institutions, finance companies, farmers, and grain dealers. Lines 9 and 10 show residential mortgage loans (as distinct from business loans) of which 57% are insured under the NHA. Since the 1967 revision of the Bank Act the banks have been active lenders in the housing mortgage field. The other major item to note is the holdings of securities other than Government of Canada securities (lines 11 and 12); about one-third of these are provincial and municipal securities, and two-thirds are corporate securities.

The liquid assets of the banks (lines 1-5) yield less return than do other assets but are readily marketable to meet cash requirements. The largest part of these are treasury bills and other Government of Canada securities (lines 3 and 4). The most important part consists of deposits at the Bank of Canada plus statutory note holdings (line 1). These are the "primary cash reserves" of the banks, on which no interest is paid and which the banks are required by law to hold as a specified fraction of their deposits. The chartered banks also hold a large proportion of their liquid assets in the form of secondary reserves as required under the Bank of Canada Act. It is through the creation or reduction in these reserves that the Bank of Canada controls the aggregate volume of bank deposits and influences credit conditions.

Regional Flow of Funds

The Canadian branch banking system facilitates the flow of funds from geographic areas with surplus deposits to geographic areas whose demand for funds exceeds their savings in the form of bank deposits. Since the Bank of Canada began reporting assets and liabilities of banks by geographic areas in 1974, the figures show that Ontario and Saskatchewan have been exporters of banking funds to the rest of Canada, with Ontario providing much the largest share. It should be noted, however, that these data have limitations because of the exclusion of the *caisses populaires* and other financial intermediaries in looking at flows of funds and because such assets as government securities, corporate securities, day-to-day loans, Bank of Canada notes and deposits, Wheat Board loans and deposits by the government of Canada must be allocated on a somewhat arbitrary basis. The allocation is also somewhat biased because of the effect of the location of head offices on the "booking procedure" for loans to large companies that borrow through their head offices but actually spend the money in another province. As well, money market deposits originating outside Ontario are often booked in Toronto.

Our research also indicates that the structure of deposits and loans in Canadian chartered banks is in general determined by the economic profile of each province. Thus on a per capita basis, a high level of demand deposits tends to be associated with high average income, notably in Ontario, British Columbia and Alberta. Savings deposits are highly correlated to income province by province, except for Quebec, where the chartered banks' share of savings deposits is low. Corporate deposits, which make up the majority of non-personal term deposits, are concentrated in centres of corporate and manufacturing activity.

Loan demand is also primarily determined by economic factors. Mortgage loans are highest per capita in provinces that have a high rate of population growth, notably Alberta and British Columbia. Small business loans are highly correlated with retail sales per capita. Farm loans are highest per capita where agricultural activity is highest.

Profitability

After the 1967 revision of the Bank Act the profitability of the chartered banks increased quite substantially, as of course was expected. The 1976 Economic Council of Canada study shows an increase in the after-tax rate of return on equity of the seven largest banks from an average of 8.1% in the 1963-67 period to 12.9% in 1968-73. The study notes that this latter figure is higher than that for all U.S. insured banks in the same period. The *White Paper* notes that the 1963-67 rate of return on equity of the banks was below that of other industries, while in the 1968-73 period it has been higher than that of other sectors. The Canadian Bankers' Association, in its brief to this Commission, dealt at some length with the rates of return on assets of the chartered banks, and their relation to the spread between the banks' borrowing and lending rates for the years 1967-75. Over this period, the balance of revenue of the banks as a percentage of total assets increased sharply from 0.96

in 1967 to 1.25 in 1969, then declined to a lower level for 1971-73, dropped sharply to 1.04 in 1974 and rose to 1.24 in 1975. Balance of revenue is the figure normally used as a measure of profits, and includes a provision for losses on loans at an average rate over a five-year period. For the years 1970-75, the Association compared this ratio for international business with that for domestic business for the five largest banks (Table 10.3). While it shows a lower rate of profit on international assets, 0.79% over the six years as compared with 1.33% on domestic, it also shows a very sharp rise in 1975 to 1.05%, when the rate of domestic assets also returned from a depressed level in 1974 to the level of the preceding years. Several banks commented in their briefs to this Commission on their rates of return on equity, noting the need both to build up their capital by retaining earnings and to demonstrate sufficient profitability to raise new capital for expansion.

While two of the banks in their briefs compared Canadian bank profits with those of U.S. banks and of other industries, we think the best up-to-date comparison is that given to the Montreal Society of Financial Analysts in December 1976 by the president of the Canadian Bankers' Association. These figures compare the seven largest Canadian chartered banks with a large number of industries as represented by companies reported in the Financial Research Institute Service. These are large non-financial companies most of which are publicly traded. This comparison shows that chartered banks had an average after-tax return on equity from 1968 to 1975 of 13.6%. Over the same period the average after-tax return on shareholders' equity for the 30 non-financial industries was 10.3%. The highest non-financial sector return was 17.5% for office equipment companies, and the lowest was 4.3% for electric utilities. Other industries of interest are: auto and auto parts (15.5%), metal mining (14.0%), printing and publishing (13.3%), oil and gas refiners (11.9%), broadcasting (9.9%), and transport (6.4%).

The same presentation compared the seven largest Canadian banks with the five largest U.S. banks. It covered only the years up to 1973, but we have also obtained the comparison for 1974 and 1975. Together they indicate that over the years 1968-75 the average after-tax rate of return on shareholders' equity for the seven Canadian banks was 13.6%, while that of the five largest U.S. banks for the same period was 12.6%. After-tax return during this time ranged from 18.3% to 11.2% for the Canadian banks and from 14.8% to 10.3% for U.S. banks. In all years but two the rate of the Canadian banks was higher. There are substantial differences between the accounting practices of U.S. and Canadian banks, and real difficulties in finding a set of U.S. banks that are properly comparable to the Canadian banks, but in spite of these problems we think these comparisons indicate the general state of Canadian bank profitability in recent years.

In comparing profits of the banks with those of other industries since 1970 one must bear in mind that the profits of other industries would be less if proper allowance had been made for the distorting effects of inflation in calculating them. One must also consider that industrial profits as a whole have generally been very low in comparison with the high rates of interest

Table 10.3

Domestic and International Business, Five Largest Canadian Banks, 1970-75
(Percentages and Millions of dollars)

	Assets[1]					Balance of Revenue[2]					Balance of Revenue as a Percentage of Assets		
	Domestic		International			Domestic		International					
Year	Amount	Percentage	Amount	Percentage	Total Amount	Amount	Percentage	Amount	Percentage	Total Amount	Domestic	International	Total
1970	28,616	71.0	11,667	29.0	40,283	414.8	84.3	77.4	15.7	492.2	1.45	0.66	1.22
1971	32,354	71.9	12,654	28.1	45,008	418.4	81.0	98.1	19.0	516.5	1.29	0.78	1.15
1972	38,174	73.6	13,724	26.4	51,898	515.2	82.4	110.0	17.6	625.2	1.35	0.80	1.20
1973	44,189	72.0	17,175	28.0	61,364	592.1	82.6	124.2	17.4	716.3	1.34	0.72	1.17
1974	53,176	69.4	23,474	30.6	76,651	628.6	78.2	174.7	21.8	803.3	1.18	0.74	1.05
1975	63,330	70.0	27,102	30.0	90,432	851.8	75.0	284.1	25.0	1,135.9	1.35	1.05	1.26

Source: Canadian Bankers' Association, Brief to the RCCC (December 1975), p. 71.
Notes: 1. Average monthly assets calculated on a 13-month-end basis.
2. As at October 31.

prevailing during the last decade. A return of 13% or less for non-financial institutions over a period of years has proven inadequate to bring forth new equity investment in a period when return on government guaranteed debt is close to 10%. By way of comparison, the rate structure of the proposed Kitimat pipeline was set to return 14.5% on equity to investors, and with guaranteed purchase agreements this investment is fairly low risk. The historical premium of low-risk equity over guaranteed debt is at or just above 3%.

So many assumptions must be made in comparing Canadian and foreign bank profitability, or in making comparisons with non-financial institutions, and the differences in profit rates are sufficiently small, that after doing extensive work ourselves we are unable either to support or to refute the conclusion reached by others that the chartered banks are earning excessive profits on their Canadian operations. Possibly non-financial institutions in Canada have been earning too little return on equity.

One thing that should be mentioned in a discussion of bank profitability is the unique feature of commercial banking: banks have a built-in stabilizer, which produces profits in good times or bad while industrial corporations do not. Bank profit performance over the past decade has not been exceptional in good times, but has been much better than average in bad times.

In normal times, the cost of short-term money to the banks is considerably less than the return from longer-term investments and loans. The difference between the cost of capital and its return is called the banking spread. When the economy threatens a downturn, the relation of interest rates will usually reverse itself. Businessmen try to keep their borrowings short-term, expecting to be able to refinance when interest rates drop. Investors want to take advantage of longer-term, higher-interest investments to avoid or minimize the expected drop in rates. In this situation, the banking spread narrows, and short-term rates may even rise above long-term rates, as happened in 1973-74.

Even when the spread decreases sharply, however, banks are saved by their core of low-cost chequing and savings deposits. At the crest of a boom, the banking spread gets smaller, but loan volume increases to offset the drop in profit margins. Bank leverage ratios (the ratio of total assets to equity) rise dramatically under such circumstances, to 28:1 in Canada in 1975, as high as 34:1 for U.S. institutions such as Bank of America in 1975.

When an economic slowdown comes, as in 1974-75, demand for loans falls and loan losses rise to high levels. The banks' borrowing and lending rates fall, but the borrowing rate falls more sharply than does the lending rate, which is determined in part by yields in the commercial paper and bond markets. The basic bank spread thus grows wider at exactly those times when loan volume is decreasing and losses are highest.

Thus there is a self-correcting mechanism. In a bouyant economy the banks make money on volume. In a declining or stagnant economy they make money on spread. The industry is essentially self-stabilizing with or without favorable Bank of Canada or government actions, and can be expected to show stable earnings simply because it can be expected to show losses very seldom. In late 1975 the Bank of Canada adopted a "monetarist approach" under

which interest spreads changed less markedly than in the past, but the historical pattern of stabilization is still operative.

Another explanation for observed bank profit figures was suggested by The Royal Bank of Canada in its brief:

> ... during periods of unanticipated rapid inflation (as occurred in 1975) most banks will experience a temporary acceleration in their percentage return on shareholder capital. This situation arises because annual profits tend to rise in proportion to the volume or stock of loans oustanding—which has the almost automatic tendency to swell during periods of high inflation. However, there is no similar automatic tendency for the banks' stock of capital to rise or swell, in immediate response to inflation. Thus, shareholder return—measured as the percentage of profits to capital—will increase.

Efficiency

The major banks have been profitable in recent years. Have they also been efficient? The banks themselves have told us in their briefs that their large size and diversified services contribute to their efficiency, through specialization of staff functions, spreading overheads across a variety of services and the use of computers and other techniques.

Our own work and the Canadian research of which we are aware have not been able to discover substantial economies of scale in banking when the number of branches is held constant. It may well be that most economies of scale are exhausted at some asset size and that beyond this level what a bank acquires by increased size is flexibility, diversity of expertise and credibility in national and international financial markets.

BRANCHING

There seems little doubt that the very large scale of the major Canadian banks does provide them with strength, stability and a good reputation, which enable them to extend diversified banking services throughout Canada and to secure profitable international banking business. However, there are some criticisms of their overall efficiency. In 1964 the Porter Commission discussed the possibility of there being excessive branching in the system as a whole:

> Indeed, some would argue that far from suffering from a lack of bank branches, we have more than are needed to provide the community with adequate banking service. If this is true, the result can only be to increase the cost of bank services or to reduce the bank shareholders' return. Since the opening of unnecessary branches is a wasteful form of competition, the American authorities have attempted to control bank branching in a variety of ways. However, such controls are always difficult to administer equitably, may result in some communities being poorly served, and might well impede healthy development by preventing efficient banks from expanding as rapidly as they might to provide better service to the public. We think it best to retain the branching freedom which has been part of our legislation, although we believe that there are tendencies in some areas to excessive expenditures on branching. The banks have clearly done a remarkable job in serving Canada's newer communities and their loss of competitive position cannot be

ascribed to a shortage of outlets either in those or other centres. They might in future make more use of other forms of competition rather than adding to the density of branches in urban and suburban areas.

The Bank of Nova Scotia dealt with this point in its brief to us, pointing out that Canada has 42% more deposit-taking offices per capita than did the United States in 1973. The bank suggests, however, that comparison with the United States is not an adequate yardstick (though it was used by the Porter Commission and others) and that there are several geographic and economic factors that have resulted in and justify the large number of branches. They argue that branches in small towns and frontier settlements provide reliable and important services, which have a social and geographic value that may warrant their operating at a loss financed by profits elsewhere.

This Commission considers that there are probably more urban and suburban branches than is optimal from the point of view of the efficiency of the system as a whole, as indeed is true of many kinds of retail business. On balance, however, we see no practical way of reducing the number other than through gradual rationalization.

RATIO OF NET INTEREST REVENUE TO TOTAL ASSETS

The Economic Council in its study of deposit institutions has compared the efficiency of the Canadian banks with that of U.S. banks by comparing the difference between all domestic interest revenues and all domestic interest expenditures (that is net interest revenue expressed per dollar of domestic assets). In this comparison, they found that after deducting income taxes (which are much higher on banks in Canada because U.S. banks hold tax-exempt state and local securities that do not exist in Canada), the net interest revenue per dollar of assets in Canada was about 5% more than that in the United States. This would be consistent either with a higher profit rate on equity in Canada or with higher costs per dollar of assets (that is with some lower efficiency), or some of each. However, the Council concludes that the differences between the two systems are so numerous and substantial that a significant conclusion about efficiency on that basis would not be warranted. The Council also compares the difference between the average rate of interest on loans and that on deposits (that is net yield) after making a number of adjustments because of the larger proportion of non-interest bearing deposits in the United States, but apparently without adjusting for other differences between the two systems. On this basis the Council concludes that Canadian costs of banking are higher than those in the United States partly because of higher income taxes and partly for "other reasons". We think that the differences between the two systems make it difficult or impossible to separate these "other reasons" meaningfully and to draw conclusions about them.

International Banking Activities

The largest Canadian chartered banks have engaged in international operations for over a hundred years, primarily in New York, London and the

Caribbean. During the past 10 years the nature of these international operations has changed dramatically. In the late 1960s, Canadian banks began a major expansion of their international activities, largely as a result of the rise of the Eurodollar market and multinational corporations. Banks have expanded from overseas branches and agencies to include representative offices, foreign affiliates and subsidiaries.

Just how successful they have been in expanding international operations is indicated by the fact that at the end of 1966 their foreign-currency assets amounted to 25.1% of their Canadian assets, while by the end of 1976 they had increased to 42.4%. Foreign currency liabilities as a proportion of Canadian dollar liabilities in the same period rose from 24.7% to 43.5%. Total foreign-currency assets and liabilities of the chartered banks increased by 667% and 688% respectively from December 1966 to December 1976, while Canadian dollar assets grew at a much slower rate, increasing by 394% and 390% respectively over the period. Foreign-currency operations have made a major contribution to the overall asset and liability growth of the Canadian banks over the last decade.

Much of this growth can be attributed to the development of the Eurocurrency system, where Canadian banks compete with foreign banks for large U.S. dollar deposits on the Eurocurrency market. They relend these deposits to residents or non-residents (including foreign banks), or invest them in U.S. dollar-denominated securities.

About 25% of the balance of revenue of the five largest Canadian chartered banks comes from foreign-currency operations. This performance is not spectacular in view of the fact that foreign-currency assets account for almost 30% of total assets. Margins (loan yield minus deposit yield) are low in foreign wholesale operations, although volume is very large.

The composition of the foreign-currency assets and liabilities of the chartered banks also changed significantly with regard to residency, type of holder and place of booking during the 1966-76 period. Interbank activities have become much more common. Deposits with other banks have risen from 26.9% of the total foreign-currency assets in December 1966 to 51.34% in December 1976, whereas deposits of other banks with Canadian banks have increased from 22.8% of total foreign-currency liabilities to 54.2% over the same period.

International activities by Canadian banks are not closely monitored by Canadian authorities and are not specifically regulated under the Bank Act. Canadian banks do not have to hold cash or liquidity reserves against foreign-currency deposits. The Inspector General of Banks does have broad supervisory powers over the foreign-currency operations of the chartered banks, and does collect data on many of the international activities of the banks.

Table 10.4 indicates the geographic distribution of Canadian bank branches, agencies, representative offices, and branches of subsidiary companies as of May 31, 1977.

Table 10.4

Location of Canadian Chartered Banks outside Canada, May 31, 1977

Location	Number of Branches
United Kingdom	28
United States	70
France	8
West Germany	7
Bahamas	52
Barbados	26
Guyana	11
Mexico	4
South and Central America	26
Dominican Republic	22
Virgin Islands (British and U.S.)	7
Puerto Rico	16
Trinidad and Tobago	33
Jamaica (and Cayman Islands)	93
Other West Indies	31
Other Europe	16
Asia (including Middle East)	42
Australia	5
Total	497

Source: Canadian Bankers' Association.
Note: Chartered banks are represented by branches, agencies, representative offices and/or branches of subsidiary companies.

Competition

The Financial Institutions Competing with Banks

A variety of classes of companies and other financial institutions compete with the banks in one market or another. The more important of these are listed in Table 10.5, which shows the aggregate assets held by each class and by the largest single institution in the group (where that is available). In this section we shall describe briefly the nature of the business carried out by each institution.

TRUST AND MORTGAGE LOAN COMPANIES

Both trust and mortgage loan companies have been specifically recognized in the Bank Act as competitors of the banks, by the provision banning interlocking directors. Taken together (because they are similar and often affiliated) their aggregate assets (excluding estate, trust and agency funds administered by them) are about $27.7 billion and the largest single company involved has assets of about $3.4 billion (Table 10.5). These companies offer chequable deposits, non-chequable savings deposits and term deposits in the one- to five-year range, together with a number of related services. They

Table 10.5

Major Financial Institutions in Canada
(Millions of Dollars)

	Total Assets			Annual Revenue, 1975	Largest Institutions by Asset Size, December 1975
	December 1967	Latest	(Date)		
Private Sector					
Chartered banks	31,669	121,849	(10/76)	10,309[i]	28,832[h]
Trust and mortgage loan companies	7,125	27,667	(12/76)	2,308	3,436[a]
Trusteed pension funds	8,068	21,572	(3/76)	3,863	1,296
Life insurance companies	12,912[b]	25,908[b]	(12/76)	N/A	2,542
Caisses populaires and credit unions	3,382	14,987	(9/76)	616	–
Sales finance companies	4,501	10,073	(12/76)	1,436	2,391
Property and casualty insurance companies	2,304	6,679	(12/76)	N/A	–
Mutual funds	2,229	2,774	(9/76)	161	364
Foreign bank affiliates	n.a.	2,402	(12/76)	n.a.	n.a.
Commercial paper[e]	187[d]	1,796	(12/76)	–	–
Quebec savings banks	506	1,118	(12/76)	115	–
Public Sector					
Canada Pension Plan	681 (3/67)	9,770	(3/76)	2,129[g,j]	N/A
Central Mortgage and Housing Corporation (CMHC)	–	9,191	(12/76)	799	N/A
Caisse de Dépôt et Placement du Québec	419[f]	5,340[f]	(12/76)	318[f,g]	N/A
Federal Business Development Bank	305	1,454	(12/76)	116	N/A
Government savings institutions[c]	241 (3/67)	1,067	–	n.a.	777

Sources: Bank of Canada *Review*; Statistics Canada, *Financial Institutions*, 61-007; Annual Reports of CMHC, Caisse de Dépôt, Superintendent of Insurance; Statistics Canada, *Quarterly Survey of Trusteed Pension Plans*, 74-001.

Notes:

a. As most trusteed funds do not publish their total asset figure, it is not possible to determine the largest fund. The figure given represents the CNR's fund, the largest fund for which data is publicly available.
b. Canadian assets only.
c. Deposits only. Excludes provincial government deposits.
d. December 1968.
e. Only that portion issued by non-financial corporations.
f. Includes funds under management.
g. Includes contributions.
h. October 1976.
i. Year ended October 31, 1976.
j. Year ended March 1976.

n.a. = not available.
N/A = not applicable.

invest most of their funds in mortgage loans on residential properties, but they also hold longer-term securities as investments and shorter-term securities (as well as bank deposits) as liquid assets. They put about 2% of their assets into personal and business loans. Under various provincial statutes they are subject to "basket clauses" that limit their combined consumer and business loan portfolio to 5-7% of assets. Their leasing portfolios are quite large, however. The trust companies also administer many billions of dollars' worth of assets held in estate, trust and agency funds under their fiduciary powers, on which commissions and fees of approximately $178 million were earned for the year ended December 1976. As well they are very active in real estate and derive a significant proportion of their earnings from real estate commissions and services connected with the housing industry.

CAISSES POPULAIRES AND CREDIT UNIONS

By far the largest numerical group of institutions competing with the banks in deposit business and certain types of loans to individuals is that comprising the *caisses populaires* and credit unions, of which there are thousands of "locals". These are normally associated in each province with one or more "centrals", which assist them in holding reserves and providing services. The locals are cooperatives in which the membership is normally limited to certain areas or the employees of a particular employer. Their aggregate assets as of December 1976 were approximately $15 billion. They receive deposits as well as share capital from their members. Their total chequable deposits amount to about $3 billion, their non-chequable demand savings deposits to about the same, their term deposits to about $5 billion and their share capital to $3 billion. Thus they compete for the retail banking business on a widespread and decentralized basis. They make personal loans and mortgage loans to their members, and, to the extent of about $0.5 billion, business loans to cooperatives and commercial enterprises. They are organized and regulated under provincial laws. The revised credit union acts emerging in several provinces (Ontario and Manitoba are the latest) vastly expand the business powers of credit unions. The Ontario act, in particular, has a general "enabling" clause permitting credit unions to carry out a broad range of lending activities currently engaged in by chartered banks.

LIFE INSURANCE COMPANIES

The life insurance companies are the largest financial intermediaries, next to the banks. Their business overlaps that of the banks primarily in the investment of funds in bonds and mortgage loans. They also deal actively in the private placement market and purchase substantial quantities of securities directly or through an investment dealer. Such a purchase competes with a bank making a term loan to a business corporation. Insurance companies make loans to individuals against existing insurance contracts but do not pursue such business, as it is unprofitable. The aggregate assets of the life insurance companies held in Canada at year end 1976 were about $26 billion, about 39% of which is mortgages and 36% bonds.

TRUSTEED PENSION PLANS

The next largest group of financial institutions, and the most rapidly growing one, comprises the trusteed pension plans, which in 1976 amounted in aggregate to about $25 billion. Their individual sizes and investments are not disclosed, but at least one, that of the Canadian National Railways, amounts to over a billion dollars in value. The majority of these aggregate assets are invested in the bonds and stocks of larger and more established companies and in mortgages, all of which overlap the investments of the banks.

FINANCIAL CORPORATIONS

The sales finance and consumer loan companies (now termed "financial corporations") had aggregate assets in 1976 of about $11 billion, the largest individual company accounting for about $2.4 billion. They obtain the bulk of their funds by selling short-term paper in the money markets and by selling bonds and debentures. They normally have substantial lines of credit with Canadian and U.S. banks. They finance retail sales to consumers ($2.3 billion outstanding), make personal loans ($1.8 billion outstanding) and provide financing for industrial and commercial customers and wholesalers. In recent years they have rapidly increased their activity in financial leasing and mortgage lending.

FOREIGN BANKS

There are several smaller classes of institutions that invest funds in bonds or shares, such as the non-life insurance companies and mutual funds, but these need not be described in detail here. One category of potentially greater importance is that comprising Canadian corporations that are financial subsidiaries or affiliates of foreign banks, which operate in Canada outside regulation under the Bank Act (although, if they incorporate as financial institutions of a type covered by a statute, for example, the Trust Companies Act or the Loan Companies Act, they are subject to that statute). The Bank of Canada publishes (in its *Review*) statistics on all those they can identify as being Canadian corporations owned by foreign banking institutions and primarily involved in commercial lending or the money market (it excludes trust and venture capital companies as well as financial institutions affiliated with foreign companies other than banks). These statistics show foreign bank assets in December 1976 at about $2.4 billion. There are 22-25 major and very active foreign bank affiliates, 2 of which have Canadian assets exceeding $500 million. Foreign bank lending is financed primarily by borrowing in the money market and by funds from parent or affiliated companies. Foreign bank affiliates use their funds for making business loans and financial leasing of equipment. While still small by comparison with the banks and some other Canadian companies, they are often subsidiaries of very large foreign banks, enjoy a strong credit rating and are sophisticated competitors of the Canadian banks in wholesale and commercial lending.

The increasing penetration of the Canadian market by foreign banks has to be viewed in the context of the changing role of Canadian and U.S. banks, and particularly in the context of the increasing involvement of U.S. banks in the private placement of debt securities, an activity that Canadian banks are prohibited from undertaking. The biggest and most powerful of the U.S. banks have gone far beyond taking deposits and offering short- and medium-term loans to business. If a company wants to expand its financial base, a bank like Citicorp, J. P. Morgan, Chase Manhattan, or First Chicago will undertake normal short- and medium-term commercial lending, advise the corporation on possible acquisition or divestiture (at a fee), help it structure and organize a new issue of equity or debt, and also arrange for private placements of these securities with institutional investors. U.S. banks are prohibited by U.S. legislation (the Glass-Steagall Act) only from actually underwriting or distributing securities. In 1976, U.S. banks placed about $700 million in debt and $225 million in equity. The largest single placement through a bank was made in 1975, for $200 million. U.S. banks have also syndicated and underwritten Eurobonds for private placement to replace or refinance their own Eurocurrency term lending to North American customers.

The Commission does not think that it would be desirable in Canada to have the melding of commercial banking and underwriting functions that is occurring in the United States, because of the very real dangers in concentrating so much financial and economic power in one set of institutions. The U.S. trends do have an impact on Canada, however. U.S. banks with Canadian affiliates can offer underwriting and related services based on U.S. money and security markets that competing Canadian banks cannot offer, to a market of medium-sized companies that do not already have relationships with other financial intermediaries.

The U.S. banks also have a special advantage in that they can take business from subsidiary firms in Canada whose parent firms do business with the banks' parents abroad. Such captive business is found extensively in the advertising and insurance fields with U.S. subsidiaries in Canada, in relationships analogous to those in banking.

The vulnerability of Canadian banking business to foreign competition is apparent in bank loan figures. Total bank business loan volume at the beginning of 1977 was about $28.2 billion, of which $16.6 billion was in about 6,400 loans of $1 million or more. Thus 2% of the business loans made by Canadian banks account for almost 58% of dollar lending activity. These are presumably the loans for which foreign bankers compete. Such competition is not usually on price, as interest spreads for loans of this size are already narrow and lending rates virtually identical. If the competition is based on the range of services offered, then Canadian banks are at a disadvantage in comparison with U.S. banks in the underwriting aspects of financial services excluded under the Bank Act and possibly in leasing and factoring.

We have no recommendations to offer on correcting this competitive imbalance, or on the overall issue of participation by foreign banks. Recommendations on these issues will be extensively discussed and debated as part of

the 1977-78 Bank Act amendments. The resolution will depend at least in part on assumptions as to whether banking is indeed a key sector of the Canadian economy, and as such should be subject to special regulation or protection vis-à-vis foreign competition.

Public Sector Financial Institutions

We will not endeavor to set forth details of the size of all the various types of governmental agencies that supplement privately owned financial organizations. The largest, yet the most restricted in its investments, is the Canada Pension Plan Investment Fund, which amounted in 1976 to about $10 billion, virtually all invested in provincial government securities issued at interest rates equivalent to those on federal government long-term bonds. The next largest is the Central Mortgage and Housing Corporation, whose total 1976 assets of $8 billion were almost wholly invested in various types of mortgage loans, about one-third of the outstanding loans having been made at market rates but most of them having been made at rates below the market for various public purposes. The current practice is to emphasize the latter almost entirely.

One of the largest and most diversified institutions is the Caisse de Dépôt et Placement du Québec, in which the funds of the Quebec Pension Plan and other Quebec government accounts, amounting to $5.3 billion in mid-1977, are invested in government, municipal and corporate bonds and in stocks and mortgages. The Province of Alberta Treasury Branches and The Province of Ontario Savings Office are essentially small government banking operations, but their public deposits of $777 million and $287 million respectively are too small to affect the competitive position of the privately owned institutions, except perhaps in local markets in Alberta. In more specialized fields, the Farm Credit Corporation, financed by the government of Canada and with assets of $2 billion, is the main institution in Canada making farm mortgage loans. The Export Development Corporation, with assets of about $1.2 billion, finances export credits, as well as insuring and guaranteeing such credits provided by suppliers, banks or other institutions.

The Federal Business Development Bank (FBDB) is a new Crown corporation that came into being in 1975, taking over the operations of the Industrial Development Bank (IDB). The IDB provided mainly financial assistance to smaller businesses unable to obtain financing from regular sources. FBDB was set up to expand IDB services, specifically to provide proportionally more equity financing and more comprehensive management counselling services. Total assets of the FBDB at March 30, 1977, were $1.43 billion.

In 1967, the federal government created the Canada Deposit Insurance Corporation (CDIC), Ontario, the Ontario Deposit Insurance Corporation (ODIC) and Quebec, the Quebec Deposit Insurance Board (QDIB). Deposit insurance, by protecting depositors against financial loss due to bankruptcy of the institution holding their deposits (a term broadly defined by CDIC), reduces the risk of a "run" on the institution and thus the risk of bankruptcy due to uncertainty. In Canada, the branch banking system ensures that a run

on any one branch will most probably not bankrupt the entire institution. The trust and mortgage loan companies, however, whose deposits from the public were increasing, neither had extensive branch systems nor were required to hold reserves. Hence, additional protection for the public was needed. The CDIC may also act as a lender-of-last-resort to member institutions (all federally incorporated, private, financial institutions taking deposits). It can obtain up to $500 million from the federal government to make loans to members temporarily in financial difficulties and unable to obtain funds elsewhere.

Other public sector financial institutions include the Ontario Housing Corporation, Quebec Housing Corporation, Alberta Municipal Finance Corporation, Alberta Housing Corporation, Saskatchewan Economic Development Corporation and other government bodies that lend money to individuals and private enterprises.

Competition in Deposit Markets

In judging the nature and the extent of the competition between these various institutions and the banks, it is necessary to look at the particular markets in which they compete. There are three basic types of deposits: personal savings, nonpersonal term and notice deposits and demand deposits with chartered banks. The last category will not be discussed because the portion of demand deposits attributable to the personal sector is not considered to be part of savings. The banks are the only institutions required to hold non-interest-bearing reserves on demand deposits, and, as a result, demand deposits in chartered banks bear no interest. Demand deposits made in chartered banks, whether personal savings or not, tend to be minimum amounts (although they do vary substantially with the level of interest rates), and represent funds intended for use in financial transactions of the depositor.

PERSONAL SAVINGS

The personal savings or "retail" market share held by the major deposit-taking institutions are shown in Table 10.6. As expected, the chartered banks have the greatest share of this market, about 55% as compared to 25% for trust and mortgage loan companies and 19% for *caisses populaires* and credit unions. The *caisses populaires* and the credit unions have increased their share of these deposits since 1967, while the chartered banks' share has declined from 57% to 55%. Although the banks' share declined between 1967 and 1976, in absolute amounts deposits grew from about $12 billion to $39 billion.

If Canada Savings Bonds are considered as being equivalent to personal savings deposits, then the banks' share of total deposits increased slightly, while the Canada Savings Bonds' share declined from 24% to 18%. The removal in 1967 of the ceiling on the interest rates the banks could charge on loans, together with the lower reserve requirements on notice deposits and greater freedom to invest in mortgages, has enabled the banks to remain competitive for these savings deposits.

Table 10.6

Canadian Retail Money Market, 1967 and 1976
(Millions of Dollars)

	December 1967		June 1976	
	Amount	Percentage	Amount	Percentage
Banks[1]	11,760	57.3 (43.7)	39,051	54.7 (45.1)
Trust and mortgage loan companies[2]	5,286	25.7 (19.7)	17,919	25.1 (20.7)
Caisses populaires and credit unions	3,039	14.8 (11.3)	13,332	18.7 (15.4)
Quebec savings banks	456	2.2 (1.7)	1,034	1.5 (1.2)
Personal savings market	20,541	100.0 (76.5)	71,336	100.0 (82.4)
Canada Savings Bonds	6,319	(23.5)	15,212	(17.6)
Total	28,860	(100.0)	86,548	(100.0)

Source: Bank of Canada.
Notes: 1. Personal savings in chartered banks plus, in 1976, term deposits of one year or more in bank mortgage subsidiaries. Personal demand deposits are excluded as it is assumed that only amounts sufficient to cover current expenditures are kept in demand accounts.
2. Includes all demand deposits plus all term deposits with original term to maturity of over one year. In 1976, term deposits of one year or more in bank mortgage companies are excluded.

"WHOLESALE" DEPOSITS

The banks have the largest share of "wholesale" deposits, i.e. large non-personal term and notice deposits. While trust and mortgage loan companies do compete with the bank for these funds, the main competition in this field comes from traders in the market in the sale and purchase of short-term notes, "commercial paper" and treasury bills (Table 10.7).

Major borrowers in the money market, apart from the banks themselves and their "acceptances" (that is guarantees) of notes issued by others, include the sales finance companies, Canadian financial subsidiaries of foreign banks, major non-financial companies with a high credit standing and provincial governments and municipalities. This commercial and financial short-term paper, amounting to about $8 billion, provides volatile and sensitive competition to large bank certificates of deposit for short-term business balances.

Competition in Loan Markets

CONSUMER CREDIT

There are three major lending fields in which the banks compete with other institutions. In the field of consumer credit, the 1967 change in the Bank Act resulted in a substantial increase in consumer lending by the banks, a substantial reduction in the interest rates charged on consumer loans relative to

Table 10.7

Canadian Money Market Funds,
December 1976

	Millions of Dollars	Percentage
Chartered banks		
Non-personal term and notice deposits	18,887	48.4
Foreign currency deposits of residents	6,984	17.9
Trust and mortgage loan companies		
Fixed term deposits with original term to maturity of less than 1 year	1,841	4.7
Government of Canada[1]		
Treasury bills	1,429	3.7
Bonds with less than 3 years to maturity	1,760	4.5
Provincial and municipal governments		
Treasury bills and other short-term paper	556	1.4
Paper		
Sales finance	3,158	8.1
Commercial	4,022	10.3
Bankers acceptances	1,135	2.9
Less bank holdings of paper[2]	(795)	(2.0)
Total	38,977	99.9

Source: RCCC research.
Notes: 1. Excludes holdings of government accounts, the Bank of Canada and the chartered banks.
2. This amount is excluded from the overall total but, because it cannot be allocated among different types of paper, it is included in the individual amounts.

other interest rates, and more uniform rates across Canada. The brief to this Commission from the Bank of Nova Scotia contains detailed information concerning the impact of the banks on this market. The latest figures on consumer credit outstanding, as reported regularly by the Bank of Canada, show the banks have provided about 59% of the total of about $27 billion (which compared with a total of about $8 billion in March 1967), the *caisses populaires* and credit unions about 14%, the sales finance and consumer loan companies about 11%, and the retail dealers 11%, while smaller shares have been provided by the life insurance companies' policy loans, the trust and mortgage loan companies, and the Quebec savings banks. In December 1966 (before the Bank Act revision) the share of the banks in outstanding consumer credit was about 32%, while that of the sales finance and consumer loan companies was about 30% and that of the retail dealers about 20%.

MORTGAGE LENDING

In the field of mortgage lending the situation is quite different. Here too the importance of the banks' role has increased since 1967, when the Bank Act first permitted them to lend on conventional first mortgages. Under the

previous Act, they had been permitted to lend only on National Housing Act mortgages. In this market there are many large lenders and a very large number of borrowers. The largest source of funds, especially for mortgages on residential property, are the trust and mortgage loan companies. Second come the life insurance companies (who were earlier the largest source but now prefer long-term commercial mortgages rather than the shorter-term residential loans). As well there are a variety of other institutional and corporate lenders, including government agencies. The share of the banks in the outstanding mortgages at December 31, 1976, as reported by Statistics Canada, was about 14%, the same share they held at the end of 1975. The banks have proven to be aggressive participants in this large, growing market, which is relatively unconcentrated on both the supply and demand side. The same can also be said of the other deposit-taking institutions, the near-banks, whose share in the mortgage market has also been rising since the 1967 revision of the Bank Act, notwithstanding the competition of the banks.

BUSINESS LOANS

The third and main lending field in which the banks operate is that of business loans. This is a large and varied category about which the Economic Council report states the following:

> The commercial lending market differs from other lending markets in that, among the deposit institutions, only chartered banks play a significant role. This market is also distinctive because the alternative sources of funds for businesses are numerous and varied—including the issue of short-term paper, bonds, and equities; the use of accounts payable and government assistance; and reliance on internal funds. The range of alternatives varies substantially, however, by size of firm. Larger firms have access to direct, as well as international markets; smaller firms depend more on accounts payable and on chartered banks for their external funds.
>
> The commercial loan market is extensive. Outstanding business loans of Canadian chartered banks amounted to $18.2 billion at the end of March 1974—an amount nearly equivalent to total consumer credit outstanding. Thus business loans represented 53% of all Canadian-dollar loans made by chartered banks. The share of business loans as a proportion of bank assets rose steadily from 25.1% in 1961 to 34.3% in 1974.

The business loan market is difficult to delineate. The lenders include all chartered banks, finance companies and the Federal Business Development Bank. The borrowers include businesses of all kinds, industry, public utilities, construction contractors and merchandisers. The market also includes "capital leasing" by leasing companies and sales finance companies. At the end of the first quarter in 1975, the total outstanding of such financing amounted to $27 billion. In addition, the business loan market is served by affiliates of foreign banks and, to a small extent, by trust and mortgage loan companies, credit unions and *caisses populaires* and by finance companies, which purchase commercial paper. Because of inadequacies of data as well as double counting problems, a total for business loans is not available. However, Table 10.8 shows

Table 10.8

Business Loans – Outstanding Balances of Selected Holders [Canada], 1975[1]

	Bank	Sales Finance & Consumer Loan Companies	Finance Leasing Companies	Industrial Development Bank	Total
$ Million	20,960	4,388	528.3	1,087.3	26,963.6
As % of Total	77.7	16.3	2.0	4.0	

	Affiliates of Foreign Banks	Trust & Loan Companies	Credit Unions & Caisses Populaires	Commercial Paper
$ Million	1,515	226.2	80.4	7,345

1. First quarter-end 1975.
   Note: Some of the balances held by foreign bank affiliates are already included in figures pertaining to sales finance and finance leasing companies. For this reason, their outstandings could not be included in the total figure. Balances of trust and loan companies and credit unions are rough estimates done by BNS and, therefore, are also excluded from the total.

Source: Bank of Nova Scotia, "Corporate Concentration and Banking in Canada", mimeo. brief to RCCC (Feb. 1976), Table 8.

estimates of the various segments made by the Bank of Nova Scotia in their brief to this Commission.

The chartered banks have played an important role in expanding the flow of funds to their customers, not only by generating funds within the banking system, but also by giving them access to the money market by guaranteeing their commercial paper in the form of bankers' acceptances. The amount of bankers' acceptances outstanding is generally over $1 billion.

While the chartered banks have been by far the largest suppliers to the business loan market, they have not been growing as fast as the leasing companies, the subsidiaries of foreign banks and indeed the money market generally. Corporate bonds should also be considered to be competitors for parts of the business loan market as maturities on bank loans lengthen, while those on bonds decrease. At the end of 1975, the outstanding corporate bond debt in Canadian currency was $19.2 billion, and an additional $5.2 billion was outstanding in foreign currency bonds. It can be seen that this compares in size with the $27 billion shown for the traditional sources of business loans.

The standard delineation of the business loan market also excludes receivables of non-financial companies. At year-end 1974, receivables of industrial corporations amounted to nearly $33.5 billion, comparable in dollar volume to the business loans outstanding of chartered banks, sales finance companies, finance leasing companies and the Federal Business Development Bank combined.

It is evident that the banks are the dominant institutions making business loans but are subject to the constraint of the money and bond markets when

competing for large borrowers with good credit standing. There is also some competition from other institutional lenders and financial lessors for loans of all sizes. The extensive branch system of the banks gives them an accessibility advantage in lending to small businesses. Small and medium-sized businesses are more reliant upon the banks for credit lines and terms than are larger borrowers.

In the briefs and our hearings we were supplied with information concerning certain special types of loan arrangements. Consortium financing has become common on very large international loans in the Eurocurrency markets during the past 15 years and it is now becoming increasingly common in Canada. It is particularly necessary for large-scale projects, such as those in the energy field, and indeed several Canadian banks have developed particular expertise in arranging large-scale consortium lending. At the other extreme have been specialized loan and financial services for farmers and the few "store front" banks for low-income urban areas.

Nature of Competition among Banks

OLIGOPOLISTIC CHARACTERISTICS

In Canadian markets the major Canadian banks compete with one another as oligopolists. That is, as sellers having a large share of a market with relatively few competitors, they must take into account the effect of their actions on their competitors' reactions. At the retail level and to a lesser extent in wholesale transactions, banks normally emphasize competition in the services they provide and in other non-price factors. There are occasional changes in prices (usually in interest rates) initiated by one or another of them to which the others react and out of which a new level of price emerges. However, the banks are subject to competition from other institutions, particularly in the fields of mortgage and large business loans. It should be recalled that it has been only in the past ten years that the banks have been prohibited from entering freely into agreements among themselves about interest rates on loans and deposits. Only since 1976 have they been prohibited from agreeing to fix service charges.

Banks are subject to another peculiar condition in this respect because it is the central bank, on public policy grounds, which acts as price leader in changing the levels of interest: changes in the bank rate are always followed by the chartered banks. In times of strong competition this may result in changes in spread as well as changes in levels of interest rates.

On two occasions between 1967 and 1976 the chartered banks in consultation with, or at the request of, the central bank and with the approval of the Minister of Finance, worked out agreements to limit interest rates. The first agreement came about in 1969, when the Bank of Canada's monetary policy was to reduce liquidity of the banking system as part of a restraint program while interest rates were rising. The major banks, at the request of the Bank of Canada and with the approval of the Minister, agreed not to compete aggressively for large Canadian dollar deposits. As a result, the rate of interest on

these deposits rose less than on other short-term notes. Again in 1972, after consultation with the central bank and approval of the Minister, an agreement among the banks lasting until January 1975 was worked out to limit the rise in interest rates on large dollar deposits that was then taking place.

From the above review of the markets in which the banks compete, their share of those markets, and their size vis-à-vis competitors, it is evident that the major banks are very substantial institutions. Their widespread network of branches, their strong position in both deposit and lending markets, their profitability and their international reputation all contribute to this position. The major banks are also active participants in international banking. The largest Canadian banks have ranked in the 20 or 25 preferred first-tier banking institutions in the world in recent years, when confidence in many foreign banks was shaken by foreign exchange crises and the problems of financing recurrent, large, international deficits. This first-tier status allows them to borrow in major international money markets at the best possible rate, and thus to relend to customers around the world at rates competitive with those of other major international institutions.

INTEREST RATES

Deposits. The behavior of interest rates on personal deposits and smaller non-personal term and notice deposits appears to follow the normal patterns of price behavior among oligopolists: that is one or another takes a lead in changing the rate, often following a change in the bank rate, and others follow fairly quickly. On rare occasions a bank may choose to reduce or reject the lead bank's change and set a pattern by its own action. On the largest deposits, interest rates are negotiated according to the state of the market and the bargaining powers of the depositor vis-à-vis alternative short-term investments.

Loans. On the lending side, the rates charged on standard, unsecured personal loans have been relatively stable, increasing only twice since 1967. With regard to mortgages on residential properties the situation is more complicated because of the presence of other large lenders, and non-price rationing and a preference for established customers when funds are short.

On business loans, the "prime" rate for the best customers is published and usually changes when the central bank rate changes. The prime rates charged by all banks tend to equalize quickly after a central bank change, whoever first responds to it. The rates on most other business loans are determined by adding a margin to the prime rate, a margin that rarely exceeds 3%, for the normal type of nominal demand loans. On rare occasions a bank will lend to a major customer at less than the prime rate.

The Bank of Canada collects quarterly a sample of rates charged on new demand business loans, and publishes the average rate, weighted by dollar volume, in its *Review*. Figure 10.1 compares the prime rate on bank loans, the average rate on new demand loans and the money market rate for three-month finance company paper. The last is normally below the prime rate, but is much more volatile. The weighted average rate on new demand loans ranges between 0.5% and 0.75% above the prime rate.

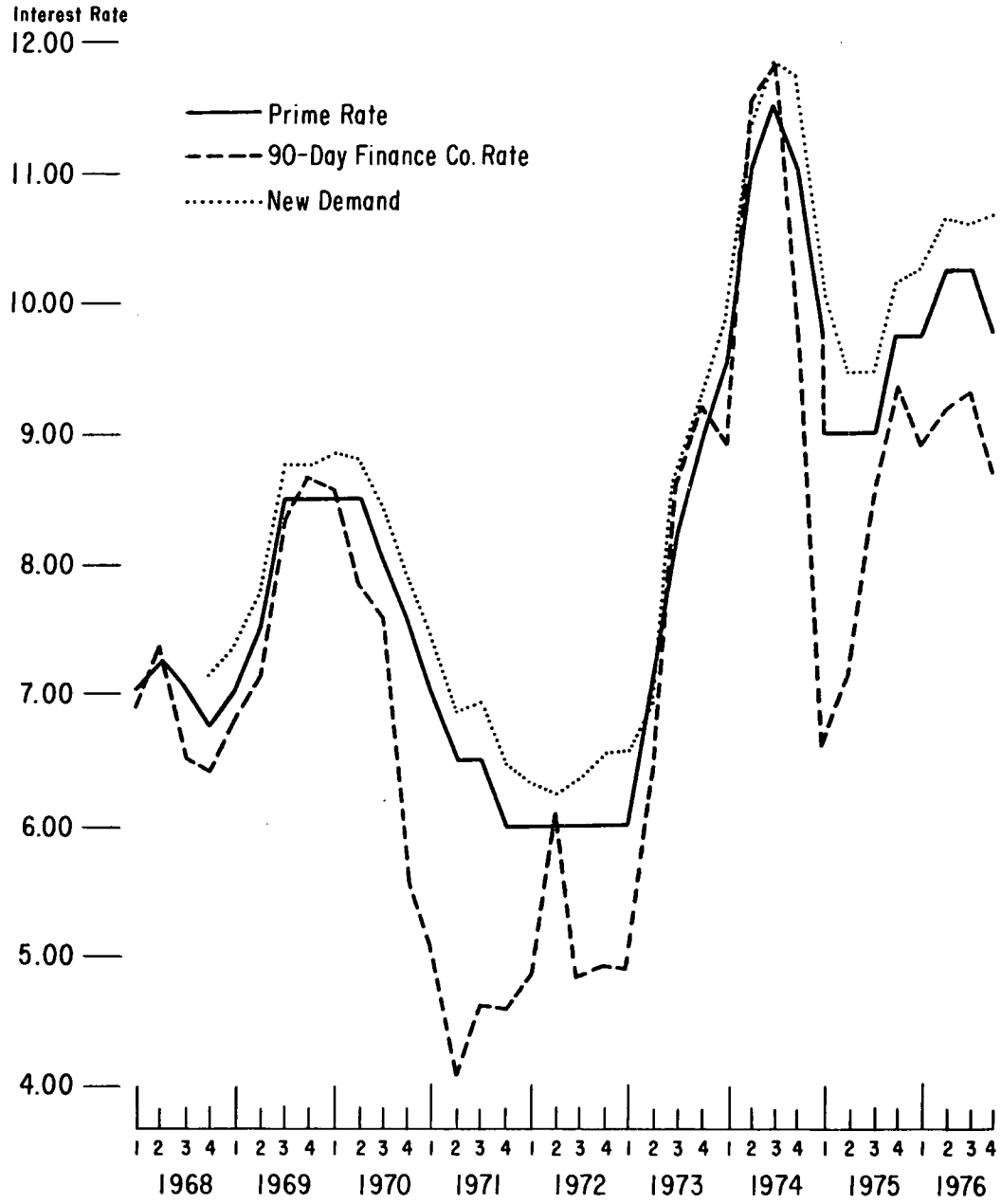

FIGURE 10.1. Comparison of Interest Rates, Canada, 1968-76.

Source: Bank of Canada *Review*.

In 1964 the Porter Commission said:

> At present there is a strictly limited amount of price competition among banks in their lending business. Banks may differ in their view of whether a particular customer merits prime rate or not, but their rates are subject to agreed minimum levels. Price competition has been further restricted in periods of credit restraint by agreements among the banks to the effect that no bank will take over an account from another by offering a better rate or a larger line of credit. The "no raiding" pacts have not survived for long but while they do, the borrowers' main negotiating weapon, the threat to go to another bank, is effectively spiked.

Since that time, the Bank Act has outlawed such agreements on rates. Representatives of the banks appearing before us indicated that borrowers could, and not infrequently did, go to other banks in search of better terms. In their "retail" business at branch level bank managers generally have an incentive to compete for business loans below certain size limits but are restrained by formula lending or by guidelines in the margins they charge over prime rate.

COMPETITION FOR LARGE ACCOUNTS

There quite clearly is active competition among the banks for the accounts, or shares of the accounts, of the largest corporations. This only infrequently takes the form of price competition on the effective interest rate charged; indeed most large customers already borrow at "prime rate" or very close to it. Competition more frequently takes the form of larger (or small but sophisticated) customers negotiating for lines of credit, lending conditions, security covenants, or other aspects of the loan package. It is noteworthy that the ratio of size of credit lines in relation to the amount actually used is consistently higher for larger authorized credit lines, both over time and across various industries, than it is for the smaller ones. While this may be due to a variety of factors, it would be consistent with some negotiated advantage for large and valued clients.

It should be noted that, at times when money is tight and credit must be rationed, the banks say they give priority to smaller customers rather than to their large corporate customers. The Chairman of one bank told us, "We give priority [under these circumstances] to mortgage lending, to consumer needs and to the requirements of small businesses, which often have no other source of financing but their chartered bank. . . . Major corporations have access to many other sources of credit, including the money markets in Canada, parent companies abroad, the Eurodollar market, foreign banks operating in Canada, and so on." Such a system of priorities is in line with the strong suggestions that have been made by the Bank of Canada to the chartered banks at times when credit availability has been tightened.

Cross-Subsidization

An issue considered by the Commission in Chapter 5, "Conglomerates", was the existence of cross-subsidization among activities of an organization,

particularly where one activity was carried on at a loss over a long period and subsidized by other activities on which the organization was able to earn above-average returns.

Banking is one of the few areas where we have observed a form of long-term cross-subsidization. The chartered banks, and indeed all Canadian deposit-taking institutions, charge a price well below cost for personal chequing accounts, for servicing utility bills and for a few other services. Some trust companies perform these services at no charge. The purpose of such cross-subsidization is quite clearly to use personal chequing accounts as a "loss leader" for savings accounts, and for general banking business.

The Commission has no recommendations to make concerning such practices. Banks subsidize an important service for individual customers but the effect does not seem highly detrimental to other institutions.

Entry into the Banking Business

The 1967 amendments to the Bank Act were in large part intended to increase competition by prohibiting agreements in interest rates, by removing the ceiling on rates, by banning some interlocking of directors, by permitting lending on conventional mortgages and by altering the formula for reserve requirements to encourage a greater variety of deposits. On the other hand they did nothing directly to ease entry into the banking business and in fact restricted severely the possibility of foreigners setting up a chartered bank, or of a Canadian company establishing a bank as a subsidiary. While five new banks have been incorporated, and some of the smaller banks have grown more rapidly than the larger ones (La Banque Provinciale du Canada in part by merger with the Banque Populaire in 1970 and with Unity Bank of Canada in 1977), the fraction of the total Canadian assets held by the five largest banks has declined very little.

General Conclusions Regarding Competition

We have concluded that the general situation of the banks does not call for substantial further regulation. However, the oligopolistic nature of competition among the banks (which is similar to that in many other industries), makes it desirable to promote by whatever means are practicable a greater ease of entry into the business of banking itself, and a greater degree of competition between other financial institutions and the banks.

The prohibition of agreements on interest rates and the removal of the statutory ceiling on rates charged by the banks have permitted the strong growth of the banks in the past decade and the shift from what had been something like a cartel operating subject to a statutory ceiling on rates to the present situation of competition among the leading banks constrained by competition from other markets and institutions. There has been relatively little competitive pressure from new banks, although the smaller banks in aggregate have grown slightly faster in relation to the established banks.

The economic barriers to entry of new banks into the retail branch banking business, which are noted in the study of the Economic Council, appear to us so formidable that easing of the legal and procedural barriers would not be enough to bring any early increase in competition sufficient to permit a new bank to rival one of the big five. The regional banks, which might be taken to include the Bank of British Columbia, together with the two much older and larger Banque canadienne nationale and La Banque provinciale du Canada, seem unlikely to make serious inroads on the national market share of the big five.

COMPETITION BY OTHERS IN THE RETAIL BANKING FIELD

The trust companies can be expected to grow in the retail banking field, but the rate will depend on whether legal and institutional circumstances are favorable to them. They are still small by comparison with the banks, but the competition they provide seems to have improved somewhat the retail services available to depositors. The credit unions and *caisses populaires* collectively have been growing more rapidly than the banks, particularly in their share of chequable deposits, and may well continue to do so. In our view, the trust and loan companies on the one hand and the *caisses populaires* and credit unions on the other are the only existing and potential competition for the banks in the retail branch business and should be encouraged to continue in that role.

We are therefore concerned that proposals in the *White Paper* would require these institutions to become members of the Payments Association and hold non-interest-bearing reserves. We believe that in the long run they should belong to that Association and should hold reserves adequate for the purposes of the clearing function. However, we think at this time it is unwise to weaken the competitive ability of these institutions vis-à-vis the larger banks in order to accomplish long-term objectives. We think it would be desirable to permit these existing institutions (trust and mortgage loan companies, *caisses populaires* and credit unions) to decide themselves whether they wish to become members of the Payments Association now or to wait until later when its advantages would be more important and the current objections less serious.

We think it desirable that the trust and mortgage loan companies be explicitly permitted to enter more fully into the business of making personal loans in competition with the banks, perhaps by legislation expanding the permitted limits of their basket clauses. Their growth in the past ten years has come about to a large degree from the abnormal demand for residential mortgages, arising in considerable part from demographic changes that will certainly slacken during the next decade.

While it is less essential in terms of competition that trust and mortgage loan companies enter the commercial lending field, because it is already competitive, we think it desirable that they be permitted to make commercial loans to smaller businesses. Already several trust companies are getting involved in commercial lending through wholly owned subsidiaries and others have explored incorporation as "savings banks". While we recognize the important potential conflict of interest for trust companies between their

trustee services and commercial lending, we do not believe this can be convincingly resolved in the way that the Economic Council proposes by "the separation of intermediary and fiduciary activities over time." We would suggest, however, that the possibility be explored of restricting the class of borrowers to whom trust companies may make commercial loans to businesses that have neither issued securities to the public nor are subsidiaries, parents or affiliates of such public companies. In this way their competition with the banks might be directed usefully toward smaller, private companies, where the potential conflicts of interest with fiduciary duties would be relatively small and might be prevented by specific restrictions against lending to companies whose shares or debt are held in fiduciary accounts.

COMPETITION FROM NEW BANKS

A major potential source of competition for the large banks in the commercial or wholesale sector appears to be from new specialized banks. We support the establishment of such new banks whether or not controlled by foreign banks (or bank holding companies), subject, of course, to whatever limitations are established by Parliament under the Bank Act. This should introduce additional effective competition on a controlled scale and perhaps some valuable innovation.

We would also recommend that new Canadian-controlled banks be permitted to start on as favorable a basis as possible to compete with new foreign-controlled banks and the existing banks. To get the initial strength for a successful start against this competition, it may well be necessary that they be permitted to commence under the firm majority control of a strong corporate or other associated group able to retain majority control of the bank for a substantial number of years before beginning to reduce its shareholdings down to the 10% limit applying generally under the Bank Act. We think this type of additional domestic competition will be possible only if there is a clear policy defined in the legislation giving the necessary assurance to potential Canadian entrants that they can have sufficient time to become profitable and to have something valuable to sell when the time comes. As long as there is a controlling shareholder or group of associated shareholders, "self-dealing" provisions should apply to that bank, as they now apply to other financial institutions, to prevent it lending to or investing in related companies under essentially the same control (with the exception, of course, of specified bank subsidiaries).

The Commission has indicated its strong support for easier entry to the Canadian banking sector, both at the retail and wholesale banking levels. But we feel that, while there is an important role for small and medium-sized banks to play, this will supplement rather than duplicate that played by the major Canadian chartered banks. There have almost certainly been economic as well as regulatory reasons for the lack of small and medium-sized domestic Canadian banks. As Canada achieves a more advanced industrial economy, the role of specialized or local banks filling other roles may become more important, but it will not soon replace that filled by the existing major banks.

One great advantage of the size and strength of the Canadian banking sector is seen in its ability to compete in international financial markets. The largest Canadian banks have also gained considerable expertise in the type of consortium financing necessary to develop the largest of our energy and resource projects during the rest of this century. It would be difficult or impossible to undertake consortium financing of major projects without very large banks.

Finally, our system of large national banks provides major borrowers such as the provinces access to major capital markets in Canada and abroad, an access that would be much more difficult without the presence of these large banks and the confidence engendered by their size.

MERGERS

The *White Paper* proposes that the law relating to mergers of banks be part of the general competition law relating to mergers, but that the Minister of Finance have the power to authorize "such mergers which, in his view, are in the interests of the stability of the financial system." We see no objection to the application of the competition law in this respect, although we also see no necessity to shift the administration of a power that comes into play so infrequently and on which it will be necessary in any case to consult the Minister of Finance. Successive federal governments in the past 15 years have not announced any policy in regard to bank mergers, and only two mergers involving relatively small banks have been approved. Our study of the situation leads us to observe that no mergers among the five largest banks would appear to us to be necessary or desirable in the medium-term future but that if two or more smaller banks wished to merge to be more competitive with the big banks such a proposal should be sympathetically considered on its merits. In addition, we recognize the continuing possibility that from time to time a small bank in serious financial difficulties may have to be taken over by one of the stronger banks as a means of protecting the public interest, including the good reputation of the Canadian banking system as a whole.

DISCLOSURE

The general subject of disclosure of corporate information is discussed later in this *Report*. Here we wish only to mention some aspects of disclosure that pertain particularly to the banks (and to other financial institutions not subject to the general corporations or securities acts). The Bank Act itself sets forth many of the financial statements that must be made by the banks, either to their shareholders or to government for publication or for the purpose of regulation or compilation of statistics. The 1976 *White Paper* indicated in general terms that further disclosure would be required regarding bank activities, changes in accounting practices and other areas. The proposed changes do not seem to go as far as the breakdowns in aggregate figures proposed by the Association of Canadian Bank Analysts in their brief to the Department of Finance in November 1975. We think that the bank analysts' proposals would

be very useful to investors and others in assessing the business performance of individual banks and that the information requested could be provided in the annual statements of each bank at little expense.

The banks are greatly increasing the numbers and range of their subsidiaries and affiliated companies both in Canada and abroad. While some information on these is published, we think it is in the public interest that the banks should clearly identify their subsidiary and affiliated companies even where they are jointly owned or controlled by that bank and other financial institutions. The information given should include the type of business in which the subsidiary or affiliate is engaged, its total assets, the investment in it by the bank and other affiliates of the bank and the percentage of voting shares held. We also support the proposal in the *White Paper* that the statements of each controlled subsidiary whose accounts are consolidated into those of the bank should be published separately. For each subsidiary and affiliate so reported, the banks should also indicate where applicable their policies on their charges to their subsidiaries for banking services provided to them.

We also think that the banks, as corporations, should be required to circulate management proxy circulars like those business corporations are generally required to circulate under section 144 of the Canada Business Corporations Act. The form and content of such circulars should be established by regulations under the Bank Act and should include that information required of other corporations unless there are good reasons to the contrary.

One aspect of the circular that might differ from that for corporations generally concerns indebtedness of directors, and those nominated to be directors, and officers of the bank. In the case of the banks this would normally involve relationships that exist in the ordinary course of business, and we think they need not be disclosed. However, the aggregate of loans outstanding to directors and to persons nominated to be directors should be disclosed in the proxy circular, and also the aggregate of loans to companies of which the directors or nominees are officers.

We suggest these as a minimum standard in addition to the financial disclosure already required of Canadian chartered banks. The level of bank disclosure in Canada is currently somewhat below that existing in the United States and very substantially less than the voluntary disclosure code announced in November 1976 by BankAmerica Corporation (see Chapter 13). This disclosure policy reverses the usual bank policy of considering all information confidential and requiring justification for individual disclosure, assumes that the "right to know" is paramount and requires justification for imposing limits on the right to know. As part of that policy, and with only minor exceptions, BankAmerica makes available to the public all information it files with government agencies. While this goes far beyond what is proposed for Canadian banks, or required for U.S. banks generally, and beyond what we think Canadian law need require, it is a good example of what a very large and responsible corporation judges to be desirable in its own and the public interest.

Directorship

The Banks' Boards of Directors

The Bank Act has a number of special provisions applying to boards of directors that differ from those in the general corporation acts. There has been considerable public interest in the size and composition of these boards and the extent to which bank directors are directors and executives of other corporations and may be regarded as part of a network of corporate influence throughout Canada. In addition, the composition and functioning of boards of directors form a part of the relations between the banks and their major corporate customers. The Commission has therefore given some special attention to this subject and asked questions about it in its public hearings.

The boards of the banks are typically much larger than those of the great majority of commercial and industrial companies. While this had led us to question whether they are unwieldy, and therefore perhaps less effective than they should be, and whether the large size dilutes the sense of responsibility of individual directors, we cannot assert that the reassuring answers to these questions given us by bank witnesses were wrong or that the size of the boards is harmful to the public interest. The bankers in their briefs and testimony to us have stressed the importance of having representation on their boards from all regions of Canada and all the major industries to provide a source of informed advice and good business judgment. The banks have not shown an equivalent desire to achieve a correspondingly balanced diversity in occupational experience, age, sex, language or social background among their directors. This has exposed them to criticism as a recognized central circle of the "corporate elite".

In regard to the functions of their boards of directors, bankers have stated that, while it is necessary for the boards or their committees to approve loans above specified sizes as part of an effective managerial system, in fact directors rarely intervene in questioning or changing the decisions of lending officers and senior management. The essential duties of the directors are to advise and guide management in regard to policies of the bank, including lending policies, to monitor the performance of senior management and, if and when necessary, to appoint new chief officers. The bankers have also confirmed to us that they expect directors to assist in obtaining or retaining the accounts of major customers.

There seems no doubt that senior executives of important Canadian businesses and leading lawyers regard it as an honor and a valuable experience to serve on the board of one of the well-established banks. These boards are composed largely of the chief executives of major corporations that are customers of the bank (though not necessarily of only that bank), and that will usually borrow from that bank. Another element of the board is usually composed of leading members of legal firms who serve the bank in various parts of Canada. To some degree, therefore, most members of the board have important business relations with the bank in addition to their fiduciary duties as directors.

This nature and role of the boards of banks is traditional and certainly well known. The directors are, as far as we can judge, persons of ability and integrity. So we mean it as no personal reflection on incumbent bank directors when we express our concern about the situation where the boards of our major lending institutions are composed almost entirely of persons who have an additional relationship with the bank, usually as the chief officer of a borrower. Inevitably this creates the possibility of a conflict of interest, collective as well as individual, where the directors' obligations to the bank may clash with their duties elsewhere. Regardless of the degree of integrity and good faith that exists, in such a situation circumstances may cloud judgment. At present only a small number of directors on the boards of the major banks can look at and evaluate the policies, management and activities of the bank free of any complication that might arise from their own business connections.

Given these circumstances, and recognizing the important role of the chartered banks in the Canadian economy, we recommend that the law require that a bank's board of directors always include a reasonable proportion of members who have no direct business relationships with the bank as borrowers or advisers, or indirect relationships by being officers or members of corporations or firms that are borrowers or advisers. These persons might be academics, lawyers or business people unconnected with the particular bank or others who might have non-corporate backgrounds. A director in the other group (e.g., an operating officer of a borrower) who found himself faced with an actual conflict of interest would be governed by the present provisions of the Bank Act relating to non-participation in decisions. Because of the very high regard in which bank directorships are generally held, we think it would not be difficult for the banks to find eminently qualified people without business connections with the bank to serve on their boards. Many chief executives of corporations are prepared to serve on the boards of other large companies that appear quite unrelated to their own company.

Interlocking Directorates

We have also given serious consideration to the subject of interlocking directorates between banks and other corporations, since some writers have attributed suspicious importance to these highly visible connections. There is no doubt that many of our most prominent business people serve on the board of a bank and also on the boards of other companies. Banks and other companies certainly look for the same sort of board members, people with senior business management experience or experience in corporation law. However we are satisfied from our study of the situation that the banks do not use these outside directors in common as a source of confidential information on their client companies. The banks can and do obtain and rely upon confidential reports and financial data obtained directly from their borrowers.

For this reason we see no need to extend to others the ban on directors of trust or mortgage loan companies, or of other banks, serving as directors of banks. Indeed it seems to us that the limit set by section 18(7) of the Bank Act

on the number of directors of another company who may be elected or appointed directors of a bank is an unnecessary nuisance. Its origin seems to have been in a recommendation of the Porter Commission that would have applied to "any other single banking institution" when that Commission was proposing that trust and mortgage loan companies be treated as banking institutions. Since separate provision was made in the Act for a complete ban on such interlocks (which had been frequently and deliberately used as a connection), the inclusion of section 18(7) cannot be justified on the basis of the Commission recommendation. All we have found in justification of it were some rather general remarks by the Minister of Finance to the Senate Committee on Banking and Commerce about the desirability of less interlocking, spreading the distribution of the directorships and securing more variegated boards. We think it is not effective in attaining these purposes and that the measure we have proposed above is more important.

Since we hope that the trust and mortgage loan companies will continue to be effective competitors of the banks in the fields of service to depositors and personal loans, we would not suggest eliminating the ban on their directors' serving on the boards of banks and of such competing companies. Indeed, as other institutions become stronger competitors of the banks in future, it may be desirable to extend this ban to them in a later revision of the Bank Act, as well as to the boards of any recognized non-bank banking affiliates of foreign banks.

Shareholdings of Directors

The Bank Act requires a director to be a substantial shareholder in the bank on whose board he sits. This provision has been in the law for many years, as had an earlier provision for double liability of shareholders, which was dropped in the 1930s when the banks' rights to issue currency notes were terminated on the setting up of the Bank of Canada. While we found some senior bank witnesses who thought a more moderate shareholding would still be desirable, we believe that in principle directors need not be shareholders, and that token shareholdings would serve no useful purpose. The requirement for a large shareholding even though financed by a loan from the bank, as is often the case, may deter some otherwise desirable directors from serving because of the financial risk involved in the vicissitudes of the stock market. The Canada Business Corporations Act and other modern corporation law does not require that directors of companies in general be shareholders at all, and we cannot see why the directors of Canadian banks need be subject to this requirement. We recommend that it be dropped. In the establishment of new banks it will be necessary to ensure that they are adequately financed and have responsible and competent directors and top management, but that is a separate question.

Senior Bank Officers as Directors of Other Companies

On another but related subject, we have noted the following brief and somewhat cryptic observation of the Porter Commission (it follows a section dealing with bank holdings of the stock of non-financial businesses):

> In a related area we believe it unwise and undesirable for the executive officers of banking institutions to serve as directors of other commercial concerns, with the exception of subsidiaries or affiliates, but we do not feel that this practice warrants a legislative prohibition.

No reason was given for this advice and it does not appear to have had much effect. The most senior officers of three of the five largest banks are directors of a dozen or more apparently unaffiliated other businesses, and the senior officers of the other banks have a few such directorates. We questioned some of these senior bankers on this subject. One of them, with many directorships, said he had never agreed with the Porter recommendation and that he thought both the bank and the other company benefited from having "someone from the financial world on their board". Another with many directorships said in his bank's brief that while the senior officers of the bank could gain valuable experience on the boards of other companies, the bank had to be very careful not to let its senior officers become so involved in the affairs of other companies that their primary responsibility to the bank might suffer. He added "... I do it for competitive reasons and because I think the bank gets the benefit." A third senior banker, with only a few outside directorships, said, in response to a question about a possible conflict of duty, "No, this is certainly part of the reason (for restricting outside relationships). The problem that you have raised we have concerned ourselves with long and hard and discussed and worried about it. There is no doubt that the potential problem is there."

This Commission recognizes that there is some risk that having many outside directorships, for competitive reasons, may take up too much of the time and efforts of the chief officers of banks, and that conflicts of duty to the bank and to the other company involved may arise. It may also be that the subordinate management and lending officers of the bank could be affected in their judgment of a company's credit if the president of the bank is on its board. We think these considerations should be appraised by the boards of the banks concerned and that in each case the senior officers of a bank should accept an outside directorship only with the prior consent of the board. The capacity of the individual and the circumstances of each case are likely to vary so much that legislation on this matter is not appropriate. As we say in Chapter 12, our study of other types of companies as well as banks, and of the increasingly heavy legal responsibility of directors as a result of statutory changes and judicial interpretation, leads us to believe that no one with another full-time occupation should serve on more than a few outside boards of directors. A gradual restraint exercised in this respect would assist in bringing a wider diffusion of the responsibility of directing Canadian business and a more diversified character to corporate boards.

Chapter 11

Investment and Business Growth

This chapter discusses the environment for investment in the Canadian economy, particularly that for investment in dynamic small and medium-sized businesses. We discuss the need for greater aggregate supply of investment capital, the institutionalization of investment, the impact of the tax system, and other environmental factors reflected in the supply of investment and the viability of smaller businesses. We conclude with a brief discussion of two ideas for tax changes that might help to solve the aggregate savings and risk-return problems in the Canadian economy.

Many roles are filled by dynamic smaller firms in our economy. In some oligopolistic industries where economies of scale are not important, they can increase price competition. As indicated in the discussion of workable competition in Chapter 9, although in many industries smaller firms are unable to match the variety of product offerings of large firms in oligopolistic markets or their overall invention or innovation, they can compete on price, service and location or in individual segments of a market. In some industries in which large firms follow parallel price and service policies, dynamic smaller firms competing on price or service may increase the range of alternatives available to customers. In this way consumers may have available the whole spectrum of price-quality-service choices, although not necessarily from any one supplier.

Several definitions are used to distinguish among "small", "medium" and large firms. Although a definition based on size (whether of assets, revenue or employment) is necessarily arbitrary, it is frequently necessary for administrative purposes. For instance, the Department of Industry, Trade and Commerce uses a working definition, which defines a "small business" as an independently owned firm "with fewer than 100 employees in the manufacturing sector, and fewer than 50 employees in other sectors". Other definitions of small business are less concerned with absolute size as such and instead emphasize the owner-managed aspect of enterprise and the relative share of the market. Using this approach, the Canadian Federation of Independent Business accepts the U.S. Small Business Administration's definition of a small business as a

firm that "is independently owned and operated, and which is not dominant in its field of operations". In this chapter, the term "smaller" is used to include both small and medium-sized firms, although we are aware of the importance of making the distinction between independently owned and managed small businesses and branch plants. As well, we are concerned with the relatively young or new firms that are not dominant in their markets and with innovative firms in technologically new industries.

We are particularly interested in the most dynamic of the smaller businesses, those that can both challenge the entrenched positions of the dominant firms in their industries and provide the nucleus for rapid future growth of the economy. Such firms typically have both higher risk and higher returns (in the long run) than older, better-established firms, both large and small. It is commonly believed that conventional lenders in Canada are generally unwilling to provide capital for high-risk firms, whose growth is often stunted as a result (sometimes they fail entirely).

Other reasons have been suggested to us for generally encouraging smaller firms. One is their social and cultural importance. For example, strengthening the base of small and medium-sized business in smaller towns or in less industrialized areas of the country may help in stemming the migration to major urban centers, which in spite of our large land areas has made Canada the most urbanized society in the industrialized western world. An increase in the number and variety of smaller enterprises would be of great value to smaller centers that are currently one-industry towns. Smaller businesses are often more sensitive to regional differences and more aware of regional requirements than are larger firms. Smaller businesses also have a considerable impact on employment. Of the more than one million businesses in Canada, the majority are small and privately owned. In 1973, 90% of all Canadian firms employed fewer than 100 people each, and collectively these firms accounted for 60% of total employment. As indicated in Chapter 9, in comparison with almost every western industrial country, Canada has a lower ratio of small and particularly medium-sized firms to larger firms in many industries. This is true in spite of the fact that the largest establishments in Canada do not themselves compare in asset size, sales or growth rates with the largest firms world-wide. Even where ratios of small and medium-sized firms in Canada are comparable with those in the United States, it appears that smaller firms have not grown relative to growth rates of larger ones to the same extent as they have in the United States.

The lower ratio of small businesses in some industries suggests either substantial barriers to entry or an anticipated risk-return ratio that does not attract new investment in those industries. The lack of medium-sized firms suggests either impediments to the growth of smaller firms or a risk-return relationship that provides inadequate incentive to such growth. In any case, there are the questions of where dynamic, new small businesses are to come from and whether conditions exist to enable them to grow.

In our briefs and hearings and in discussions with many investors, we heard evidence that there were managerial, financial, technical and scale

barriers to entry and to growth in Canada and that returns were inadequate to make investment in smaller ventures attractive. We did not find agreement on the relative importance of these factors. Some investors argued, for example, that the main deficiency was in the overall quality of Canadian management; that an adequate supply of proposals for new, well-managed projects would bring forth appropriate financing. Others argued that there was an adequate flow of proposals but a lack of capital to finance them. Other investors argued that, even if there were adequate projects and financing available in Canada, the much superior risk-return ratio available in the United States and elsewhere would severely limit investment in Canada. Problems exist in all these areas, but perhaps most dramatically in the provision of financing. We begin by discussing the developing shortage of investment capital in Canada and then focus on the situation for risk capital.

The Supply of Investment Capital

The financial problems of small and medium-sized companies must be viewed in the context of the developing shortage of investment capital in Canada and, as part of that problem, the need for increased business profits. In the seven years from 1970 to 1976, Canadians invested $214.6 billion in machinery and equipment, other business investment, housing and government construction. Stated in 1977 dollars, this is about $280 billion. It is currently estimated that in the seven years beginning in 1977, Canada will require between $460 and $520 billion (current dollars) of investment. About 30-35% of the projected investment will be in energy and transport; part of this has already been committed and much of the remainder would be difficult to postpone without adversely affecting our standard of living. The projected total investment requirement represents an increase of 2-3% (over the 1970-76 average of 22.5%) of the gross national product (GNP) that must be saved and invested. Though there exists considerable "slack" in the economy at present, there is some concern that the real growth rate of the economy may fall short of what is required to call forth the necessary volume of savings to finance the projected capital requirements. Investment in the basic industries in Canada from 1974 to 1976 tended to be for replacement, pollution control and adaptation to alternative energy sources rather than for new facilities to add additional productive capacity. In part, this occurred because Canadian industry was operating at 84-88% of capacity over this period. However, this capacity figure is increasingly suspect, since what is listed as unused capacity includes facilities too inefficient to be used and facilities that pollute and cannot be used.

Table 11.1 indicates the sources of funds that were available for investment over the 1970-76 period. The statistics suggest that Canada will have to find incentives other than a very large rise in interest rates to increase the amount of its GNP saved. In recent years, the largest share of funds have come from depreciation allowances, which do not represent a net addition to our stock of capital assets. In any case, depreciation allowances are a declining

Table 11.1

Sources of Gross Saving, Canada, 1970-76
(The Finance of Gross Domestic Capital Formation)
(Percentages)

	1970	1971	1972	1973	1974	1975	1976
Personal saving[1]	16.7	17.6	21.2	24.6	26.5	30.3	29.5
Government[2]	15.4	12.4	11.0	13.0	15.9	0.3	0.7
Corporate savings[3]	16.0	14.8	15.1	16.5	12.5	11.9	13.2
Capital consumption[4]	55.2	51.7	49.0	45.3	41.5	44.7	44.3
Non-residents saving[5]	−5.2	−0.9	2.9	0.8	5.4	13.2	10.4
Residual error	1.9	4.4	0.8	−0.2	−1.8	−0.4	1.9
	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total savings							
Billions of dollars	$17.8	$20.3	$23.4	$29.5	$38.0	$40.0	$45.6
As percentage of GNP	20.7	21.5	22.2	23.9	25.8	24.2	24.0

Source: Statistics Canada, *National Income and Expenditure Accounts,* First Quarter 1977.

Notes:

1. Persons and unincorporated business (personal saving plus adjustment on grain transactions).
2. Total revenue less total current expenditure of the federal, provincial and local governments, the hospitals and the Canada and Quebec Pension Plans.
3. Corporate and government business enterprises (which equals undistributed corporation profits plus undistributed profits of government business enterprises plus capital assistance plus inventory valuation adjustment).
4. Capital consumption allowances and miscellaneous valuation adjustments (of persons and unincorporated business, government, and corporate and government business enterprises).
5. Non-residents saving equals the surplus (−) or deficit (+) of Canada on current transactions with non-residents and indicates savings made available to the economy by non-residents.

source of total investment capital. The decrease from 55% in 1970 to 44% in 1976 is largely due to inflation and it indicates the degree to which productive assets have had to be replaced at higher prices.

Another striking change is the net contribution of government. Government savings are the difference between total revenue at all levels of government and the total current spending of those governments. Over the period 1970-76, government invested about the same proportion of the GNP (ranging from 15-17%), but did so in the latter years almost totally by way of borrowed funds, bringing its net investment close to zero. The investment from non-Canadian sources since 1970 has been substantial, but it peaked in 1975 and is projected to decrease slowly for the rest of this decade.

The rate of personal savings seems to have peaked during 1975. The major factor in this is the maturing of pension plans, part of personal savings. When a pension plan is new, it has many contributors but few pensioners and so accumulates funds rapidly. As the fund matures it grows more slowly and ceases to be a net provider of new investment money. Canada's pension funds (excluding Registered Retirement Savings Plans) are at various stages of maturity, but over the next seven years can be expected to provide a lower proportion of new capital than they have over the last seven years.

The number of alternatives available to maintain or increase saving as a percentage of GNP are limited. One alternative would be to permit Canadian interest rates to increase to a higher level (well above rates in the United States) over a long period, which would raise the flow of personal savings and the inflow of non-resident capital but at a high cost in overall economic dislocation and a further and perhaps dramatic increase in the level of external debt. In mid-1977, Canada's foreign debt was $49.7 billion, a doubling in a decade. Another alternative would be for federal, provincial or local governments to reduce their current expenditures and their reliance on debt financing.

The only other alternative that seems feasible is a substantial increase in corporate after-tax profits. Because of the relative openness to imports of some sectors of the economy, and the high labor costs in the manufacturing sector, there is little scope for widening profit margins so that returns on capital improve sufficiently to induce new investment. Some other way must be found to improve the risk-return ratio and thus to increase the proportion of GNP flowing to savings and investment.

The Supply of Equity Capital

One important aspect of the shortage of capital has been the decline in the number and aggregate value of new equity issues in Canada since 1969. There was a buoyant market for equities in the late 1960s, a collapse in 1970 and some recovery in 1975 for preferred issues, but with net new common issues remaining at depressed levels (Table 11.2). The increase of net new issues of preferred shares and of debt in 1975 and 1976 has been partly attributed to a "rush to the market" by some large Canadian firms as a result of the announcement by the Securities and Exchange Commission in the United

Table 11.2

Net New Issues of Corporate Bonds and Shares, Canada, 1964-76

Year	Bonds[1]		New Equity[4]			Number of New Public Common Equity Issues[5] by Companies of			Gross Value of New Equity Issues by Companies of			
	Payable in Canadian Dollars[2]	Payable in Canadian and Foreign Currency[3]	Preferred Shares	Common Shares	Total	Less than $1 Million	$1 Million to under $2 Million	$2 Million to $3 Million	Less than $1 Million	$1 Million to under $2 Million	$2 Million to $3 Million	Total
	(Millions of Dollars)					(Numbers of Prospectuses)			(Thousands of dollars)			
1964	573	787	38	269	307	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
1966	404	970	177	388	565	4			1,323			1,323
1968	436	734	122	436	558	13	7	4	6,077	9,100	10,060	25,237
1969	451	833	143	851	994	29	34	7	15,957	46,541	14,098	76,595
1970	1,131	1,494	101	251	352	14	3	1	5,241	3,900	2,406	11,547
1971	1,786	1,834	111	230	341	16	2	3	7,085	2,769	7,687	17,541
1972	1,551	1,623	199	420	619	7	12	8	3,602	16,205	18,535	38,342
1973	1,578	1,555	84	527	611	8	8		3,503	12,602		16,105
1974	1,551	1,778	434	304	738	5			1,274			1,274
1975	2,293	2,917	743	486	1,229	2			520			520
1976	1,239	4,244	631	569	1,180	1	1		375	1,815		2,190

Source: *Bank of Canada Review* (Aug. 1977), *Financial Post Record of New Issues*, Ontario Securities Commission and Royal Commission on Corporate Concentration (RCCC) research.

Notes:

1. Includes secondary offerings and debt portions of combination debt-equity offerings.
2. Net new bond issues payable in Canadian dollars only (excludes issues placed in overseas markets).
3. Net new bond issues payable in Canadian and foreign currencies (includes Canadian dollar issues placed in overseas markets).
4. Net new preferred and common stock issues payable in Canadian and foreign currencies.
5. Excluding issues by mining (or exploration) companies and all issues that are privately placed. Also excludes combination debt-equity and rights (or combination shares-warrant) offerings in addition to all debt, finance and secondary issues.

n.a. = not available.

States in early 1975 that firms reporting under SEC rules would also have to report inflation-adjusted earnings for the 1976 operating year, thus indicating lower earnings levels and much higher price-earnings ratios than had previously been reported. The attraction to the chartered banks of new types of preferred shares may also have contributed to the increase.

Private placements of new equity appear to have declined in number but increased in dollar volume from 1969 through 1975. Most of the dollar volume of private placements is in larger companies in more mature industries rather than in smaller companies in high-risk areas. Given the high rates of inflation in the past few years, equity requirements for all firms have certainly risen, making the comparison between levels of new issues in the late 1960s and recent levels more dramatic.

Even when new issues of equity returned to their 1969 levels, the aggregate figures conceal the fact that recently the issues have been largely in the form of preferred shares rather than common shares and primarily for larger enterprises (as small and medium-sized companies are generally foreclosed from this kind of financing). To raise equity in the form of common shares requires a much better environment in the stock market than does preferred share financing. The percentage of preferred to total new equity financing has risen from 32% in 1972 to 60% in 1975 and to 53% in 1976 (Table 11.2).

For both small and large companies, the substantial dollar amount of debt and preferred shares combined with relatively small amounts of new common stock has produced escalating corporate debt-to-equity ratios over the past seven years. The leveraging of debt, with its resultant higher-risk capital structure must inevitably stop somewhere, thus curtailing the growth of firms. At some point there must be either new equity or increased corporate retained earnings before growth through debt financing can continue.

A related issue raised before the Commission on several occasions was the tremendous difficulty faced by small, privately held companies in going public through a securities issue. If a company cannot get past the small, privately held stage, there is much less incentive to start or invest in new ventures with the intention of taking a profit as they develop and mature, and there is much less liquidity in such an investment. Over the past several years virtually no new equity issues under $3 million have been underwritten in Canada. There were 5 issues in 1974, 2 in 1975, and 2 in 1976 (Table 11.2).

Table 11.3 indicates the average costs of issue for recent public securities issues in Canada. We include these figures because they do not support the commonly held belief that fixed costs for small equity issues are prohibitive. Also, the smallest companies could raise money either through debt or preferred shares at rates not more than 3 percentage points above the rates charged to the largest companies. A small issuer encounters both higher issue costs for either debt or equity and higher proportional legal, audit, printing and perhaps translation costs than would a large issuer, other things being equal, but the differentials are not prohibitive themselves although they act as a disincentive. What prevents access to public debt and equity markets for small firms is not cost but a lack of buyers at rates of return similar to those that bring forth capital in other countries.

Table 11.3

Costs of Issue of Public Securities Issues (Excluding Mining Issues), Canada, 1974-77

Size of Issue	Cost of Issue*		
	Debt Issues	Preferred Shares	Common Shares
$1–3 million (issuer has no previous securities in market)			10–12½%
About $5 million (issuer has no previous securities in market)	up to 7%		10–12½%
$1–5 million (issuer known, good credit rating)	3–4%	5–6%	up to 8%
About $10 million (good, well-recognized credit)	2%	4–5%	up to 8%
$25 million and over (good, well-recognized credit)	1½–2%	3–4%	up to 8%

Additional Expenses

Legal, audit and printing costs for a public issue are $50,000 minimum. If the issuer has no previous securities in the market, costs are $75,000 minimum. Maximum legal, audit and printing costs for a very large issue are about $150,000. If offered in more than one language, translation and printing costs would add to the cost.

Source: Investment Dealers Association of Canada, and RCCC research.

Notes: Some private placements may have been made through facilities provided by firms or institutions not part of the Investment Dealers Association or the major Canadian stock exchanges, and therefore not covered in this sample. The underwriting spreads reflected here may not be strictly comparable even on similar types of issues by the same issuer. For example, some parts of issues may be placed privately, some issues may be placed on a best-effort agency basis. Also, underwriting fees vary depending on the terms and characteristics of issues such as term options, heavy sinking funds, and so on. Thus while the information is fairly representative of costs of transactions, there may be individual transactions which for a number of reasons are above or below the ranges stated.

* – Variable costs associated with an issue of public securities as a percentage of the total amount of the issue.

Most saving by Canadians is done through institutions: bank deposits, guaranteed investment certificates, Registered Retirement Savings Plans (RRSPs), Registered Home Ownership Plans (RHOSPs), pension funds and life insurance. These institutions have concentrated their funds in bonds, mortgages, equities of the largest Canadian companies and the debt of the federal and provincial governments. The institutionalization of savings has come at the expense of a shift away from personal investment in equities. National income statistics show that dividends as a percentage of individual investment income have declined from 40% in 1966 to 19% in 1975, while bond and bank interest payments have increased from 40% to 72% and mortgage income and other investment income have remained relatively stable at 10%.

The institutionalization of investment and the trend away from personal investment in equities seem in large measure a result of the 1971 taxation

changes in Canada. The impact of these changes has been to shift emphasis from seeking capital gains to investment in tax-sheltered or tax-free situations. We indicate below the kinds of tax shelters being used and the degree to which funds are diverted away from risk investment.

The most important individual tax shelter is the exemption of one's principal place of residence from capital gains tax. A priority for many Canadians today is the purchase of as large a home as can be financed in the short run. Another priority for many Canadians is to invest in an RRSP or an RHOSP, both tax-sheltered. Most of these plans are administered by large institutions and run conservatively, their funds being invested largely in debt instruments or large enterprises. The flow of personal funds to tax-sheltered investments is illustrated by the growth in RRSPs and RHOSPs from 1970 to 1976 (Table 11.4).

Table 11.4
Investment in Registered Pension Funds, RRSPs and RHOSPs, Canada 1970-76
(Millions of Dollars)

	1970	1971	1972	1973	1974	1975	1976
Registered pension funds	728	817	964	1,093	1,310	1,416	1,605
RRSPs	225	318	655	923	1,244	1,725	2,100
RHOSPs					194	395	460
Total RRSPs and RHOSPs	225	318	655	923	1,438	2,120	2,560

Source: Statistics Canada, *Pension Plans in Canada*, Cat. No. 74-201; Bank of Canada; Dept. of National Revenue.

A partial solution to the problem of institutional conservatism might be to encourage self-administered, tax-sheltered RRSPs. Several trust companies in Canada currently offer self-administered plans, but they are expensive to operate and require a great deal of paperwork to meet government requirements.

The next priority for an individual is to make an investment that will return a tax-free $1,000 per year for the lowest possible investment. Over the past few years this has meant debt instruments of large institutions or Canada Savings Bonds, but virtually never equity, and certainly never equity of small and medium-sized companies with low dividend payouts.

There is evidence that when an industry is seen to be profitable, or where tax advantages exist, there are a great many Canadians who become active investors even though the risks have not changed. For example, shortages of start-up and expansion capital have not occurred in the construction industry. New builders and suppliers have continuously entered the field, and had no difficulty in obtaining funds to begin or expand operations in an industry that has been blessed in the recent past by favorable tax legislation. A great deal of

money became available for Canadian movie production and for natural gas exploration in the mid-1970s when these high-risk activities were given special tax status.

Nevertheless, a much higher proportion of funds flow through the institutional investment process in Canada than in the United States, and it is in part the domination of markets by institutions that creates the overall appearance of conservatism. The reasons that the institutions themselves do not reinvest a high proportion of these funds in equities seems due to the nature of the institutions and their liabilities and to their internal organization and reward systems which minimize any incentive to invest in the equity of smaller companies.

The Supply of Term Debt

Many people have told us of a gap in the supply of term debt to medium-sized firms. Term debt is usually defined as that issued for a one-to-twenty-year period but it is most common in the five-to-ten-year range. There are also substantial differences in the compositions of debt and equity of corporations of various size. The bulk of debt raised by large corporations is in the form of bonds. The principal source of long-term debt to small and medium-sized corporations is mortgage debt, which accounts for about half of all long-term debt they raise. Smaller corporations do not have access to the corporate bond market in Canada, although they may manage to place bond issues privately. Smaller firms also make more intensive use of long-term debt in the form of loans from suppliers.

The reason for the gap in the provision of debt to smaller firms is not clear, however. The income streams of smaller firms may be more variable than those of larger firms or they may not have a "track record" and hence appear more risky to lending institutions. On the other hand, Canadian banks may earn satisfactory profits without making higher-risk loans to smaller firms, as they do in the United States.

Over the past few years an increasing number of intermediaries have been willing to supply term funds to medium-sized firms. Roynat, companies like Permanent Capital Corporation in Toronto, the Federal Business Development Bank, venture capital companies and financial leasing companies are serving segments of this market. Life insurance companies have contributed to the supply of term capital through mortgages on non-residential buildings, although in mid-1977 only one life insurance company held a significant number of non-mortgage securities of medium-sized companies. Two new banks, the Canadian Commercial and Industrial Bank and Northland Bank, argued in their charter applications that there is a real need in Canada for term loans to small and medium-sized businesses, which they intended to meet. Affiliates of foreign banks are increasingly moving into this sector, especially through specialized leasing.

Since 1971 there has been a significant increase in the role of established banks in term lending, as reflected in the percentage of term loans to all business loans made. Most of this growth has come in loans to corporations

with assets exceeding $25 million, but some has been in the $10-$25 million category. It is likely that the real number of term loans to business of all sizes exceeds that reported by banks, because many term loans appear on bank books as demand loans but with an understanding that the loan can be rolled over for a longer period.

We do not consider the gap in the supply of term capital as important a concern as the other capital gaps we discuss in this chapter. We point it out as an illustration of one more problem that has faced medium-sized businesses seeking to finance rapid growth.

The Supply of Risk Capital

It was suggested to us in several briefs and in our hearings that a deficiency in the availability of risk capital in Canada is a factor in the relative shortage of small and medium-sized business in this country. Risk capital is sometimes referred to as venture capital; we use the terms interchangeably to refer to the provision of capital where the loan or equity investment is neither secure nor liquid, a situation that may of course prevail at many stages in a company's development, and with large as well as small enterprises. Risk capital or venture capital may be in the form of equity, debt, convertible debt or combinations of these. The shortfall in Canada is not only in the supply of equity, but includes all capital for high-risk, high-return investments. The shortfall seems, however, to be most pronounced in the lack of money for startup situations, particularly when compared with the United States.

Before World War II, virtually the only source of risk capital in Canada outside the mining sector was wealthy individuals who made personal investments in companies not suitable for traditional bank lending or for institutional portfolios. After the war, some of these individuals organized small staffs of professional managers with pools of funds intended for venture investment. Typically, these prototype venture capital firms were focused on areas of particular interest to the individuals. Canada Overseas Investments and Helix Investments in Canada and Rockefeller Brothers Inc. in the United States began as family investment capital operations. The success of these professionally managed venture firms brought others into the field, some subsidiaries of large companies or financial institutions, some representing capital pools that had not before been involved in this type of investment. We discuss next the role of venture capital companies, chartered banks, individuals and government agencies in providing risk capital.

THE ROLE OF VENTURE CAPITAL COMPANIES

Venture capital companies are important, not because of the total dollar volume of their investments, but because they have in the past been one source of risk capital for small and medium-sized businesses and could expand that role in the future with the right incentives. The venture capital industry in Canada has operated somewhat differently from its counterparts in the United

States and the United Kingdom, with the difference being partly a result of the smaller size of Canadian venture capital companies.

To the best of our knowledge there are only seven venture capital companies in Canada with capitalization of $10-$15 million, the minimum capitalization necessary to carry a diversified investment portfolio from startup to maturity. Some of the existing venture capital companies have had to tailor their investment strategy to overcome the shortfall. One way is to seek investment opportunities that can be realized in a short time. Another is to invest in less risky investments by avoiding startups or other investments that will require subsequent rounds of financing. The most common strategy is for a venture capitalist to use debt investments as well as equity, with an interest flow to help the venture supplier over the early years and equity participation that can then be held at low cost and sold if a suitable opportunity arises. This approach favors investment in more mature companies, as a new venture usually has no capacity to service debt in its initial stages of growth.

Once a company in which a venture capitalist has invested reaches a mature, profitable stage the investor looks for a way to divest the holding and recycle the capital into new investments. The traditional way of doing this has been for the company to "go public". The Canadian equities market has not been favorable for the equity of new small companies since the late 1960s.

The second way of divesting is to arrange for the acquisition of the whole company, or at least the venture capitalist's holdings, by another company or investor. The Foreign Investment Review Act has limited this alternative and by reducing the competition of foreign buyers has somewhat reduced the market value of small, privately held businesses. After the initial uncertainties surrounding FIRA, however, its effect on the market for small firms has decreased in importance.

A third way of divesting is to sell the venture capitalist's holding back to the principals of the company or to the company itself. This possibility is sometimes written into the investment from the beginning but it has the shortcoming that it is not usually in the company's best interest to redeem its shares by the expenditure of scarce, internally generated capital. The same shortcoming applies to realizing an investment by taking large dividends out of the company.

The difficulty of divesting in Canada has contributed to what is a natural tendency in every country: that over a short life cycle many venture capital companies evolve to become closed-end investment trusts, operating companies or holding companies. The natural attrition accentuates the need in normal times for new venture capitalists to come into the industry.

The number of venture capital companies in Canada and the dollars invested by them declined markedly from 1970 to 1976. In 1970 there were about 45 major venture capital companies (with funds available for investments over $2 million each) active in Canada, making about 120 investments a year. In 1976 there were 23 major venture capital suppliers (not including the Federal Business Development Bank), with 56 investments made by 33 compa-

nies or consortia of companies. Some of the more significant venture capital companies that have or are withdrawing from Canada include Charterhouse Canada Limited, Guardian Venture Group, Citicorp Venture Capital Canada Ltd., Merban Capital Corp., International Capital Corp., Nevron Capital Corp., and MacMillan Bloedel's venture capital division. The only significant recent new sources of active venture capital in Canada are the four companies to which the Canada Development Corporation has committed funds plus newly formed affiliates of Brascan Limited and Inco Limited. The companies that have left the industry have cited the deteriorating risk-reward relationship for investment, the difficulties of divesting and the tax situation in Canada vis-à-vis the United States.

The total amount invested by major venture capital companies in 1976 was approximately $17 million, compared with $6.5 million in 1975 and about $40 million in 1970. These figures exclude natural resource investments, which vary widely year by year depending on the tax status of the individual investments. By way of comparison, major venture capital companies in the United States are estimated to have invested about $670 million during 1976 (not including the investments by Small Business Investment Corporations, which are discussed below).

The composite picture we have is one of a shrinking Canadian industry, both in terms of number of companies and dollars invested, with those who remain in the industry putting an increasing proportion of their assets into tax-haven natural resource industries, and into investments outside of Canada.

THE ROLE OF THE CHARTERED BANKS

In Chapter 10 of this *Report* we discussed the operations of Canadian chartered banks. The chartered banks are not generally in the business of providing risk capital. Canadian banks do occasionally make use of flexible and innovative lending techniques such as income debentures or retractable preferred shares, but these are usually directed to firms with more than $1.0 million in sales or assets. Specialized lending techniques are generally available only in larger, commercially oriented branches of the banks or at their head offices. To make use of them a borrower must be sophisticated enough both to know to go beyond his local branch for assistance and also to convince his bank of his ability to service the debt. He must be able to prepare cash flow, interest and debt service coverage projections and to explain the various assumptions and supporting rationale behind those projections.

Several chartered banks either have chosen to provide capital through small venture capital divisions, or to participate in ownership of venture capital companies to provide risk capital to small and medium-sized businesses. The bank's preference in such financing is usually for an interest-bearing instrument to achieve current income, but financing also takes the form of subordinated debt or preferred shares, often with overrides to achieve a minimum rate of return.

Section 76 of the Bank Act places a constraint on banks in that they are prohibited from holding more than 10% of the outstanding voting shares of a

company if their investment is over $5 million, but with an investment under $5 million they can hold up to 50% of the shares. Under a proposal in the government's 1976 *White Paper*, the chartered banks' participation would effectively be restricted to 10% of any venture investment, rather than the 50% for investments under $5 million now permitted. This would restrict venture participation by banks since it prohibits them from taking a position that allows them to assume control either to protect an investment in a company that is being badly managed, or to purchase the interest of another participant who wishes to withdraw. The Commission finds the *White Paper*'s recommendations unduly restrictive and recommends that section 76 be amended to raise the $5 million limit to $10 million.

THE ROLE OF INDIVIDUAL INVESTORS

Another source of venture capital is individuals who make personal, high-risk investments. There is no information available on the aggregate of such investments nor any formal clearing mechanism to put suppliers and users of such capital together. Some informal "matching" is done by members of the legal profession, investment consultants, accountants, bankers and others, but the process is an imperfect one. We have been unable to determine the degree to which individuals fill the need for risk capital investment, but indications from investment advisers and others are that with a few exceptions this source is limited to relatively small amounts of capital.

THE ROLE OF GOVERNMENT AGENCIES

The shortage of risk capital available from the private sector is reduced by numerous government agencies, federal and provincial, which offer financial assistance to small and medium-sized businesses. We have identified 97 separate federal and provincial government assistance programs available to smaller businesses, and undoubtedly there are others. The programs range from loan agencies and guarantors to assistance with training programs, pollution abatement and other individual expenditures. For example, the federal Department of Finance guarantees business loans up to $75,000 to businesses whose gross annual revenues do not exceed $1.5 million for the purchase, installation, renovation and improvement of equipment or premises or the purchase of land. The Federal Business Development Bank (FBDB) provides loans or loan guarantees. However, most government agencies concentrate their lending on low-risk types of business (although they may involve high-risk individuals or geographic areas). The FBDB is an exception to this lending pattern. It entered the venture capital field in 1976 and in the first 18 months of operating in this area made 51 investments for a total of $6.3 million. The Department of Regional Economic Expansion has also been a major source of funds to both small and large businesses in some regions of the country.

It is difficult to classify federal or provincial assistance programs because their objectives are so clearly different from those of other suppliers of capital. Governments' objectives may include creating local employment, increasing

exports, replacing imports into a region or the country, introduction of new technology, regional economic growth and creating new employment skills. Often a prerequisite for much government funding, particularly from federal agencies, is evidence that the funds cannot be obtained from other sources and that the project is unlikely to go ahead without government assistance. The wide range of criteria other than profitability leads government agencies, particularly provincial agencies, to take considerable time to approve applications. Despite these initiatives by government and the private sector, there is a shortage of risk capital in Canada to finance the small, dynamic businesses necessary to increase competition and lead growth in the economy.

SMALL BUSINESS INVESTMENT CORPORATIONS

The United States has not had the same problems as Canada with the supply of risk capital, partly because the environment for enterpreneurship has been seen to be better, partly because the risk-return ratio in the U.S. has clearly been better, partly because the tax system has been more favorable. One example reflecting the more favorable environment and tax system in the United States is the Small Business Investment Company (SBIC) created under the Small Business Investment Act of 1958.

At March 31, 1976 there were 325 SBICs in operation in the United States, with assets totalling $1,100 millions (43% of which was borrowed). During 1976, SBICs invested in 2,200 small and medium-sized firms, 1,225 of which were first-time investments. Half these firms had been in existence less than three years. The annual sales of these new firms averaged $2.1 million, and they employed an average of 62 people each. For the six years ended December 31, 1976, the successful SBIC-financed firms grew at an average rate of 22%, while the average growth rate for the U.S. economy was 5-7% over the same period.

Proposals for a Venture Investment Corporation (VIC) in Canada, similar to the SBIC, have come from many sources in the past several years, including a report by Robert Grasley to the Ministry of State, the Investment Dealers Association, and the Association of Canadian Venture Capital Companies. At the provincial level, Ontario and Quebec have passed legislation giving provincial tax relief for those corporations making *bona fide* risk capital investments in those provinces, and Alberta, New Brunswick and Nova Scotia have either proposed or indicated strong interest in similar legislation. However, provincial solutions to a national problem have a limited impact and they raise the possibility of provincial competition over tax concessions. An effective tax-based solution for this national problem of risk capital must come at the federal level.

In their brief to the Commission, the Association of Canadian Venture Capital Companies recommended the federal licensing of special Venture Investment Corporations to invest capital in startups and small business in Canada. They suggested that amounts invested in shares in such a company be fully deductible from the taxable income of the shareholder. This would be an extraordinarily generous tax provision. "Flow-through" provisions would tax

the income of the company only in the hands of shareholders but not in the hands of venture capital intermediaries. Further recommendations include extending the loss-carry-forward period to ten years from five for small and medium-sized companies.

Solutions of this kind might encourage large corporations with capital and managerial talent to enter the risk capital field, and perhaps expose their younger executives to the management problems in it as part of their training. However, VICs are not the answer for rapidly growing medium-sized companies, which would quickly outgrow the funds available in VICs not financed by institutions.

Nevertheless, the SBIC concept in the United States is one indication of how quickly and effectively tax changes can attract capital and entrepreneurs to the market. If the federal government wants to increase the flow of funds to startups and high-risk, high-return areas very quickly, a plan similar to SBICs might be equally effective in Canada. Problems of definition and equity would no doubt arise, and it would be necessary to guard against abuse of the plan. However, such problems could presumably be solved by statutory amendments, as they have been with RHOSPs and similar programs in recent years.

Management and Technical Expertise

As we pointed out earlier in this chapter, it is sometimes argued that the lack of dynamic, smaller businesses may reflect a shortage of sound projects. This shortage is said to arise from a lack of entrepreneurship, management skills, engineering and other technical expertise, or a "critical mass" of highly skilled managerial and technical people in one location in the country.

Such a claim is obviously difficult to prove or to disprove. The relatively low level of formal business education in Canadian management has been the theme of considerable research and writing over the past decade. It has been argued that Canadian management has a traditional decision-making style that emphasizes neither entrepreneurship nor scientific approaches to decision-making; that there are insufficient trained, experienced managers who can supplement their intuitive decision-making with analysis; or that the high degree of foreign ownership of Canadian industry has produced many individuals trained in only one narrow, functional area of business such as marketing or finance, but few with experience in overall business strategy and planning or in making large-scale entrepreneurial decisions.

Some evidence of a "managerial gap" comes from comparative statistics on education and other characteristics of middle and upper management in Canada and the United States. Studies have concluded that the typical Canadian senior executive is older than his U.S. counterpart, has received less formal education, has risen through the ranks more slowly and is more likely to have been selected on the basis of experience rather than formal professional background or training. Based on 1975 statistics, the managerial group in Canada had a smaller proportion of university educated people and, perhaps

more relevant, a much smaller proportion of people with graduate qualifications in business administration, administrative studies or related fields, than was true in the United States. There were in the United States three and a half times as many Master of Business Administration graduates per 100,000 people in 1975 as there were in Canada. Statistics on graduate business education may not be an accurate indicator of entrepreneurship and business expertise but they are indicative of the relative importance placed on management skills and entrepreneurship in a society.

In comparing proposals to venture capital suppliers submitted in Canada and the United States, the Commission has found considerable differences in quality and depth of presentation. At the risk of oversimplication, the typical Canadian submission is made by an individual entrepreneur or a small group with what appears to be a good proposal backed by strength in one or two functional areas but with no expertise in others and no well-developed idea of where such expertise is to come from or of long-term business strategy. The Canadian venture capital supplier is then placed in a position of having either to turn down the proposal or to become involved in finding additional management people or expertise to fill the management team. Those U.S. proposals we have seen were much more fully developed, contained not only a proposal but short and long-term development plans and seemed to originate with entrepreneurs who had a considerable range of background and skills.

Within our general concern about management and technical expertise is the difficult problem of maintaining a healthy climate for new, high-technology enterprises. These deserve special attention for several reasons. Certainly these are the enterprises most sensitive to a lack of management or technical expertise or a "critical mass" of highly skilled people. They are particularly important in the context of our proposals for workable competition because new or innovative technology represents one way in which new firms can compete in markets characterized by an oligopolistic structure and mature firms. Less related to our mandate, but no less important to the problems facing Canada, is the fact that rates of sales growth and job creation in innovative and high-technology companies are very much greater than they are in more mature companies.

We raise the problem of managerial and technological gaps because they are both important problems and constraints in considering the financial gaps discussed earlier. The managerial gap may tend to close as management skills become more broadly distributed through the economy and as younger managers with formal training in business administration mature and gain more experience. The management problem is complicated by the degree of foreign ownership, government ownership and regulated industry in the economy, none of which are conducive to the development of rounded entrepreneurial skills, and by the relatively small resources being devoted to management training.

Taxation

It is abundantly clear from what we have said in this chapter that savings over the next few years will be inadequate to finance the necessary business investment and that current and expected risk-return ratios will be inadequate to induce risk capital investment. This and the other serious problems of the Canadian economy which we reviewed briefly in Chapter 1 concern us deeply.

We think there must be more questioning of things that have heretofore been accepted as unchangeable. If the problems we face are as deep-seated as we think, then their solutions probably require equally fundamental changes in some of our economic arrangements. Mere tinkering with effects will not come to grips with basic underlying causes. All of us must be prepared to think about the unthinkable.

It seemed to us, therefore, that we might be able to stimulate this kind of thinking if we could ourselves throw a provocative proposal into the arena. For several reasons, we decided that the tax system was an appropriate candidate for discussion.

First, experience shows that the economy does respond to tax changes. We have pointed out several examples in this chapter. Second, we believe that major changes to the tax system will be necessary to raise the supply of savings and to improve the expected return sufficiently to attract those savings to business investment. It is appropriate to discuss the tax system in this chapter because a healthy, small business sector is one of the most realistic antidotes to the economic concentration that is inevitable in the Canadian economy, and which is a constant threat to competition. The health of small business depends, more than anything else, on a vigorous economy. In addition, the measurement of taxable income and the system to collect tax on it are particularly severe problems for smaller businesses. A tax on profits is disproportionately burdensome on a small business because retained earnings are often its principal source of capital. Finally, the complexity of the tax system creates a compliance cost that the small business is least able to afford.

In making suggestions in this area, we are aware that there is disagreement about the impact of tax changes on savings and investment. Most observers agree that investment is determined by perceptions of future risk-return relationships rather than by short-term tax changes. We also recognize the argument that changes to spur investment may be less effective when applied to an industrial economy that from 1975 up to at least the first quarter of 1977 was operating at less than 85% of capacity. However, we view tax change as a long-term attempt to alter permanently the risk-reward balance rather than to cure short-term problems. For this reason, our remarks are directed to possible changes in the basic structure of taxation and, in particular, to changes that will reverse the existing bias against equity investment and toward the institutionalization of savings. Several of the witnesses we heard made suggestions for new deductions or allowances designed to encourage or stimulate either small business or business generally. As our opening remarks in this section indicate, however, we think more is required. We decided,

therefore, to invite a reconsideration of two fundamental features of the tax system. Specifically, we ask whether capital gains taxation is worthwhile and also whether it is appropriate to tax business income at the time it is now taxed.

We acknowledge that the two ideas discussed here are radical. They would have far-reaching economic effects, including possibly profound consequences for government revenue, which would have to be compensated for by reductions in expenditure or new taxes, or both, some of which would be extremely painful. We realize that the recommendations that follow may not be the best way to meet the shortfall in investment or may not be feasible for a variety of reasons. Nevertheless, we think the problem is so important that study and debate on the issues must be started so that changes of whatever nature are effected as soon as possible. We do not regard these recommendations as definitive but as an attempt to highlight the issues involved and to give our best efforts at a solution to them. If there is critical reaction to these proposals, we hope that it will not be so much to refute or criticize them as to propose alternative solutions to this important problem.

Capital Gains Taxation

Canada began to tax capital gains in 1972 because Parliament accepted the argument that it was unfair to tax ordinary income fully and exempt capital gains. This is a perfectly reasonable argument on grounds of equity, although it was not carried to its logical conclusion, for only half of capital gains are taxable. In addition, the kind of capital gain that most people expect to enjoy at some time (that realized on the sale of a "principal residence") is exempt altogether.

Estimated yields from the tax on capital gains rose from $54 million in 1972 to $235 million in 1976, slightly less than half of which was paid by corporations. These are very modest sums indeed, especially when compared with the total federal tax revenues of $32.4 billion in 1976/77. It is true that the stock market has been depressed for most of the period in which the capital gains tax has been in existence and that the yield from the tax should increase if the market becomes more buoyant (the extent to which the existence of the capital gains tax is responsible for the depressed market is a matter for considerable argument). However, amendments to the Income Tax Act, including the decision to exempt the first $1,000 of capital gains, dividend and interest income (previously the exemption applied only to dividends and interest) will erode the capital gains tax base further.

In exchange for a relatively small sum in tax revenue and a partial move toward more equity, Canada's tax system was made much more complex and expensive to operate. The question is, was it worth it? We do not think so. There is no reason to expect that the capital gains tax will ever make a significant contribution to the government's tax revenues. It certainly will not do so while the Canadian economy remains in its present depressed state, and the existence of the tax is one depressing factor that the economy can ill afford at this time. The design of the capital gains tax ensured that it would do little in terms of equity, and the most recent amendments to the tax law are a further step backward in this sense. The result is a complicated and costly

addition to the tax system and a disincentive to business investment, with little compensating benefit.

Abolition of the capital gains tax would be worthwhile because it would simplify the tax system at a small cost in revenue and equity and, in addition, contribute to a better investment climate in Canada. That the latter is desirable, indeed necessary, cannot be doubted.

Taxation of Business Income

Business income, it should be noted, is not the same as corporate income because many businesses are not incorporated. Also, many corporations have income, such as investment income and capital gains, which is not business income. The distinction between business income and corporate income is important conceptually, though perhaps less so quantitatively. We will return to the distinction later but for the moment will discuss corporate income as though it is the same as business income.

If corporate income is taxed, a tax system must face the problem of whether and, if so, how to tax dividends because, of course, dividends are distributions of corporate income. If dividends are also taxed in the hands of the shareholders who receive them there is double taxation of the same income because the corporation is only an intermediary.

Before 1972 Canada ameliorated this double taxation in several ways. First, although dividend recipients were required to take dividends into income and to calculate tax at the appropriate personal rates on total income, they were then allowed to deduct from tax payable a dividend tax credit amounting to 20% of the net dividend. Secondly, corporations were allowed to pay a special additional tax of 15% or 20% on certain amounts of corporate income that had already borne the usual corporate tax at the time it was earned. The remaining 80% or 85% of these amounts could then be distributed without any further tax in the hands of the shareholders. Dividends paid by one corporation to another were generally not taxed at all but were of course taxed in the usual way when eventually paid out to individual shareholders. In this rough and ready fashion, shareholders receiving dividends were compensated for the tax that had been paid by the corporation at the point where the income was first earned.

Among other changes, the reform of the Canadian tax system in 1972 attempted to make the dividend tax credit system more precise, so that corporate income was taxed in the hands of individual shareholders at their appropriate personal rates, with a full credit for the tax paid by the corporation at the time the income was earned. The special 15% and 20% tax elections were abolished or confined to corporate income earned before 1972. The corporate tax system is more complicated than this brief explanation implies, partly because it must also deal with the problem of capital gains earned by corporations and subsequently distributed as dividends. The point of interest in terms of this discussion is that there is not really any longer a tax on corporate income as such. Corporations do indeed pay tax on income as they earn it, but this tax is really an advance payment on behalf of the shareholders. As a

corporation pays dividends the corporate tax previously paid is, in effect, refunded or credited against the tax that those shareholders resident in Canada are then required to pay on the dividends. Non-resident shareholders are subject to an additional withholding tax of 15% or 25%, but they are normally able to credit this withholding tax against the tax they will pay in their own countries on their total income, including their Canadian dividends.

It is worth observing at this point that the "gross-up and credit" procedure by which corporate tax is passed through to dividend recipients has steadily become both more arbitrary and more generous to shareholders. Originally, a dividend recipient would "gross-up" his dividend by one-third, include that enlarged sum in his income, calculate his personal tax, and then deduct from tax payable the amount by which he grossed up the dividend, that is, one-third of the net dividend he received. On the assumption that the corporation had originally paid a tax of 25% on the income it earned, the gross-up and credit formula was thought to be very close to neutral; the aggregate of the credits to resident shareholders neither exceeded nor fell short of the amount of tax paid by the corporation on the income out of which the dividend was paid.

To the extent that combined federal and provincial corporation tax rates were more or less than 25%, the gross-up and credit procedure either failed to return to shareholders the total tax paid by the corporation or it returned too much. The credit is about right to the extent that the dividend is paid out of income that is taxed at the lower or "small business" rate of 25%, for example. The 5% reduction of tax on corporate profits earned from manufacturing or processing operations can result in an excess credit to shareholders of such companies.

The amendments to the Income Tax Act made in 1977 increased the gross-up and credit of one-third to 50%. Under this revision in the formula, resident shareholders other than those in the very highest personal income tax brackets will recover more through the dividend tax credit than the corporation will have paid in the first instance on their pro rata share of the corporation's income. Thus Canada has moved since 1971 from a position where there was some relief from the double taxation of corporate income to one where corporate source income may well be taxed less heavily than most other kinds of income.

We make no observations on what the proper level of taxation of corporate source income should be or on whether that kind of income should be taxed more or less heavily than other kinds of income. We ask only whether the *timing* of corporate taxation is appropriate. Should the tax system, as it does now, tax corporate income as it is earned and give that tax (or a somewhat greater or lesser amount) back to resident shareholders as they receive and pay tax on dividends? Or should corporate income perhaps be exempt from tax so long as it is employed in the business, with the tax becoming payable only as that income is distributed?

We favor the latter alternative for several reasons. For one thing, taxation on this basis should greatly assist small business because, if the retained earnings that are its chief source of expansion capital are not reduced by

taxation, the aggregate amount available for reinvestment will be increased substantially. Secondly, and this applies to the profits of large as well as small businesses, profits are not properly available for either private or public consumption so long as they are productively employed in business. The figures we reported earlier in this chapter show dramatically the need for increased investment, and that the share that should be provided by retained corporate profits will simply not be available. A change in the tax system to alter the timing of the taxation of retained corporate profits would meet the problem squarely.

In addition, inflation has undermined in a most fundamental way the art of income measurement. Because reported profits in many industries are illusory, the effective corporate tax rate is very much higher than the apparent rate. We do not believe that the accounting profession or anyone else will be able to devise a means of discounting for inflation that will produce a fairer figure for taxable income, if only because inflation affects different businesses in different ways. The problem is not one of accounting, as many seem to assume. Rather, the problem is that the unit of measurement, money, which is what the accountants have to work with, has become an unreliable indicator of value. Recognizing, in a very limited way, the inflation problem, the 1977 Income Tax Act amendments granted a 3% inventory deduction to compensate, in some degree, for the effects of inflation and illusory inventory profits. This approach, in our opinion, is a mere palliative as well as a further complication in the income tax system.

The fundamental point is that it is no longer possible to measure business income with sufficient precision for tax purposes and, equally important, in a way that can be applied fairly to all businesses. There can be no equity in a tax system when the concept that is at the root of the system, income, means different things depending on the kind of activity that gives rise to that income.

Another reason for arguing for a tax deferral for business income is that the income tax provisions determining what business income is, combined with those applying to corporations as such, are by far the most lengthy and complex in the Income Tax Act. If it is possible to devise a tax applying instead to corporate distributions it should be possible to simplify the statute. We do not pretend that we have foreseen and worked out solutions to all the technical problems that would be encountered in such a change. There is no doubt that the change would be difficult, at least in the transition stage.

All the same, anyone with an understanding of the present Income Tax Act will acknowledge that it is easily the most complex of any on the statute books. The resources devoted by businessmen and their professional advisers to understanding and complying with it have never, to our knowledge, been calculated, but there can be no doubt that the compliance cost is formidable. In addition, the bulk of the administrative burden and cost to government of operating the law surely derives from those parts of the Act that deal with the taxation of business and corporate income. The costs are not confined to the costs of operating the Departments of Finance, Justice and National Revenue and the salaries and fees paid to tax advisers in the private sector. There is also

the cost that society incurs in having so many of its best minds engaged in the sterile and unproductive task of tax compliance. In addition to the other reasons for reconsidering the way in which business or corporate income is taxed, we think that the probable savings in compliance and administrative costs would make such a reform worthwhile.

There are some serious problems in any revision of the tax system along the lines we suggest, and we will describe briefly the most obvious of them.

First, if corporate income tax as we now know it were abolished there would be a severe effect on government revenue. Revenue from the corporation income tax was $6.42 billion for 1976/77, or nearly 20% of total federal tax revenue. This figure is overstated to the extent that the offsetting dividend tax credit reduces the revenue from the personal income tax.

We do not know of any way to predict what effect abolition of the present corporate tax would have on dividend payments. Since abolition of the tax would roughly double the amount of profits available for dividends, one could reasonably expect some increase in dividend payments, and this of course would mean an increase in personal tax, which would tend to offset the loss of revenue from the corporate tax. An increase in dividend payments, together with the fact that the corporate tax had been abolished, would almost certainly produce a marked improvement in business and investment prospects, and this would be reflected in higher stock values and an increase in returns from the capital gains tax (if that tax were retained).

As against this, business could see the abolition of the present corporate tax principally as a source of expansion capital and also as a way of reducing prices. Both objectives are highly desirable in themselves, especially now when investment capital seems to be shunning Canada and when Canadian industry is becoming less and less competitive. If the tax savings were employed chiefly in these ways, however, government revenue would probably drop sharply.

While it is easy to say that it is impossible for a government suddenly to reduce its tax revenue by 19%, it is worth recalling that total federal tax revenue *increased* by more than 350% in the ten years from 1967 to 1977. The immediate revenue loss that would result from even a sudden change in the manner of taxing corporate income does not look quite so unmanageable when it is viewed against the rate at which the government's total tax revenue has increased in recent years. Nevertheless, any replacement of the present tax on corporate income with one on corporate distributions would have to be phased in gradually. At the same time, reform of the corporate tax on the lines we suggest may well justify reduction or elimination of some other tax concessions.

Taxation has been described as the art of plucking the largest amount of feathers from the goose with the least amount of hissing. A tax on corporations is much more attractive politically than one on individuals because, in our electoral system, corporations have only a limited ability to hiss. But the political attractiveness of a corporation tax may well be one of the strongest reasons for doing away with it. Many people are saying that the state's appetite for tax revenue will have to be curbed if the economy is to thrive. If that is so, a

good way of injecting a necessary and healthy discipline into government finance may be to make tax collection politically more painful than it has been.

A tax on corporate distributions could not be expressed as a withholding tax because the rate of tax would have to be considerably higher than the 15% rate now provided for in the international tax treaties to which Canada is a party. It is not realistic to expect a wholesale and early revision of those treaties. The distribution tax would have to be imposed on resident Canadian corporations, but be based on amounts distributed or deemed to be distributed to shareholders, not on income earned by the corporations. This would not preclude the granting to resident Canadians of a tax credit (with or without a form of "grossing-up") based on the amounts received by them from such corporations.

The gain in simplicity we hope for would be lost if dividend distributions had to be analyzed according to the kind of corporate income out of which the dividends were paid. For this reason, we think the tax should apply simply to corporate distributions. But this would mean, for example, that capital gains of corporations would be fully taxed on distribution (even if the capital gains tax were otherwise abolished). All corporate distributions to shareholders (probably including stock dividends, but not true repayments of capital) would provoke the distribution tax, and all distributions would carry the right to whatever dividend tax credit was decided upon. The system suggested here is somewhat less symmetrical than the present one, but we frankly prefer simplicity to symmetry. The price of a tax deferral on retained profits is a certain roughness round the edges.

The kind of tax change discussed here would stimulate a search for avoidance techniques, in particular, ways to "strip" corporate surplus without incurring the distribution tax. In all probability, however, any such avoidance techniques would be new variations on an old theme. The tax authorities conquered the "surplus stripping" problem even before "tax reform" in 1972. We are not therefore worried about tax avoidance. Indeed, the simplicity of a distribution tax system may well make it easier to deal with the kind of schemes that might be devised to escape the tax. There would no doubt have to be a number of rules "deeming" corporations to have distributed profits in certain circumstances.

Income other than business income received by at least some, if not all, corporations would have to be taxed as received rather than as distributed; otherwise there would be excessive tax deferral through the use of holding companies. The law may have to "deem" an amount equal to corporate non-business income (including capital gains) to be distributed in the year it is received. An alternative would be a tax on all or most corporate non-business income at a rate high enough to ensure that it was in fact distributed in the year it was received.

Distinction between corporate income earned from active business and that earned from a passive investment by a corporation creates problems of definition and also requires an allocation of expenses between at least those two categories of income. These are by no means insignificant problems but, again,

many of the difficulties could be sidestepped through "rough justice" rules. For example, if a corporation's gross non-business income did not exceed, say, 10% of total income, its total income could be treated as business income. Most corporations in active commercial or industrial business with only small or occasional amounts of rental or interest income, for instance, would not have to concern themselves with the provisions designed to force distribution of non-business income.

Although a tax credit, combined with a technique to force distribution of investment income, should work well with many holding companies and other intermediaries, it may be necessary to restrict the credit in some cases. For example, tax-exempt intermediaries such as pension and retirement funds could be denied the tax credit so that they would, in effect, be taxed on their dividend income. It seems clear from the figures we cited earlier in this chapter that the tax system has been generous to these plans, with the result that investment flows have been distorted. If it is desirable to reduce the attractiveness of these investment vehicles, a denial of a tax credit may be a better way of doing it than a restriction on the deductibility of contributions made to those funds. It might also be necessary to restrict or deny the tax credit to some other financial intermediaries such as mutual funds and insurance companies. Selective restrictions of this kind would also reduce the revenue loss to government.

The income of unincorporated businesses in Canada is not large in aggregate (7.4% of total reported personal income in 1974), because most business, large and small, is carried on through the corporate form. The question arises as to how non-corporate business income is to be taxed if corporate income is exempted. One alternative would be to let it be taxed as income in the hands of the proprietors and partners, as it is now, reasoning that most of the remaining unincorporated businesses would then go through the relatively simple step of incorporation to take advantage of the new corporate tax regime. Another alternative would be to allow unincorporated business to elect to have the corporate tax rules apply to them even though they did not actually incorporate. Again, it might be simpler if professionals and farmers, for example, were allowed to compute their income on the cash basis, as they could do before 1972. Provisions designed to put unincorporated businesses on a footing roughly equivalent to corporations would be preferable to elaborate ones that attempt to obtain a very precise equality of treatment.

Chapter 12

Corporate Ownership, Control and Management

Introduction

In this chapter, we look at some of the features of large corporations as legal entities. Among the matters discussed are the legal structure of the corporation, the roles played by the shareholders and directors and assigned to them by law, our views on these roles, various suggestions for structural reform of corporations, and conflicts of interest within the corporation.

Three fundamental statutory elements—shareholders, directors and officers/managers—form the framework of major Canadian corporations. These components are generally distinct, but they can overlap. Within the corporation, each group has both a legal role and a role that has evolved through custom and practice and is somewhat different from that implied by the legal model. The lines between the theoretical and the practical are not clear, however, and at both levels there are some links among the three groups. Each group will be examined, particularly from the aspect of corporate control, which we consider to be central to any realistic discussion of corporate concentration.

The comments that follow should be considered mainly in relation to the major Canadian corporations, as it is there we find the "major concentrations of corporate power in Canada". While some of what we say may well be appropriate to most other widely held corporations, we concentrate on the very large firms.

Shareholders' Rights

The holders of voting shares in corporations are granted by statute certain rights regarding the corporation's business and affairs. In the large, widely held Canadian corporation, it is difficult for an individual shareholder (except one with a significant or controlling position in the company) to exercise his rights in a meaningful way, because the voice of any single shareholder is normally so faint as to be inaudible. In this context major corporations are very much like other large institutions: their very size and structure seems to induce, or at the least contribute to, a feeling of alienation, powerlessness and apathy on the part of the individual.

It has long been recognized that small shareholders rarely assert their rights in most major corporations. They do have certain rights, however, some of which are relevant to the question of control of the corporation, in particular, the right to elect the directors. The outcome of the election is invariably predetermined, because the process of nomination is in the hands of the incumbent management and board, as is the proxy machinery. Those in control have a great advantage over any other shareholder because they are required by law to solicit proxies, and these are almost always returned in management's favor. A 1976 American study entitled *Constitutionalizing the Corporation* (by the Corporate Accountability Research Group) analyzed directorial elections from 1956 through 1973 in companies that were required to file data with the Securities and Exchange Commission. The elections of directors that went unopposed, and where the slate proposed by the incumbent management and board was automatically elected, ranged from 98.1% in 1958 and 1961, to 99.7% in 1973. The elections (the vast majority were uncontested) in which management retained control of the board ranged from 99.7% in 4 of the years, to a high of 99.9% in 10 of the years. While to our knowledge no comparable statistics for Canada are available, we believe a Canadian survey would reveal similar results.

The individual shareholder's other management-related rights are in some cases novel and largely untested; in other cases they are of longer standing but generally unused, and in almost all cases they are unlikely to be exercised without some support from other interested shareholders. These other rights vary from the relatively new opportunity to make a "shareholder's proposal" to the right to request the appointment of an inspector to investigate the company's affairs. But these and other rights would be exercised only in unusual situations: they cannot be considered so central to the regular government of the corporation as to permit, encourage or lead to a serious level of shareholder participation. The undeniable (and generally undenied) fact is that management usually holds the power in the corporation, save where there is a large or controlling shareholder, who will then wield power (often through the board) to a degree determined by both his investment and his inclination.

Types of Shareholders

The three principal types of shareholders in public (by which we mean widely held) companies are individuals, institutions and corporations. Each of these types of shareholders will normally have different interests and objectives, and therefore may be expected to act differently as shareholders.

Individual Shareholders

Individual shareholders are people who hold direct investments in public companies beneficially. The size of their holdings may vary from just one share to many, although generally most individual shareholdings are small. For example, Bell Canada has about 250,000 shareholders, more than any other Canadian corporation. Almost two-thirds of these shareholders hold fewer than 100 Bell shares each.

As a rule, when an individual has large holdings in a company, they are held through an intermediary, such as a holding company, or through a trust arrangement. This may be done sometimes because of a concern for continuity in the event of the death of the holder, sometimes because of tax or other financial considerations. Since individuals with large blocks of stock in public companies behave very much like corporate and institutional shareholders, the remainder of this section will refer only to investors holding small amounts of stock.

Individual shareholders do not normally take an active part in the affairs of a company. Their function in the company's internal processes is limited to voting their stock, usually by proxy and usually in support of management. They cannot easily influence either the directors or the management of a company to a course of action contrary to that proposed. Their power is exercised in the form of proxy votes solicited by and delivered to management, and in this sense is clearly biased in favor of management. Effective action for individual shareholders who disagree with management's proposed actions may involve a proxy fight, and this requires adequate financing. As a result, therefore, while support of management by these shareholders is expressed by the delivery of proxies, lack of support tends to be expressed simply by the sale of the stock. If management has committed an act that the shareholder alleges is improper, there may be some recourse at law, if the shareholder chooses, and is able, to exercise his or her rights.

Although institutional shareholdings have been increasing, individual shareholdings are still substantial. From April 1975 to March 1976, Toronto Stock Exchange trading for individual investors made up 77.29% of all orders and 48.59% of the total dollar value. Institutional investors were responsible for 14.19% of the total but 43.31% of the dollar value traded. (The balance was accounted for by transactions by member firms of the TSE on behalf of another member, affiliate or broker.)

Trading completed for institutions tended to concentrate on the 100 most active stocks to a greater extent than did trading for individuals: 59.23% of the dollar value for institutional trading, compared with 35.96% for individuals, was directed toward the 100 most active stocks. It might be concluded, therefore, that the individual investor makes a significant contribution to the liquidity of less active stocks (generally the smaller companies).

Concern has been expressed by some that the level of aggregate individual shareholdings is dropping (to some extent this is confirmed by the T.S.E. statistics). One of the results of individuals holding a greater proportion of shares would be less concentration of ownership of corporations by large or institutional shareholders. Some corporations have established stock purchase plans to encourage their employees to acquire an equity interest in the firm. One common type requires the company to make a contribution to the plan in an amount equal to that made by any employee who wishes to participate. Shares of the company are either purchased on the open market by the plan's trustee or issued afresh and held for participating employees. Our impression is that generally such arrangements have been of very little interest to the great majority of the employees of companies which have established such plans.

A number of proposals have been advanced to permit the use in Canada of some kind of "Registered Employee Stock Ownership Plan". The United States has adopted such a plan, sometimes known as the Kelso Plan, involving a trust for all employees which purchases newly issued stock from the company at current market value. The stock is paid for with money borrowed by the trust from a financier, such as a bank, and the company guarantees the repayment of the loan. The company then makes periodic payments (which, for the plan to be successful, must be tax deductible) to the trust, which repays its loan with those funds. Periodically the shares held by the trust are allocated to the employees.

It is argued that a plan of this kind would produce more widespread ownership of corporations by their employees, and, assuming shares were distributed only to Canadians, would thereby decrease the amount of foreign ownership. It is clear that the plan as proposed would have many implications, not least on tax revenue, since its efficacy depends on participating corporations being able to deduct for tax purposes contributions which are not now deductible from income. The plan involves a dilution of the equity of non-employee shareholders (who, unlike the employees, will have paid for their shares) and requires the general public to subsidize a portion of the contributions to the employees' trust by permitting corporate payments to be tax deductible. It also discriminates in favor of employees of public corporations vis-à-vis employees of unincorporated businesses, which cannot participate, public sector employees and employees who wish to put their savings elsewhere. For these reasons, and also because we do not discern any appreciable interest on the part of employees in those plans now in operation, we are not prepared to recommend that this new plan be adopted in Canada.

Institutional Shareholders

Institutional shareholders include insurance companies, pension funds, mutual funds, banks, credit unions, trust companies and other organizations acting either as trustees or as owners in their own rights. Institutions are becoming important participants in the equity market and they hold a substantial number of the shares of many large Canadian companies. The size of their holdings naturally varies, but is normally much larger than the average individual holding. Some institutions, such as banks, are constrained by law to a maximum percentage beneficial holding of the common stock of any single corporation. In addition, their purchases of shares of corporations may be legally limited depending upon the dividend record and other performance measures of the corporations in question. But these legal constraints do not have as significant an influence on investment policies or on the practices and the activities of institutions as shareholders, as do their investment objectives. Most institutions prefer to hold assets that are readily marketable, although because the size of Canadian markets is limited, they often accept lack of liquidity in their holdings.

Institutional investors are almost always inactive shareholders. They usually give management their proxies, but if they disapprove of management or of corporate decisions, and their expressed concerns go unanswered, they may well sell their stock rather than oppose management, for a proxy fight involves risk, inconvenience, considerable cost and bad publicity. The least costly action is to sell where possible, and, when the controversial issue has passed into history, to make a fresh judgment as to whether the shares of the particular corporation are again an acceptable investment.

We have not considered seriously the idea of imposing on registered, but non-beneficial, shareholders statutory obligations that would require all discretionary rights attached to the shares to be passed through to the beneficial owners, because we do not think the idea is practical. One of the results of such a provision would be a significant cost of communication that would inevitably be borne by the beneficial owner. At present an interested shareholder can make such arrangements and the ordinary laws of trusts and contract will apply. With some institutions, such as pension funds, it is extremely difficult even to identify the "beneficial owners", let alone have them exercise discretionary rights. Some fund managers or trustees now insist on acting only on the direction of the beneficial owner (e.g., in some takeover bids). We have found no evidence that professional managers are abusing the trust placed in them by their investors, and for that reason, as well as for the other reasons noted, we think it unnecessary for us to recommend new regulation in this area.

Corporate Shareholders

Corporate shareholders (other than institutions) may be operating companies, or investment and holding companies, and they may be private, or public companies. Both operating companies and holding companies tend to act as shareholders in similar ways, their behavior depending largely on the nature and the size of their investment. The distinction in the present context between a public corporate shareholder (such as Argus or Power) and a private one (such as Ravelston or Gelco) is that a public company is owned by a large number of investors, while a private company is owned by a very few people (See Chapter 7). Private companies tend more to be the alter egos of individual shareholders.

Often when a corporation makes a large non-portfolio investment in a company it will seek representation on the board of directors, and may take an active interest in management. Disagreement with management decisions does not automatically result in an attempt to dispose of the investment, for a number of reasons. The investment may be sufficiently large to give ultimate control to the investor and thereby permit it to effect management changes. The investment may be sufficiently large that it is difficult to find a single buyer, and large holdings usually cannot be put on the market without having some effect on the market price. Even where an investment is not large enough to provide control, it might secure support from other shareholders; the corporate investor can provide a rallying point for dissident shareholders. Finally, the investment may still look better than available alternatives.

Types of Corporate Control

The legal rights of shareholders, and the different kinds of shareholders we have described, must be considered in the context of corporate control. Control may be considered and analyzed from several points of view. Our concern here is with the ways in which different categories of shareholdings may affect control of major publicly held corporations. Some examples are given to illustrate the different categories, but it must be remembered that corporate life is not static, and circumstances may propel a company from one category of control to another.

Absolute Control

The first category, absolute control, describes the corporation controlled by one person, corporation or institution (or a group of persons acting in concert) through ownership of all or virtually all the voting stock of the corporation. In the absence of any arrangements made to the contrary, the owners would have total influence and control over the operations of the corporation. This is a situation common to major Canadian corporations. For instance, most of the companies on our list for 1975 of the 100 largest non-financial corporations (See Chapter 2) have wholly owned subsidiaries. As well, 22% of the corporations on our list are wholly owned subsidiaries of foreign-owned corporations.

An illustration of a large Canadian firm wholly owned by a foreign firm would be Chrysler Canada Ltd. (8th on our list), owned by Chrysler Corporation of Detroit. Examples of the large Canadian firm with a large wholly owned subsidiary would be Genstar Limited and its subsidiary, BACM Limited, or The Molson Companies Limited and its subsidiary, Beaver Lumber Company Limited. In those situations, the parent can exercise total control over the subsidiary, although the subsidiary may be a major corporation in its own right. The parent can select the board of the subsidiary, arrange its financing, and control its business activities by selecting its management. Subject to any other relevant considerations the parent could transform the legally separate but operationally integrated subsidiary into a division of the parent and the subsidiary, as a legal entity, would vanish.

Majority Control

The term "majority control" is used when a corporation is controlled by one person (or a group of persons acting in concert) owning over 50% but less than all of the voting stock of the corporation. This majority control situation signifies virtually the same degree of dominance and influence over the operation of a subsidiary as does total ownership of stock. The presence of outside minority interests (supplemented sometimes by corporate policy considerations) imposes some legal restraints on the freedom and flexibility of the parent in dealing with the subsidiary's affairs. There will normally be found in this case constraints imposed by the legal requirements involving the rights of

minority shareholders. Many large Canadian firms are in this category: 26% on our list of the 100 largest non-financial firms are controlled in this way by corporate parents. As with the first category, many Canadian corporations themselves have subsidiaries that are partly, but not wholly, owned.

An example of majority control is that exercised by Power Corporation of Canada, Limited, over the affairs of Laurentide Financial Corporation Ltd. Power Corporation controls, directly or indirectly, about 58% of the voting stock of Laurentide (itself one of Canada's major sales finance corporations). The board of directors of Laurentide is selected with the tacit approval of Power, and although Laurentide arranges its own financing, major transactions are subject to the approval of the parent. While Laurentide has its own separate and independent authority on day-to-day operations, broad policy is determined in conjunction with Power.

Minority Control

In a "minority control" situation a corporation is "controlled" by one person (a group of persons acting in concert) owning less than 50% of the voting stock, but owning more voting stock than any other single shareholder or group of shareholders acting together. This situation is inherently less stable than that of majority control, since control depends upon the continued relative passiveness of other shareholders and on the controller's ability to obtain their proxy support. The length of time the minority block has been held and the force of personality of the controller may also be important factors contributing to effective minority control. Minority shareholding situations involving Power Corporation and Argus Corporation Limited are discussed in detail in Chapter 7.

Some new information on the extent and significance of minority control of corporations is provided by a research report prepared for the Commission by S. D. Berkowitz, Yehuda Kotowitz, Leonard Waverman *et al.*, and entitled *Enterprise Structure and Corporate Concentration.* Analyses were made of data relating to the connections among 5,305 companies, all of which were connected in one way or another to 361 leading Canadian corporations. Intercorporate ownership, direct and indirect, was identified and traced, as well as connections through directors and officers of the "owning" firms serving on the boards of directors or executive committees of corporations which their firms owned in whole or in part. After testing the effects of various degrees of direct and indirect ownership and of the number of directors and officers serving on subordinate boards, the authors assembled tables of interrelated firms which made possible comparison of "enterprises" of groups of companies under a common control by the usual 50% ownership definition of control, and then by alternative definitions based on 25% or more ownership, or 15% or more ownership, plus 3 interlocking directors or officers as described above.

The most important results of the study are stated as follows:

> The most striking result of our study is the low degree of leverage in Canadian intercorporate ownership: very few corporations appear to control others by holding minority shares. Moreover, most ownership ties emanating from non-financial

> institutions involved 100% ownership. By contrast, fairly extensive ownership leverage is shown by two large conglomerates, Argus Corporation Ltd.... and Power Corporation of Canada... as well as financial institutions (e.g., trust companies) which frequently have significant, though less than a 50%, share of holding companies. The owned holding companies, in turn, do not generally exhibit high leverage and appear to own at least 50%—and in many cases 100%—of the shares of the companies controlled by them.
>
> Even in those cases where minority share ownership is associated with control by our definition, relatively little ownership leverage is used.... Very little difference... in the composition of enterprises is exhibited when their definition is broadened from 25% to 15% ownership.... This is true whether the management tie is defined by directorship/officership or by executive board membership. In fact only very few substantial changes in major enterprises occur in either of these cases.

We were also interested in the extent to which the concentration ratios of enterprises in different manufacturing industries were increased by extending the usual 50% ownership test of control to include minority control as identified above. The general result may be summed up in two sentences. Changes in ownership definitions affected at most only 8 out of 153 manufacturing industries. Secondly, the weighted average of the percentage of total sales made by the top four firms in each of the 153 manufacturing industries was increased only from 50.35% to 50.66% by taking these selected definitions of minority control into account.

From the specific cases we have examined and the general analysis in the Berkowitz *et al.* study, we conclude that, while minority control is conspicuous in some large corporate groups, such as Argus, it is not very important in increasing the extent of major concentrations of power within Canadian industries.

We have described three kinds of control situations, but it must be pointed out that these categories are not exhaustive. The ingenuity of businessmen and their advisers ensures that there will be mechanisms for controlling corporations other than those listed above. The use of intricate capital structures, voting trust arrangements, pooling agreements, shareholder agreements, loan agreements, supply contracts, complex debt instruments, and other devices adds to the variety of the ways and means by which corporations may be controlled.

Voting Rights

There is one variation on the mechanisms of control that does deserve some brief comment here. The use of non-voting or multiple-voting stock gives more influence or control to the holders of certain stock than would be true if each share carried the right to only one vote. While new issues of multiple-voting stock are now uncommon, the relatively widespread existence of non-voting stock has prompted some criticism. Argus and Power are, again, good examples:

1. Argus equity stock is made up of voting common shares and non-voting participating preference shares. The Ravelston Corporation's holding of Argus stock consists almost entirely of common shares, which though representing only about 31% of total equity carry 61.5% of the total votes attached to shares of Argus and thus give Ravelston majority control.
2. In contrast, Power Corporation owns about 53% of the equity stock of Argus (apart from the senior class A and class B preferred shares). However, most of its stock is non-voting: in fact, Power has only 25% of the total votes attached to Argus shares. While this is a substantial percentage, it does not give Power even minority control since majority control is held by Ravelston.
3. As of June 30, 1977, the Desmarais and Parisien family interests (through intermediaries) owned only about 18% of the equity stock of Power Corporation. However, this holding included 97.6% of the participating preferred shares, which carry 10 votes per share (as a result of a decision in 1928). As a result they had about 53% of the total votes attached to the shares of Power.
4. Power owns or controls, directly or indirectly, about 40% of the equity stock (composed of several classes of common shares) of The Investors Group. Some of the Investors equity stock carries no votes, but most of the shares held by Power and its affiliated companies do, so that Power controls about 70% of the total votes attached to the shares of Investors.

The use of non-voting and multiple-voting stock has been examined from time to time by authorities responsible for administering corporate law in Canada as well as by the stock exchanges and securities commissions. The consensus of these groups seems to be that the presence of non-voting or multiple-voting stock is not a danger to the investing public.

We are content to accept their judgment in this matter. If minority and institutional shareholders have confidence in the management and in the controlling interest and wish to acquire non-voting equity stock, they are frequently able to do so at a price substantially below that of the voting stock. Public companies are required to disclose the voting rights attached to particular classes of shares. Such disclosure satisfies concerns for the interests of purchasers of non-voting shares.

The Role of Directors

We alluded earlier to the role that directors perform in the management of large Canadian companies. Their activities should be considered in relation to their legal powers and responsibilities. While there are some minor differences in wording, most Canadian company law statutes are similar to the Canada Business Corporations Act, which stipulates that "the directors shall manage the business and affairs of a corporation". (However, the newly passed Manitoba Corporations Act states that "the directors of a corporation shall (a)

exercise the powers of the corporation directly or indirectly through the employees and agents of the corporation; and (b) direct the management of the business and affairs of the corporation.")

In practice, the directors of most large Canadian companies are selected by senior management in consultation with the board (or by the controlling shareholder, where there is one), and the shareholders at the annual meeting almost invariably ratify that selection by electing those persons as directors. The directors then re-appoint the senior management of the company, and, of course, it is the senior management and its staff that supervise day-to-day business operations. In a large corporation that is itself wholly owned by another firm, it is the parent organization that selects the board and appoints management. The board in that situation is almost always composed entirely of employees, and rarely exercises any independent power.

No one expects the directors of a large, modern corporation to "manage the business" in the way in which directors of a small or closely held company might, but the extent of their legal duties is not yet altogether clear. The courts in Canada have not had many opportunities to comment upon the precise nature of the obligations of directors of large corporations to "manage the business", but it is reasonable to expect that the scope of their legal mandate encompasses the supervision of the broad direction of the business, and that they normally accomplish this by appointing and overseeing senior management.

We do not suggest that directors are without any real power themselves, either legally or in practice. They perform the useful function of rendering advice and counsel to senior management, and the infrequent (but when the occasion arises, important) act of replacing a chief executive officer. In addition, the law vests in the directors control of a number of important functions, the exercise of which the directors cannot delegate. For example, under the Canada Business Corporations Act, only the directors have the power to submit to shareholders matters legally requiring their approval, to fill a vacancy in the office of auditor, to settle the manner and terms of an issue of securities, to declare dividends, approve takeover bid circulars and approve financial statements.

Canadian corporate statutes, in describing the role of the board, are worded in a very general way. Judicial decisions in this area, at the senior court levels, are infrequent and it is difficult to deduce general principles from cases turning on particular facts. We recognize, however, that with our complex society and the growing awareness by groups in society of the impact that corporations have on them, there may be more frequent opportunities for the courts to assess and comment upon the functions of directors. In the 1974 *Canadian Aero Service* case Chief Justice Laskin of the Supreme Court of Canada, in remarking upon the fiduciary aspect of a director's duty, stated that "the general standards of loyalty, good faith and avoidance of a conflict of duty and self-interest to which the conduct of a director or senior officer must conform, must be tested in each case by many factors which it would be reckless to attempt to enumerate exhaustively."

The Canada Business Corporations Act and other Canadian statutes now impose upon directors a higher standard of diligence and care than existed at common law, and we expect that there will be a growing body of corporate jurisprudence, defining and delineating more fully the duties and the rights of directors.

In the course of our hearings, we have studied and read much about boards of directors of major Canadian corporations. Naturally it is not possible to talk definitively about what all boards do or do not do, because circumstances among corporations differ, and there are, within a certain range, varying degrees of activity by boards. Boards may "do" something by just existing; their very presence can be a check on an overzealous management. Boards have been known to act firmly in crises. Subject to these observations, it is possible to generalize that many Canadian boards, and certainly those of large corporations, fulfill mainly an advisory and confirmatory role. They do not normally "make" decisions but confirm and ratify the decisions made by senior management, and they are a source of advice and counsel when it is sought by management. They also perform the tasks the law has delegated only to them, even though the initiative for the performance of the task may come from management. Typically, Canadian directors spend only a modest amount of time on the corporation's affairs: most have their own businesses to run and many serve on several boards, thus limiting the time they can devote to any one corporation's business. Where a director "represents" a controlling shareholder, however, he usually exhibits a much higher level of activity than he would otherwise.

Changes in the Directors' Role

We are conscious of a growing recognition by senior management and others that the contribution that might be made by boards and the significance to public corporations of the composition of boards are matters that have not been sufficiently considered in the past. There is a shift in attitudes: some corporations are beginning to expect more activity and responsibility from their directors. We view this trend as highly desirable, and we think it will be reinforced by several phenomena.

First, more and more people are becoming aware of the impact that corporations have on their lives. They will continue to demand that corporations be ever more responsive to legitimate public and shareholder needs. The board can be a valuable instrument in helping the corporation to be responsive.

Second, the public perception and understanding of big business could stand some improvement. Since the board of a corporation is very visible, some corporations, partly in their own self-interest and partly to broaden the sources of advice at the board level, are now taking steps to obtain more diversity of interests and backgrounds among the people serving on their boards.

Third, board members are coming to realize that failure to fulfill, in a meaningful way, the responsibilities vested in them by law may result in direct, personal exposure to law suits.

Fourth, managements, in their own self-interest, are seeing that the board can be a useful source of aid and assistance, and that more of the burdens of directing major corporations should properly be shared by the directors.

The Commission thinks that the board should not be expected to duplicate the role of the officers of the corporation: the board is not intended or designed to be, and should not try to be, a second level of management. But that does not mean that the board should be totally divorced from the function of management, or totally dependent on management for information. Directors are given the right and the responsibility of managing the business of the corporation, and, by practice and convention, this means directing the management of the corporation's business. To fulfill this obligation adequately, directors must be sufficiently knowledgeable about the corporation's affairs to ask management the right questions, and to be able to judge whether or not they are receiving the right answers. The role of the board should include the initiation of and participation in active discussion on issues of corporate policy (especially those that might reasonably be expected to come under some later public scrutiny). The role of the individual director should also include the initiation of and participation in such discussions, even though that may appear unsettling and unnecessary to management.

In short we see an expanded role for directors. Directors must monitor management: this is their duty in the interests of the corporation, and it will be in the best interests of all affected by the corporation. The responsibility flowing from the proper exercise of this function will require directors to spend more time on the affairs of the corporation than they normally do now. To advance the concerns of the corporation (and its shareholders) in a manner consistent with the interests of the community in which it functions, directors will have to be concerned with, and cognizant of, matters beyond those brought to the board's attention by management. The board should act as a check on the executive, be fully informed of the company's affairs, and be able to monitor the actions of management. Any other role for directors will be inadequate and will result in their being the "captives" of the management that selects them.

Recommendations

Several conclusions may be drawn from these comments:

First. Given the expanded role we envisage for directors, we think that boards and some board committees should be composed largely of persons drawn from outside the company. These "outside" directors would be persons who are not present or former officers or employees of the company or its parent or affiliates, and who are not closely related to any of the senior management. Also, they should not have a close contractual or advisory relationship with the company (including parent and affiliates) or management, such as would be the case with the company's outside counsel or its underwriter. They would then be much more likely to bring to the director's job a more independent critical and objective attitude than it is fair to expect from "inside" directors.

However, underwriters and legal counsel are frequently well qualified to fulfill the monitoring role of a director, even when they also act professionally for the company on whose board they sit. For one thing, financial and legal matters are subjects often dealt with at the board level. Secondly, underwriters and lawyers in active practice tend to develop a valuable critical sense and they are well placed to observe problems and situations comparable with those they will see as directors of a company. Finally, they will seldom be as dependent upon one company as a company officer will ordinarily be. It could sometimes be detrimental to treat underwriters, legal counsel and other professional advisers as "insiders" in the full sense, even though they are not truly "outsiders" either.

One way to resolve the problem would be to acknowledge that, while professional advisers will often be highly suitable as directors, they should not sit on the boards of companies with which they have a professional relationship. Companies should seek such directors not from the underwriting, legal and other firms which act for them, but from firms with which they do not normally deal. We hesitate to be categorical about this because many professionals may not be willing to serve as directors unless they can combine those duties with ordinary professional work for the company.

We are content to make the point that if professional advisers are not truly independent they cannot satisfy the ideal criteria of an outside director. In the inevitable balancing of "outside" and "inside" components of a board of directors, the anomalous position of professional advisers should be recognized. Where a substantial proportion of the directors are truly outsiders, there need be less concern over the presence of a director who is also in a professional relationship with the company. Where, however, the board is dominated by company officers or other insiders, more effort should be made to ensure that any professional advisers on the board do not also act for the company in a substantial way.

Because we believe the board should become a more meaningful institution, we disapprove of the practice (which, although slowly diminishing, is still very common) of placing large numbers of "insiders" on boards of large public companies. The board is readily able to obtain all the benefits of an officer's or adviser's knowledge and experience without also having him sit on the board, and the board is better able to perform its function with fewer of these "insiders" as part of the formal structure. On the other hand there is a real benefit in having a direct and continuous liaison between the board and management, and there should be no objection to the president's sitting on the board. For the same reason, and also to provide continuity and exposure, some companies may wish to have one, or perhaps two, other senior officers on the board. But beyond two or three at the top, we can see no advantage from having insiders on boards.

If a company is a wholly owned subsidiary there is much less reason for concern about the composition of its board. Many such subsidiaries operate, in effect, as branches or divisions of the parent company and, where such subsidiaries are small, then boards of directors are little more than a formality.

Where subsidiaries are sizable, and in particular when they are also foreign-owned, we think, however, that such boards should have outside members for the same reasons that apply to other large corporations.

Second. We believe that individuals should not sit on the boards of more than a very few publicly held companies. Directors usually have a full-time occupation, and we do not see how it would be possible to carry out the duties of a normally senior position while also performing the serious duties of director in more than a very few companies. There are exceptions, however, in the case of those people who are "professional" directors, or those who for some reason have the time to devote to more companies than might otherwise be considered reasonable.

Third. We see an augmented role for the audit committee of the corporation, in connection with transactions involving potential conflicts of interest among the directors, officers, major shareholders and the company. Audit committees were first introduced legislatively in Canada in the late 1960s, largely as a result of a series of well-publicized corporate failures, but many companies had established such committees before the law compelled them to do so. These committees are intended to fulfill a specific and somewhat limited role, but we think that they can properly be asked to do more. We return to this point later in this chapter.

Fourth. The directors should increase the direct contact they have with the corporation's independent auditors and its outside counsel for two reasons. First, the directors could obtain from these advisers additional information and clarification of factual aspects of corporate activities (and the auditors and lawyers should have no difficulty in participating in that kind of communication). Secondly (but only if the auditor or lawyer is not thereby placed in an untenable position of potential breach of duty to the corporation), a director could obtain the adviser's views and advice about corporate policies and transactions undertaken or proposed. In both cases this would be contact independent of management, and it should enhance the director's understanding of the implications of his or her part in the decision-making process. Access to the independent advisers should be direct, confidential if the director so chooses, and at the corporation's expense. If an adviser is unable, because of a potential conflict of duty, to provide the advice sought, the corporation should reimburse the director for any reasonable expense then incurred in seeking outside guidance.

A major consequence of these recommendations is that directors will have to devote considerable time to their duties, and that they will have to be paid enough to ensure that qualified people will accept the job. We recognize that many of the rewards of board membership are non-monetary but suggest that greater monetary rewards will be necessary if individuals are to perform the expanded duties expected of them.

It was suggested to us that directors should also have the assistance of some expert staff of their own. These would be employees of, and paid by, the corporation, but would be selected by and be responsible to the directors. The

purpose would be to supplement the directors' knowledge of technical or complex matters, and to do so by a mechanism divorced from corporate management itself, so that the directors would not have to rely entirely on the explanations provided by management. We think that our recommendations can be implemented without such a change. In any case some experience should be accumulated with other changes before consideration is given to this more far-reaching idea.

Diversity on Boards of Directors

If, as we suggest above, individuals in future should accept significantly fewer directorships of public companies than is common now, many companies would have to select some directors who are new to the role. Companies would be able to choose directors with different backgrounds and viewpoints from those which are typical today. In any case we consider that diversification of this kind among directors would be highly desirable, and would help major corporations to understand better the impact their activities have on society. We also believe that it is quite feasible, for although some argue that there is a scarcity of qualified Canadians to serve on boards, that view is based on too narrow a concept of the qualities required in a director.

We understand the desire of the chief officers of major corporations to have on their boards people who have had experience themselves as chief officers of other corporations, and we would not suggest that most directors should not have these qualifications. But we think that more directors with the necessary intelligence and good judgment could be found among those who have had experience elsewhere than in business. An effort is now made by many companies to diversify their boards on geographic lines; we suggest the same in terms of occupational backgrounds and viewpoints. We do not suggest tokenism in this respect; those selected should expect, and be expected, to participate actively in discussions at the board on many subjects, and they should have sufficient stature and ability that their views will carry weight with their colleagues who have business training and expertise. Good directors should be expected to question and debate corporate policies and plans, which should then develop along lines that reflect the various views of and contributions made by the board. We think that diversity of this kind will help corporations to confront at the highest level, and to understand the problems they face in the turbulent economic and social setting in which they must now operate.

It has been argued by some that corporate reform should go further: that directors should be given by law, individually or collectively, specifically defined areas of authority (e.g., to supervise and be responsible for product safety), and that this will foster greater personal and corporate responsibility. However, we think that the law is now fashioned broadly enough to allow directors to exercise authority for those corporate acts over which, under any system, they could reasonably be expected to have control.

The suggestions we have made are not recommendations for legislation. We think the results will be better if these views are adopted voluntarily rather

than being imposed by law upon an antagonistic group, and then observed only with reluctance and formality. The final result might then be tokenism or cosmetic "window dressing". These are ideas that must work "not only in the courtroom but also in the boardroom". We hope that major Canadian companies will respond to these suggestions in a positive way, and will incorporate them into their formal operating activities.

"Public" Directors

It has been suggested to us that "public" or "public interest" or "ombudsman" directors should be appointed to the boards of major Canadian corporations. These would be people who would not be elected by the shareholders, and whose mandate would be to represent the "public interest". There are a variety of proposals put forth along this line, all in response to the question: "Since corporations have such a great impact on so many groups within the community, why is it only the shareholders who have the right to select directors, and why is it only to the corporation and to its shareholders that the directors are, in normal circumstances, legally accountable?"

The argument has been put effectively and clearly by Abram Chayes in an article in *The Corporation in Modern Society*:

> It is unreal, however, to rely on the shareholder constituency to keep corporate power responsible by the exercise of franchise....Of all those standing in relation to the large corporation, the shareholder is least subject to its power. Through the mechanism of the security markets, his relation to the corporation is rendered highly abstract and formal, quite limited in scope, and readily reducible to monetary terms. The market affords him a way of breaking this relation that is simple and effective. He can sell his stock, and remove himself, qua shareholder, at least from the power of the corporation....A concept of the corporation which draws the boundary of 'membership' thus narrowly is seriously inadequate....
> A more spacious conception of 'membership', and one closer to the facts of corporate life, would include all those having a relation of sufficient intimacy with the corporation or subject to its power in a sufficiently specialized way. Their rightful share in decisions on the exercise of corporate power would be exercised through an institutional arrangement appropriately designed to represent the interests of a constituency of members having a significant common relation to the corporation and its power.

The proponents of the many different models put forward suggest that if the public is in some fashion represented on the board, if there is a change whereby groups other than shareholders have a franchise, the problem of the legitimacy of power of the directors and of the corporation is answered. And once the constituencies that have a rightful "membership" in the corporation also participate, through institutionalized processes, in the government of the corporation, then the central question of accountability of the directors and the corporation is also substantially solved.

We have given serious consideration to these proposals, for they touch a question central to our mandate: whether large corporations are adequately aware of and responsive to the interests of the communities in which they

function. We do not think it practical to recommend any of the structural changes proposed. There are two basic problems with the many proposals for a so-called public director. One relates to the role such a person would play in a business organization. It is not clear whether he should be a social auditor, an ombudsman, a spokesman for the "public interest", or a representative of all groups, except shareholders, concerned with the corporation. It is equally uncertain whether he would be a voting or non-voting board member; whether he would share the same responsibilities as other directors; whether he would owe the same duties as other directors to the corporation, and to the shareholders; how he would obtain any effective power and authority, and how the many conflicts that would inevitably arise in such a situation would be resolved. We have not seen any prescription that answers these questions satisfactorily.

The second problem is even more fundamental. The critical question that has not been satisfactorily answered by any of the proponents, or any of the authors whose work we have studied, is this: "Who should be entitled to select the public director, and by what process should he be selected?" If the idea is to provide an answer to an alleged lack of legitimacy, it is mandatory to have an acceptable and workable selection arrangement; otherwise the public director will be no more "legitimate" than any other director.

Chayes recognized the importance of this question, and the difficulty inherent in it: "It is not always easy to identify such constituencies nor is it always clear what institutional forms are appropriate for recognizing their interests." We go further and say, after careful study of many proposals, that it is *never* easy to identify the appropriate constituencies, and the appropriate institutional forms are *never* clearly definable. Even if it were possible to select special interest groups, balancing the extent of their participation relative to one another and to shareholders would inevitably be completely arbitrary. Even Ralph Nader considers the idea of a "public interest" director unworkable, and would have only the shareholders elect the board albeit by an expanded electoral procedure. The difficulty with this question is that the potential "appointing groups" are amorphous and transitory. In one year a particular group may appear to have a legitimate interest to be recognized, and in the next year it may have ceased to exist. There will, in addition, be as many potential constituencies striving for the right to participate in the election of a director as there are interpretations of what is truly in the "public interest".

We agree that the activities of the major Canadian corporations do affect many "publics" and that they have a significant impact on, and responsibility to, people other than those traditionally understood to be its sole constituency—shareholders (of course, much the same could be said of other major groups, such as trade unions). We conclude, however, that the only practical and equitable method of selecting directors is one whereby the shareholders (a group that most commentators agree should participate in corporate government) elect or ratify management's choice of directors. The only workable scheme to ensure greater responsiveness to society's legitimate demands is to reform the board and its workings along the lines we describe in this chapter.

All the proposed schemes we have examined have as many defects as those in the present system (and some have more). A diversified and more diligent board should reduce the significance of the present defects considerably. If the interests of the general public or any particular group are still ignored by a corporation, there may be recourse of one kind or another available to protect the aggrieved parties. If not, the way to protect the complainant is to provide that recourse at law, not to graft onto the corporate structure a clumsy and impractical appendage.

Much the same kind of problem arises when considering the suggestion that Canadian corporations should have on their boards consumer directors, environmental protection directors or other directors legally and specifically charged with representing and being responsible to a certain "interest group". The selection process would usually be difficult or impossible to devise in a fair and workable way. Moreover, we think such directors would invariably, and frequently, find themselves in an irreconcilable conflict among duties to the special interest group, to the shareholders and to the corporation. We believe our earlier suggestion, to have some board members with special knowledge of pertinent areas, without placing special legal responsibility on them, is by far the most sensible approach.

Worker Directors

The idea of worker, or employee directors, is much more difficult and complex.

Other countries have varying arrangements featuring a degree of worker involvement at some level in the decision-making process. These schemes range from joint consultation (where management makes the decisions but permits worker representatives to be heard) to worker control (where final authority rests in the workers' representatives), with a wide variety of plans between those two extremes. In Britain the Committee of Inquiry on Industrial Democracy (Chairman, Lord Bullock) made an extensive analysis of this question. The Committee divided on its recommendations, and its *Report* has created considerable controversy in Britain. One of the most highly developed Western European arrangements, and probably the best known in Canada, is the German system of co-determination. This involves a two-tier board system, with equal representation of workers and shareholders on the supervisory board (corresponding roughly to a Canadian board of directors), but primarily management representation on what corresponds to the executive Committee of a Canadian board of directors.

These plans exist for different reasons, including the hope of alleviating worker alienation, increasing productivity, distributing power and authority more equitably, and contributing to industrial harmony. These are all admirable objectives, but most observers have concluded that a scheme of worker participation, at the board level or elsewhere, will by itself do little to accomplish these ends, and above all will not produce industrial peace. In Germany, the machinery of participation is distinct from that of wage determination, but the processes work together and have a reciprocal influence. In

Canada, however, without a shift toward such an orderly system of collective bargaining, and perhaps the introduction of works councils along the lines of the German model, we are doubtful that worker participation itself will lead either to the greater satisfaction of any group concerned or to greater industrial harmony. Furthermore, the danger of co-option is present: "participation" may become a device by which management obtains the support of workers without any significant participation on their part.

If Canadian unions or management do think worker participation or worker directors is a good idea it should be made clear that such an arrangement could now become the subject of an understanding between union and management. No change in the law would be necessary for management to agree to include the union's nominees on the slate proposed for election to the board. With share ownership no longer a prerequisite to directorship, there would be no financial obstacles in the way of a worker director. We do see the possibility of occasional conflict of interest on the part of a worker director, between the objectives of the employees and those of the shareholders, but some practical solutions to that problem may be found in particular cases.

However, the notion seems somewhat remote and academic at present, since neither Canadian labor nor Canadian management generally advocates or appears to support the idea. We conclude that at the present time, and in the context of our industrial relations history and current practice, the idea of worker directors in major Canadian corporations does not offer great promise, but the subject will undoubtedly be a matter of continued public discussion and deserves further study in the light of European experience.

Interlocking Directorates

Some have argued that interlocking directorates are indications of the existence of social and economic networks that permeate the upper echelons of Canadian business and thus serve further to concentrate power. Others have said that, since board members in practice tend to lack any really substantial amount of decision-making power, the concern about interlocks is exaggerated.

Throughout our hearings, and in many of the submissions we received, there were expressions and comments on the question of interlocking directorates. As well, we commissioned the aforementioned study of corporate interconnections by Berkowitz *et al.*

The presence of the same individual on the boards of directors of several or even a dozen or more companies is well known and is easily identified in the *Directory of Directors* and other public sources. We have not endeavored to count these interlocks or to interrelate them. We have found no real evidence that individual interlocks are significant in themselves. Many large companies are looking for the same type of person as a director, and these individuals are apparently willing to serve on a number of boards.

The significance of the phenomenon lies in the relatively limited group from which companies select directors, and the similarity of background and outlook that this frequently implies. For example, the major banks seek many of the same people for outside directors as are selected by major industrial companies. We are satisfied, based on the evidence we have heard, that banks

do not rely on interlocking outside directors as a source of information about their clients. Undoubtedly they hope their directors will bring business to the bank, subject to their fiduciary obligations as directors of other companies, but that is a different connection from that usually discussed.

Some have offered, as a partial explanation for the existence of so many directors-in-common, the view that there is a scarcity of qualified Canadians available to serve as directors. Most of these already sit on one or more boards, and (the argument goes) it is therefore inevitable that these highly qualified individuals will be sought after, with the result that there will be many overlapping or cross-directorates. Others attribute the reason for the pervasiveness of interlocks to the common class within society from which the directors have sprung or to which they have risen, to the homogeneous ideological and cultural attitudes of such people, and to the natural human tendency to seek out the familiar and friendly as companions.

The law is generally silent on the question of interlocks. The most notable statutory provisions are sections 18(5) and 18(6) of the Bank Act, which provide that a person may not be a bank director if he is a director of another bank, or of a trust or loan company that accepts deposits from the public, or of a bank under the Quebec Savings Bank Act. While these provisions have been criticized as being easily avoidable, we have found no instances of avoidance and think the law has accomplished the intention of Parliament.

The courts in Canada have not yet had many occasions to deal with the legal difficulties that might arise in an interlocking situation. The Supreme Court of Canada, in the 1974 *Canadian Aero Service* case, placed renewed emphasis on the fiduciary obligations of people in senior corporate positions. Stanley Beck interpreted that judgment as placing directors who are on boards in certain kinds of interlocking situations in a "tenuous legal position" and in "constant danger of being in breach of their duty to either, or both, of their masters".

In their 1976 Report *Dynamic Change and Accountability in a Canadian Market Economy*, for the federal Department of Consumer and Corporate Affairs, L. A. Skeoch and B. C. McDonald discussed interlocks within the context of competition policy. They stated that they were not aware of any reliable evidence that interlocks have "harmed competitive processes in Canada in any generally significant way". Neither have we discovered any such evidence, although there is reason, *a priori*, to be concerned about the situation where one person sits on the boards of two companies, each a significant force in its market, that compete with each other in any market that is material to either company.

After giving the matter consideration, we are not prepared to recommend further restrictions on interlocking directorates. We see little justification for regulation in this area, and the undesirable effects of such action might well outweigh any benefits. The cost would indeed be real, measured in terms of the disruption and dislocation of both personal and corporate activities.

There is one case where, in our judgment, the social and economic benefits of action regarding interlocks exceed the costs. That case relates to bank directors and officers, and we have dealt with that in Chapter 10.

We have also considered the situation of a person serving as a senior officer or director of two companies that are competitors in a market that is material to both companies. The access to information that such an individual has, and the obligations to both companies inherent in the nature of his role, place him in a difficult position and pose dangers to both companies. Perhaps the greatest danger is the possibility that there will be less vigorous rivalry and competition between the two firms than would occur if there were no interlock. There are few situations in Canada like that, too few to warrant a prohibition in law. We have seen no positive evidence of detriment resulting from horizontal interlocks, although the danger is always present. If detriment did arise, the common law provides some degree of protection to an aggrieved corporation, although not to the competitive process.

The proposed amendments to the Combines Investigation Act give the Competition Board power to prohibit specific horizontal interlocks, and we see this as sufficient protection for the competitive process and the public interest. For these reasons, and while we are not at all in favor of horizontal interlocks, we do not recommend a prohibition of them per se.

Management Control

We described earlier the major categories of stock ownership relevant to the question of control of corporations. In each of the cases mentioned, the controlling shareholder normally exercises control partly by ensuring that the board members are persons acceptable to him and partly by arranging for the appointment of senior management compatible with his views and objectives. The management is ultimately replaceable at the will of the controlling shareholder and this is understandable, since the controlling shareholder has the largest direct financial stake in the company's prosperity and is naturally anxious to ensure that senior management is acceptable to him.

There are many corporations where no one person or group of persons acting in concert owns a significant percentage of the voting shares. In those situations control of the corporation comes to be exercised by those who manage the corporation.

Management depends for its continued control on its influence over the proxy machinery. So long as no substantial shareholder becomes interested in the company's affairs, and recognizing that the presence of the board is always a factor, management is able to perpetuate itself and the board, mainly through its control over the proxy process.

In the banking industry, one of the most visible and highly concentrated in Canada, Parliament has acted to ensure that no person or group can acquire control of a bank. It has done this by limiting the maximum percentage of bank shares that can be beneficially owned by any one person or group. One of the principal consequences of this legislation is that (subject to the presence of the board, as we have noted) the management of a bank will always effectively control it.

Another conspicuous case of management control in Canada is that of Canadian Pacific Limited. The company has no person holding a significant

block of voting stock, and control of the corporation is exercised by senior management. Directors and senior officers of CP own less than 0.28% of the equity stock. It should be noted that one of the effects of the 1971 offer by CP to exchange high-yield non-voting stock for the outstanding voting preferred stock was to consolidate further the control position of management.

Control by incumbents, including management, may also be buttressed by the application of provisions in the law relating to "constrained shares". The ability of a public company to constrain shares (that is to restrict in some way the issue or transfer of its shares) was first created by the Canada Corporations Act in 1970. The purpose of this provision was that companies in certain businesses, such as broadcasting, could impose conditions on the issue or transfer of their shares to ensure that a minimum percentage of the shares remained in Canadian hands, and that more than a maximum percentage did not fall into the hands of "non-Canadians" and thus jeopardize a right or licence held by the company.

In 1976 one of the largest Canadian companies, Brascan Limited, passed a bylaw constraining the transfer of its shares. John Labatt Limited, about 29%-owned by Brascan (through a wholly owned subsidiary), passed a similar bylaw. These were the only firms, of those that appeared before us, to have taken such action. The reason given to us by Brascan for the passage of its bylaw was that the company wanted to ensure that it did not inadvertently become a "non-eligible person" for the purposes of the Foreign Investment Review Act, since that would impose serious limitations on Brascan's ability to act quickly in certain situations. By virtue of the bylaw, people who are "non-Canadian" will be members of a constrained class. A transfer of a share of Brascan will not be entered in the registers of Brascan and a subscription for a share of Brascan will not be accepted if the result of entering the transfer or accepting the subscription would be that the shareholdings (registered, beneficial or associated) of the members of the constrained-class or any member thereof would, in effect, exceed certain stipulated limits. One of the results of this kind of bylaw is to provide a further layer of insulation for the incumbent controlling group (in Brascan's case, the management) against any potential bidders for control.

Further Recommendations

Our reading and research on corporate control lead us to conclude that an effort should be made to achieve a better balance among the relative positions of management, the board and the shareholders, and many of our recommendations in this chapter are directed to that end. Most shareholders apparently do not seem to want to participate more fully in "corporate democracy". However, the present system is such that it is difficult to judge whether, if the system were altered, shareholders would take a greater interest in the corporate process. Certainly it is clear that at present if a shareholder wishes to participate in an effective way he has little opportunity to do so. We think that some modification of the internal corporate processes would be desirable, and would be in the best interest of both corporations and their shareholders.

The Proxy Process

We make two recommendations here. The first deals with the proxy information circular which precedes the election of directors. Shareholders would benefit by having more information than is given to them at present. By way of example, shareholders should be advised as to the amount of director's fee and other compensation paid by the corporation to each nominee who is already a director, a summary of the amount of time spent and the nature of the activities in which the nominees who are directors have been engaged on company business, any material interest of nominees in any transaction with the company (whether or not material to the company) in the period since the last proxy information circular, a brief account of the business experience of each nominee during the preceding five years indicating the nature of his responsibilities, and a statement as to any material criminal convictions and civil judgments against the nominee.

A shareholder wishing to exercise his franchise in an informed way would be in a better position to do so if he had such information. Corporations could also consider including a statement of the reasons why each particular nominee is proposed for election. There may still be no "contest" (assuming the continuation of the current practice of proposing only as many nominees as there are places on the board) but the shareholder who is so inclined could vote for some nominees (or withhold his vote) on a more informed basis.

The Nominating Process

The second recommendation relates to the process by which people are selected for board membership. In most companies senior management (in conjunction with the controlling group or key board members, where applicable) proposes individuals for election to the board. This often creates a situation where the board member feels that he owes his position (as indeed in many cases he does) to the chief executive officer. It is anomalous to have the chief executive officer, who, in management theory and in law, is responsible to the board, participating so substantially in its selection. We have earlier urged that boards be composed almost entirely of outsiders, but this would be meaningful only if the outsiders were as independent as possible, and by that we mean having the ability to counsel and monitor without subservience to the management or the controlling group. This state is fully consistent with a harmonious working relationship between the outside director and management, but, insofar as possible, the director must not owe, or believe he owes, his position and his continuity in the company to the chief executive officer. It will help in fostering an independent attitude on the part of outside directors if they are chosen, not by the chief executive officer or senior management, but by a nominating committee composed entirely of outside directors. This committee would be selected by the board, and might be headed by the chairman of the board (assuming he was an "outsider"). It would seek suggestions for board nominees from other members of the board and from senior management, including the chief executive officer; where there was a major shareholder, its views would, of course, be obtained (remembering that the nominees, once

elected, owe a duty to all the shareholders, not just the controlling group). The proposed slate would also have to be approved by the board as a whole. The nominating committee itself, however, would be ultimately responsible for determining the names that would go before the shareholders. The result, over a period of time, should be to inculcate and foster in outside directors a more independent attitude.

Conflicts of Interest

We now turn to a consideration of the difficult question of conflicts of interest. In some major corporate groups in Canada there are companies whose shares are wholly owned by one person or group of persons (or companies). In those situations the interests of the subsidiary are normally identical with the interests of the parent shareholder. Transactions may be carried out between the parent and the subsidiary (and due regard will usually be paid to the provisions of the law, including income tax requirements), but the shareholder need be concerned only with its own interests because there are no other shareholders. For example, assets may be transferred back and forth with relative ease. It is clear that this situation provides (subject to creditors' rights) great flexibility to the parent in dealing with the subsidiary, its business and its assets.

Many major companies in Canada, however, are not wholly owned subsidiaries of other companies, nor are the subsidiaries of many major companies wholly owned by them, so that there are other, outside or minority shareholders. When these other shareholders are present in a corporate structure, the possibility of a conflict of interest may arise. The conflict might be between the interests of the majority and the minority shareholders or between the interests of the management and the company itself.

In the case we are discussing here, the shareholders who are not part of the controlling or management group will normally take very little part in company activities. Their knowledge of company affairs will be limited to whatever information they obtain from the company in the annual report, the proxy information circular and interim reports, such matters as may be commented upon in the press, and information that may be given to them by or through their financial advisers. The minimum quantity and quality of information received by them is prescribed by law; anything beyond is gratuitous and is determined by the company (which normally means the management). If a transaction occurs or is proposed that might result in a conflict of interest, the outside shareholder can, if aware of it, determine whether there is some legal recourse available to protect his interests.

Directors of corporations are, of course, subject to legal rules and constraints, including their obligation to abide by what has come to be known as the "corporate opportunity doctrine". Simply put, this doctrine states that where a director of a company learns of an opportunity that may be usefully exploited by the corporation, he has an obligation, before availing himself of the opportunity personally, to advise the corporation of its existence and to

permit it to take up the opportunity. The doctrine is in the process of development in Canada, and it is not possible to say what its precise limits are. It confirms and is consistent with the fiduciary obligation of the director, and with the view that directors should be assiduous in their duty to the corporation and to all shareholders.

Other rules also provide safeguards. A director or officer who is directly or indirectly a party to or materially interested in a material contract with the corporation must disclose that fact to the corporation. Any such director must also generally abstain from voting on the transaction. Each annual proxy information circular must disclose to shareholders details of any material interest in any such transaction in the past year if the transaction has had a material effect on the company. In addition, insiders are now subject to stringent rules relating to buying and selling their corporation's securities, and to their use, or abuse, of confidential information. A prompt report to a securities commission is now required regarding such "insider trading".

There are specific provisions in certain statutes governing financial institutions relating to what might be called "self-dealing". As early as 1910 Parliament passed laws relating to "self-dealing" or "self-trading" in the life insurance industry. The laws were periodically revised and in 1970 they were revised substantially. The general effect is to provide that a company subject to the authority of the Superintendent of Insurance may not make loans to or investments in a corporation that is a substantial shareholder of that company, or to any corporation in which one of the company's substantial shareholders has a significant interest. There are also other provisions intended to restrict and limit potential diversion and misuse of corporate funds. The Superintendent of Insurance has told us that these provisions have been effective for the purposes intended.

During the course of our study we examined some transactions that illustrate the difficult problems that can arise where there are minority shareholders or where persons in management enter into transactions with the company. In these situations the interests of the minority shareholders must be protected. The first level of protection exists within the management of a company. The second level of protection is at the board. The third exists with the minority shareholder himself. We think that shareholders should have more complete, and more timely, information about transactions involving insiders than they do at present. They would then be in a better position to ensure that their rights were not being abused.

There is room for improvement in the procedures that now exist at the board level in this area. We think the present rules as to declaration and abstention should remain, but in addition the audit committee should become involved. The audit committee of a major corporation now has the duty of reviewing the financial statements of the corporation before the board approves them, and in the course of doing so normally meets with the corporation's auditor. The audit committee must include a majority of outside directors. We think that all transactions or matters (subject to a *de minimis* exception) proposed to be undertaken by the corporation that may involve any potential

conflict of interest, such as those we have described where management, directors, or major shareholders have an interest that is material to them (even if not material to the company), should be considered by and be subject to the approval of such a committee. The audit committee already exists in major corporations and, with its function of critical evaluation, is an appropriate body to perform this task. The auditors (and other advisers, where suitable) would participate in such a review. The audit committee should report to the board, and we think that the board should then send this report to the shareholders as part of its regular contact with them.

This procedure would be a welcome improvement in the communications between a corporation and its shareholders, since under current practice the rights of minority shareholders may be materially weakened by their lack of knowledge. The best way in which we can illustrate the need for this is by recounting our own experience in one situation. In analyzing a transaction we had recourse first to the same documents that a minority shareholder would receive (in this case, he would have received them many months after the transaction occurred). From these documents we were able to determine the basic nature of the transaction.

However, we could not determine from these documents the corporate rationale for the transaction, and therefore we could not determine whether the transaction was motivated primarily because of the fact that insiders were involved. We could not determine what facts were disclosed to the board or what independent analysis, if any, the directors might have taken. We could not determine whether any member or members of the board opposed the transaction and, if so, for what reason. We could not determine the method of calculating the price to be paid for the asset in question and whether that price was objectively fair. We consulted a financial analyst, knowledgeable about the affairs of the company, but he was not able to enlighten us much more. It was only when we discussed the transaction with senior representatives of the company that we obtained sufficient information for our purposes.

Of course, a minority shareholder would not have opportunity to engage in the kind of discussions that we conducted. A minority shareholder, once he learned of the transaction, would have to decide whether his interests had been neglected, or whether the transaction was fair and reasonable and in the best interests of the corporation. This places the shareholder in a very difficult position, and may be a factor contributing to the apathy of smaller shareholders. For shareholders to be able to make a proper and informed judgment in this kind of case, they should have additional information of the kind described above.

This is not to say that the lack of full and prompt information is the only difficulty faced by a minority shareholder. Enforcing rights is expensive, and major corporations and insiders normally have greater resources than the individual shareholder. But recent statutory changes in the Canada Business Corporations Act and other statutes have introduced remedies, and lowered procedural hurdles, and ought to help shareholders who wish to bring action to correct abuses. The effectiveness of these changes remains to be fully tested,

but we are optimistic that they will prove to be valuable to shareholders. While there has been some criticism of some parts of the provisions, they seem to us to be substantially adequate and clearly desirable. The recommendations we have made will complement these remedies and make them more useful.

We said earlier that the public interest on an issue such as conflict of duty will coincide with private interests. While private and proprietary rights are chiefly involved here, in the broadest sense there is an overriding public concern. It is in the public's interest that the internal activities of our major corporations, and our other major institutions, be conducted on an orderly and equitable basis, and as far as possible be seen to be so conducted. The public's perception of corporations influences its confidence in the workings of our economic system and affects its willingness to invest. We think it desirable that the interests of all concerned with corporations be, and be seen to be, fairly protected.