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RESTRICTED SHARES AND THE EFFICIENCY OF THE CAPITAL MARKET

A Background Paper prepared for Consumer and Corporate Affairs Canada by

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EXECUTIVE SUMMARY

1. If new financial instruments are introduced or more widely used, and if they are appropriately priced, then the allocative efficiency of the capital market will be improved. Scientific evidence supports the proposition that capital markets in North America are efficient in their use of public information. Thus the presumption of received economic analysis is that restricted shares improve the allocative efficiency of the capital market. The onus is on those who would limit the use of restricted shares to provide empirical evidence that this received analysis is inappropriate in the present context.

2. Corporations issue restricted shares for one or more of the following reasons: (1) to raise additional equity capital <u>in the least cost way</u> without diluting their control; (2) to conform to regulations and/or incentives relevant to non-resident ownership; (3) to facilitate take-over bids, by making them less costly, when restricted shares carry no voluntary "coat-tail" provisions; and (4) to create a liquid market for at least one class of "residual equity".

3. The OSC expresses concern with the <u>potential</u> for abuse by majority shareholders implicit in the use of restricted shares. Because capital markets are informationally efficienct, this concern is easily overstated. Bondholders, for example, use restrictive covenants to limit management's ability to act against their interest, and the residual risks to which bondholders remain exposed are

internalized into the price of these securities. The presumption of received economic analysis is that the marketplace will determine the guarantees or preferences that holders of restricted shares require if they are to buy additional securities at a price that is not deemed by management to be prohibitively low. The role of extant judicial remedies in the event of fraud or like abuses also merits note.

4. Because received economic analysis suggests that a disclosure-oriented policy by the OSC is likely to be adequate, it is essential to address the following questions prior to implementing an alternative policy.

(1) Is there any empirical evidence to support the concern that the market fails to understand the attributes of restricted shares and misprices them accordingly? A detailed study of the extent to which discounts (or premiums) on restricted relative to common shares are systematically related to factors such as the presence or absence of "coat-tail" provisions, dividend or winding-up preferences, improved liquidity and so forth would shed light on this important question.

(2) Why have corporations chosen to issue restricted shares, and what is the relative importance of such factors as non-resident ownership restrictions or incentives and the very high dividend yields required at present on preferred shares? Without a more detailed examination of this question, it is impossible to assess - for example - whether the recent acceleration in their

use is a temporary or permanent phenomenon.

(3) On balance, does the use of restricted shares impede or promote the use of the take-over mechanism as a disciplining tool of the marketplace? To the extent that restricted shares without "coat-tail" provisions make take-over bids less costly, such bids may be encouraged. To the extent that restricted shares enable majority interests to consolidate control more easily than alternative means, take-overs may be impeded.

I. Introduction

The purpose of this background paper is to assess the implications for the efficiency of the capital market that arise from the use of "residual equity" shares with no voting rights or with voting rights that are subordinate to another class having greater voting rights. These are referred to by the Ontario Securities Commission (OSC) as "restricted shares". The framework adopted in this background paper is that provided by modern finance theory, which is that area of economic analysis which deals with the operation and efficiency of capital markets. The paper is to provide a framework, drawing upon received theoretical and empirical analysis, to evaluate the salient issues regarding the use of restricted shares as a source of equity capital.

The paper first reviews the concept of an efficient market. The paper then examines, item by item, the issues raised by the OSC in its "Position Paper" dated 2 March 1984. The paper then examines the additions and amendments to Policy 1.3 proposed in the OSC's "Position Paper".

II. An Efficient Capital Market

1. Informational Efficiency, Allocative Efficiency and the Efficient Allocation of Real Resources

On page 17 of its "Position Paper", the OSC refers to its mandate "to provide a regulatory environment in which efficient capital markets operate and develop". Since there are alternative notions of efficiency in the economics literature, and since the OSC alludes to two conceptually distinct definitions in its "Position Paper", this definitial issue merits clarification.

The capital market is said to be <u>informationally efficient</u> if security prices reflect all relevant information. In an informationally efficient market, security prices are set by the market such that their expected returns are commensurate with their degree of risk. For a given set of financial instruments, informational efficiency of the capital market implies allocative efficiency of the capital market. If new instruments are introduced (and priced correctly, as will occur if the market is informationally efficient), then the allocative efficiency of the capital market is improved. By the revealed preference of the issuers and holders of financial claims, the market's acceptance of innovative instruments indicates that they are facilitating the transfer of funds from savers to end users. The novel and more widespread use of restricted shares in recent years may be presumed to increase the allocative efficiency of the capital market, provided that the capital market is informationally efficient.

The fact that the capital market is informationally and allocatively efficient does not, however, guarantee that real economic resources will be efficiently allocated. The OSC draws attention (page 13) to the question of whether the use of restricted shares may insulate "inefficient management" to too great a degree. In effect, this is a reference to the possible inefficient allocation of real resources, and is not related to the efficiency of the capital market *per se*. Consider, for the sake of argument, a firm which is closely controlled and in which management is inefficient. Because the firm is closely controlled, assume further that there is no competition in the form of take-over bids for the right to manage the firm's real resources. If the capital market is informationally efficient, then the market value of its shares will be depressed and thus accurately reflect the inefficient utilization of the firm's real resources. At least in the short run, the allocation of real resources will - by assumption - be inefficient. The question of whether the inefficient allocation of real sources will persist in the long run depends upon whether or not (1) competition for the right to manage the firm's real resources leads ultimately to a successful take-over bid and a subsequent change in management or (2) the absence of barriers to entry ultimately allows new firms to compete with the extant firm in the market for the goods and/or services that it produces. Both of these market mechanisms, but especially the latter, extend far beyond the efficient operation of the capital market *per se*.

The distinction between informational and allocative efficiency of the capital market, as well as the efficient allocation of real economic resources, is useful throughout the discussion of issues relevant to the use of restricted shares.

2. The Informational Efficiency of the Capital Market: Theory and Evidence

In an *informationally efficient* capital market, security prices reflect all relevant public information. At each instant in time, security prices are set by market forces such that the *expected* return on a security is equal to that commensurate with its degree of risk if held in a well-diversified portfolio.[1] Holders of restricted shares (and other securities) are treated "fairly" if the capital market is informationally efficient, since they are appropriately compensated for the risks that they bear.

The issue of whether capital markets are informationally efficient has been investigated *more than any other question* in the finance literature. The vast majority of empirical evidence supports the hypothesis that capital markets in North America are informationally efficient with regard to publicly disclosed information. This evidence is reviewed at length in any of the advanced textbooks in finance. The message from these studies, that the presumption should be that capital markets are informationally efficient, is cited in all of the introductory texts in finance.[2]

The intuition behind the concept of an informationally efficient market may merit emphasis, at least to non-economists. If a particular security is "underpriced" or "overpriced", there are very large financial gains to any market participant who can identify it as such. As a result, there is a strong incentive for some investors to devote resources to acquire the information necessary to determine whether a particular security is correctly valued. In market equilibrium, security prices will reflect the consensus view of informed investors. For the capital market to be informationally efficient, it is not necessary that all market participants be well informed, including those who may actually buy or sell a particular security. If an "uninformed" investor buys a security and causes an unwarranted rise in its price, then an "informed" investor will sell (or sell short) the security until its price returns to the appropriate level. So long as the corrective forces operate quickly, even an "uninformed" investor is protected from paying a price for a security that is very far from the appropriate one. To a large extent, uninformed investors can free ride on the resources devoted by informed investors to assessing the prospects for individual securities.[3]

The above discussion has a key implication. It is not appropriate to conclude that a public policy of disclosure is inadequate because some (or many) investors may fail to assess fully its implications. Security prices will be determined by the activities of informed agents, and the strong theoretical and empirical case is that these informed agents will efficiently exploit all public information. If they do not, then other agents will be able to earn abnormal returns by better exploiting this information, and their activities will then become the ultimate determinant of security prices. Just as nature "abhors a vacuum", capital markets abhor the possibility of earning abnormal returns based on known information!

III. Why Firms Have Issued Restricted Shares

To evaluate the implications for the efficient allocation of financial capital of the widespread use of restricted shares, one must first identify the reasons why firms have chosen to issue them.

Majority shareholders presumably choose to issue restricted shares for one or more of the following reasons: (1) to raise additional equity capital in the least cost way without diluting their control; (2) to conform to regulations and/or incentives relevant to non-resident ownership; (3) to facilitate take-over bids, by making them less costly, when restricted shares carry no voluntary "coat-tail" provisions; (4) to create a liquid market for at least one class of "residual equity"; and - possibly - (5) to take advantage of the holders of these shares.

Each of these possible rationales is discussed in the appropriate section of this background paper. One point, however, merits emphasis at this time. The OSC appears concerned with reason (5) above. Yet in an informationally efficient capital market, this concern is easily overstated. Bondholders, for example, use restrictive covenants to limit management's ability to act against their interest, and the residual risks to which bondholders remain exposed are internalized into the price of these securities. The presumption of received economic analysis is that the marketplace will determine the guarantees that holders of restricted securities require if they are to buy additional securities at a price that is not deemed by management to be prohibitively low.

IV. Issues Raised by the Ontario Securities Commission (OSC) in 2 March 1984 "Position Paper"

1. Disclosure

Those who challenge the adequacy of disclosure as a public policy response would appear to have one or both of the following concerns:

(1) the capital market is not informationlly efficient, so a policy of disclosure is in general likely to be inadequate;

(2) the controlling shareholders may subsequently take action that is detrimental to the interests of the restricted shareholders, a possibility which is not adequately reflected in the price of restricted shares and/or serves to reduce investor confidence.

Each of these concerns is discussed in turn.

(1) The Efficiency of the Capital Market

As previously noted, the existing scientific evidence strongly suggests that capital markets are efficient in their use of publicly available information. Market forces may be presumed to set prices on restricted shares such that their expected return is commensurate with their risk.

The OSC appears to be concerned with the possibility that restricted shares are not being "correctly" priced by the marketplace. Since the received view of the economics profession is that capital markets are efficient in their use of publicly available information, the onus is clearly on those who cite a contrary view to provide empirical support for their claim. To my knowledge, there has as yet been no scientific study of the pricing of restricted shares on the Toronto Stock Exchange, designed to identify informational inefficiencies if they exist. Barring such evidence, the extant policy of the public disclosure of information relevant to the market's pricing of restricted shares is both valuable and appropriate.

(2) Action by Controlling Shareholders Against the Interests of the Holders of Restricted Shares

There seems to be a concern in the present debate that controlling shareholders may subsequently take actions that are to the detriment of the holders of the restricted shares, and that this possibility may not be reflected in the market's pricing of restricted shares. On balance, this concern appears to be overstated.

To place the concern in perspective, it is important to recognize that potential conflict does exist among the different classes of claims to a corporation's assets, and that this potential conflict is well understood by the market place. For simplicity, consider a corporation which has only two types of claims, common shares and debt. An important insight provided by modern finance theory is that one can view the capital structure of this firm as follows. The debtholders are the owners of the corporation's real assets, but have sold a call option written on these assets to the shareholders. The striking price of this call option is the book value of the corporation's debt. Viewing the capital structure in this manner highlights the potential conflict between the holders of these two classes of claims to the corporation's real assets. Other things equal, for example, shareholders prefer to engage in riskier undertakings. If the undertaking proves very profitable, then the shareholders pay off the debtholders and retain the surplus for themselves. If the undertaking proves unprofitable, then it is the debtholders - who do not participate on the upside - who may find the corporation's real assets worth far less than the book value of their claims.

How is the above conflict resolved by the market place? First, the yield required by the debtholders will be commensurate with their perception of the risk associated with their claim on the corporation's real assets. Secondly, to control this risk, restrictive covenants are likely to be used by debtholders to restrict management's freedom to act against their interest. Debt covenants often include, for example, restrictions on management's right to issue new debt, to pay dividends, to engage in merger activity, and to dispose of assets. The use of restrictive covenants to protect the interests of debtholders, together with the differential degree of risk nonetheless assigned by the market to the debt of different firms, are well known and integral features of the capital market.

The analogy with restricted shares is straightforward. To be acceptable to the market, they require guarantees and rights that are the analogue to the restrictive covenants imposed by debtholders. Since the value of residual equity shares is tied ultimately to the dividends to be paid, a likely guarantee is that the restricted shares receive dividends that at least match those paid out on common shares. If holders of restricted shares are concerned that their interests will not be protected in the event of a takeover, they may require "coat-tail" or like provisions if they are to purchase these shares at a price that is not deemed by management to be prohibitively low. And so on.

It is useful at this time to emphasize the agency problem faced by all classes of security holders in all but the owner-managed firm. If there is a single owner-manager (O-M), he or she will take every action to increase his or her own wealth. If the O-M issues external equity, he or she will increase his or her wealth at the expense of the shareholders if he or she can do so. The O-M may do this, for example, by taking "perks" in a variety of forms. The O-M is the agent of the shareholders, yet has personal incentives which may conflict with their interests. To solve this agency problem, shareholders must incur monitoring costs of one form or another to reduce the scope of the O-M to act against their interest. This agency problem is of a quite general nature. If the O-M issues debt, then bondholders face an analogous problem. The restrictive covenants cited earlier represent the market solution to the agency problem faced by debtholders, whose objective is to limit management's ability to act against their interest.

To sum up, the incentive for management to act against the interests of different classes of claimants to the corporation's assets is well known. The market solution consists of restrictive covenants and other measures to restrict management's freedom, together with the internalization into market prices of the risks to which these claimants remain subject. The fact that the problem faced by holders of restricted shares is not unique, and that analogous problems have been long solved by the marketplace, mitigates strongly against the concern raised by the OSC.

(3) Policy Implications

Scientific evidence suggests that capital markets are informationally efficient. For this reason, the presumption of received economic analysis is that a policy of disclosure should prove sufficient to ensure the efficient allocation of financial capital. Clearly, there is no reason to ban the use of restricted shares. There is no need either to set minimum standards for them. Through the analogy with the restrictive covenants used by debtholders, it can be presumed that the marketplace will determine the guarantees that holders of restricted securities will require if they are to purchase new issues of these securities at a price that is not deemed by management to be prohibitively low. There is no reason to believe, as evidenced by the wide range of restrictive debt covenants, that the market solution will be a homogeneous set of guarantees common to the restricted shares of all issuers.

2. Take-Over Bids and Other Business Combinations

The take-over mechanism is viewed by financial economists as an important disciplining tool of the marketplace. By disciplining inefficient management, take-overs and the threat of take-overs can improve the allocation of real resources. To use the finance jargon, take-over bids serve as a solution to the agency problem faced by shareholders whose ownership is divorced from the active management of the firm. Economic arguments thus favour an environment which is conducive to take-overs, and it is in the interest of extant shareholders to devise means to facilitate the operation of the take-over mechanism.

There are two issues that are usefully reviewed at this time:

(1) current public policy in Ontario, which requires follow-up offers to minority shareholders in the event of take-over bids;

(2) the question of whether mandatory follow-up provisions are necessary to protect the interests of holders of restricted shares.

(1) The Present Policy of Follow-Up Offers to Minority Shareholders

At present, the OSC requires that take-over bids be accompanied by follow-up offers to minority shareholders if the common shares are acquired at a premium over their market price. The avowed purpose of this requirement is to protect the interests of minority shareholders, who can thus benefit from any premium paid for control. Yet economic analysis suggests that this policy may be misdirected if (1) take-over bids and the threat of take-over bids are an important disciplining tool of the market place, and (2) minority shareholders are observed, in any event, to be made no worse off in the event of an actual take-over. Since the discussion by the OSC is heavily influenced by this extant policy, the salient issues merit closer review.

A variety of sources of potential gains to take-overs have been advanced. These include: synergies in the form of economies of scale or vertical integration; financial incentives such as those associated with under-utilized tax shields; and the possible creation of market power. Of particular interest to financial economists is the possibility that gains are due - at least in part - to the elimination of inefficient management in the target firm.

Jensen and Ruback (1983)[4] have recently provided a comprehensive review of the results of several U.S. studies which have examined the abnormal returns earned by both acquiring and target firms on or after the announcement of successful take-over bids. In informationally efficient capital markets, these abnormal returns provide the correct measure of the net economic impact of the proposed take-over. The evidence indicates that shareholders of target firms experience significant gains, while shareholders of acquiring firms receive much smaller and occasionally insignificant gains. On the surface, this evidence would suggest that the shareholders of target firms receive most of the economic gains from takeovers. This result is consistent with the existence of competition among potential acquiring firms. The result also merits qualification to the extent that the (typically) much larger size of acquiring firms implies that if the economic gains were (say) split evenly in dollar terms between the acquiring and target firms, the abnormal <u>returns</u> would be larger and more significant for target firms.

The results reviewed above explain economists' predisposition to view take-over bids as an important disciplining tool of the marketplace. So long as minority shareholders are not made worse off by a corporate take-over, economic analysis suggests <u>no</u> <u>need</u> for mandatory follow-up offers or the like as a means of ensuring "fairness" in the treatment of minority shareholders. To the extent that "fair sharing" rules limit potential gains to acquiring firms, the number of take-over bids may be reduced. If an acquiring firm cannot make an above-market offer for only a controlling block of shares, the take-over may not take place and the economic gains that would subsequently accrue to all shareholders of the target firm might not take place.

Although the existing evidence is based largely on the results of take-over activity in the United States, there is no strong reason for presuming that comparable results would not obtain in Canada. The major caveat would be the concern, emanating from the much higher fraction of legally or effectively controlled firms in Canada, that the management of acquiring firms might engage in asset stripping or like abuses and thus disadvantage minority shareholders in the process.

(2) Follow-Up Provisions and the Protection of the Interests of Restricted Shareholders

The argument that holders of restricted shares need "protection" has at least two interpretations. The first is that the price of these securities may fail to reflect the fact that holders will not participate in any premium bid for control. In an informationally efficient capital market, this protection is unnecessary. The second is that acquiring firms, perhaps with the tacit approval of the target firm's management, will engage in asset stripping or like abuses.

There are three reasons why the need for protection in this second sense may be overstated. First, if holders of restricted shares have this concern, it will be reflected in the price of these securities. Secondly, there exist judicial remedies linked to the fiduciary role of management for both the holders of restricted shares and minority shareholders who conclude that management has engaged in this type of abuse. Thirdly, preferred shareholders (as well as debtholders) have an interest in preventing asset stripping. Non-voting preferred shares, with their cumulative dividend provisions, are also at risk if asset stripping is perceived as a serious threat. Although restricted shares <u>are</u> residual claims, the holder of these securities may - to some extent - be able to free ride on the restrictive covenants imposed by preferred shareholders (if this class of claims also exists) and debtholders to protect their respective interests.

Finally, the question arises as to why corresponding concerns have not been expressed by the OSC regarding the protection of the interests of (non-voting) preferred shareholders. The presumption may be that the dividend preference accorded these shares, together with the restrictive covenants that have developed in order to protect their interests, are adequate. If so, the question again arises as to why a <u>different</u> presumption exists with respect to restricted shares. In an informationally efficient capital market, this latter presumption is unwarranted.

(3) <u>Policy Implications</u>

Public policy in Ontario requires the sharing of any premium bid for control among all common shareholders, and this policy - which economic analysis may challenge - exerts a major impact throughout the "Position Paper". Yet the introduction of mandatory "coat-tail" provisions for restricted shares need <u>not</u> follow as an inevitable and logical byproduct of extant policy.

(i) In an informationally efficient capital market, restricted shares <u>without</u> such provisions will be appropriately priced by the market.

(ii) If market participants so demand, an increasing number of restricted shares will be issued with such provisions. (The OSC (page 18) suggests that this may already be occurring.)

(iii) If asset stripping or other management abuses do accompany a successful takeover, then judicial remedies are presumably available to the holders of restricted shares.

The OSC also raises the question of making mandatory "follow-up" provisions retroactive. Such an initiative would be a source of windfall gains to holders of restricted shares that currently lack such provisions, and of windfall losses to the holders of common shares of these firms. These windfalls occur because the expected value of any premium bid for control is then distributed across both classes of shareholders. It is impossible to defend such a policy initiative in the absence of hard evidence that the market fails to understand the attributes of existing restricted shares.

3. Part XIX of the Act

The discussion of this issue in the OSC's "Position Paper" is not detailed, and the cutting edge of the proposal is not clear to me. Apparently, the Commission is in the process of preparing draft amendments to the Ontario Securities Act, and it seems appropriate to defer analysis until such draft amendments are made public.

4. Oppression of Minority Shareholders

In order to address this issue, the essential first step is to catalogue the possible reasons why majority shareholders may have opted for the use of restricted shares. This is followed by an analysis of the potential use of restricted shares to promote the interests of majority shareholders at the expense of the holders of restricted shares and other claimants to the corporation's assets. The question of the relative vulnerability of holders of restricted shares versus minority shareholders, and the implications for the price discount to be assigned by an informationally efficient capital market to the restricted shares, is then explored.

(1) The Reasons Why Majority Shareholders Choose to Issue Restricted Shares

Majority shareholders presumably choose to issue restricted shares for one or more of the following reasons: (1) to raise additional equity capital in the least cost way without diluting their control; (2) to conform to regulations and/or incentives relevant to non-resident ownership; (3) to facilitate take-over bids, at least in the case in which restricted shares carry no "coat-tail" provisions; (4) to create a liquid market for at least one class of "residual equity"; and - perhaps - (5) to take advantage of holders of restricted shares and perhaps other claimants to the corporation's assets.

For mature firms that could pay the dividends required on (non-voting) preferred shares, the decision to issue restricted shares suggests - by revealed preference - that restricted shares are viewed by management as the less expensive source of equity capital at this time. For junior firms, which may lack the capacity to pay such dividends, the use of restricted shares may be the only way to raise external equity if the majority interests do not want to dilute their measure of control. In either case, if the majority shareholders view the "no dilution" constraint as binding, the prohibition of - or increased difficulty in issuing - restricted shares will raise the marginal cost of capital to the corporation and ultimately reduce the real capital formation undertaken by it.

Certain issuers of restricted shares are motivated to do so because they are governed by statutes imposing mandatory restrictions on ownership or on the voting rights of non-residents. Others are so motivated because they wish to qualify for benefits under statutes where such benefits are available only if non-resident voting and/or ownership is restricted. Such incentives would appear to be relevant, for example, for firms in the broadcasting industry[5] as well as for firms subject to the National Energy Policy (NEP). For firms who are dependent on foreign capital, concerns arising from the Foreign Investment Review Act may also be relevant.

If majority shareholders wish to facilitate take-over bids, they may wish to issue restricted shares without "coat-tail" provisions in light of Part XIX of the present Ontario Securities Act. If "coat-tail" provisions are included, then this motivation can presumably be ruled out. For firms which wish to facilitate take-over bids, and which are in a position to issue preferred shares, the latter might be the more attractive vehicle. This is because the preferred shareholders, with a fixed stream of promised dividends, do not participate in the higher earnings associated with the improved management of the corporation's assets (or other sources of gains) after a successful take-over bid.

Because stocks are more expensive to trade if they have a thin float, some firms may choose to issue restricted shares in sufficient volume to ensure a liquid market. Presumably, their concomitant desire to retain control prevents the development of a like market for the common. At times, restricted shares with identical claims to dividends have traded at a premium relative to common shares, and such premiums are presumably due to liquidity considerations.

In the present context, the OSC is concerned primarily with the last of the possible objectives, which is discussed below.

(2) The Use of Restricted Shares to Promote (Only) the Interests of the Majority Shareholders

The issuance of restricted shares does intensify the agency problem faced both by minority shareholders and the holders of restricted shares. Major sharehodlers hold a smaller fraction of the corporation's equity, and have a stronger incentive to try to direct the corporation's wealth to themselves through management perks and the like.

It is a fact of the marketplace, however, that investors must be induced to hold any new issues of restricted shares. The greater informed investors perceive the agency problem to be, the more rigid will be the guarantees they demand of the restricted shares and/or the lower will be their price. This disciplining role of the marketplace, in turn, will presumably be factored into management's choice of the optimal capital mix for newly generated funds.

Minority shareholders are also exposed to this agency problem. Further, these shareholders must be induced to purchase the common shares at their market price. If they perceive the agency problem to have increased, then - other things equal - the price of the common shares will fall. In short, the corporation may face a higher effective cost of both sources of external equity capital. This is, of course, the disciplining force of the marketplace.

(3) The Premium Paid for Common versus Restricted Shares

In an informationally efficient capital market (and abstracting from liquidity considerations), the premium assigned by the market to common shares over restricted shares with the identical claim to dividends is due to a single factor. That is the opportunity for common shareholders to benefit from any subsequent take-over bid and premium to be paid for control. This point, which is not an argument for requiring "coat-tail" provisions for restricted shares, merits elaboration.

Minority shareholders receive none of the perks that majority shareholders, through management, might be able to extract. Minority shareholders are also vulnerable to asset stripping and like abuses by management. Yet it is minority shareholders who are likely to be the investors who at the margin must be induced to pay any premium commanded by the common over otherwise identical restricted shares. Minority shareholders thus differ from holders of restricted shares only in their potential to participate in any premium for control. Thus this potential must be the source of any price premium for common over restricted shares if minority shareholders are indeed the marginal investors.

To place this discussion in perspective, it is perhaps useful to draw attention to foreign experience with non-voting or inferior-voting shares. Out of 104 corporations listed in early 1981 on the Israeli stock exchange, 25 had two classes of listed stock ostensibly identical in all respects except for voting rights.[6] The shares with superior voting rights typically sold at a premium, and the premium was very substantial, averaging 45.5%! In part, this is apparently due to the quite generous perks that flow to the interest of controlling shareholders.[7] Minority holders of the superior voting shares must be induced to pay this premium, and these shareholders do not benefit from such perks. These facts suggest that the premiums must reflect the possibility of take-over bids to the disproportionate benefit of those shares with superior voting rights. If the premium accorded the superior voting shares does reflect the potential to direct perks to insiders, then outside investors must be passive investors who - for whatever reason - fail to sell the superior voting shares when their premium is too high. One might conjecture that the likelihood that minority holders of the superior voting shares are passive investors is greater, the smaller is the fraction of the shares that they hold.

The Israeli evidence suggests that the premium for the shares with the superior voting rights is greater, the smaller is the fraction of the corporation's total equity that their holders must own in order to consolidate control. If the shares with superior voting rights represent 75% of the total votes, but only 25% of the total shares, the premium is higher than if they represent 75% of the votes and 50% of the shares, and so forth. The suggestion is that the ability to direct perks to the benefit of the holders of superior voting shares is easier in this case. In addition, the number of outside investors who need to be induced to pay the premium price is less, perhaps raising the likelihood that they are passive investors.

The evidence noted above bears directly on the question of agency costs and the use of restricted shares in Canada. It implies that if an Israeli firm issues inferior voting shares after management control has been consolidated through the use of superior voting shares, the price discount on the inferior shares will rise. Since both inferior and superior voting shares have identical claims to dividends, the "cost" of issuing the inferior voting shares rises in tandem. In short, the Israeli evidence provides some support <u>both</u> for the proposition that the extensive use of non-voting shares will intensify extant agency problems <u>and</u> the proposition that this fact will be reflected in security prices.

(4) Policy Implications

The agency problem faced by holders of restricted shares (and minority shareholders) is intensified if majority shareholders issue non-voting shares in order to increase their equity base without diluting their control. Yet this is a standard problem, and market forces can presumably deal with it. The other reasons why majority shareholders might elect to issue restricted shares also merit emphasis. Of particular note (and worthy of more detailed attention) are the incentives created by different federal and provincial regulations designed to discourage non-resident ownership. As yet, there has been no comprehensive study of the reasons for, or the market pricing of, restricted shares on the Toronto Stock Exchange.

5. Control and Ownership

The OSC draws explicit attention to the danger of asset stripping if majority shareholders have, through the use of restricted shares, consolidated control and yet have only a small equity interest.

The usual arguments about the market solution apply. Again, the suggestion is that these arguments receive too little attention from the OSC. If the holders of restricted shares or other claims perceive that the danger that management will act against their interest has risen, as implied by the above scenario, the corporation will experience a corresponding increase in the cost of raising new debt or equity capital. As noted, the Israeli experience provides evidence of the operation of this market mechanism.

It is perhaps instructive to consider what might happen if new issues of restricted shares were banned outright. For mature firms in which the majority shareholders viewed "no dilution" as a binding constraint, the more widespread use of preferred shares and/or an increase in the debt/equity would be the likely outcome. For junior firms, the raising of external equity might be effectively ruled out if the controlling interests view "no dilution" as a binding constraint. There might also arise pressure for innovation in the market for preferred shares. For junior firms, preferred share issues in which stated dividends are not paid currently but accrued until some later date would be attractive, if investors could be persuaded to hold them at a price deemed acceptable by management. For both types of firms, the incentive to permit <u>some</u> additional dilution would clearly exist. On the other hand, the marginal cost of capital as perceived by the controlling interests in both types of firms would rise, implying that real capital accumulation would fall.

6. Shareholder Rights

In considering the issue of shareholders rights, it is instructive to consider the situations of different classes of claimants to the corporation's assets. These comprise majority shareholders, minority shareholders, preferred shareholders, debtholders, and the holders of restricted shares.

If management in a controlled corporation is inefficient, and the takeover mechanism is blunted, then minority shareholders - in spite of their voting rights - are disadvantaged.

Those who express concern regarding the rights of restricted shareholders argue, either explicitly or implicitly, that preferred shareholders are adequately compensated for the fact that they cannot vote, while restricted shareholders as "residual" claimants are not. This argument is impossible to defend in an informationally efficient capital market.

If, for simplicity, we consider a firm with a capital structure comprised only of common shares and debt, we can make the following observation. The bondholders of the corporation own its assets, while shareholders own a call option written on these assets with a striking price equal to the book value of the debt. Bondholders do not have voting rights (although they will typically be able to exert direct control over management's behaviour in certain events such as bankruptcy.) Instead, they use restrictive covenants to protect their interests. Indeed, the myriad of restrictive covenants (on the issuance of new debt, payment of dividends, merger activity, disposition of assets, and so on) that have evolved to protect debtholders are suggestive of the devices available to holders of all classes of non-voting securities to protect their interests.

Restricted shares represent residual claims on the corporation's assets. In general, one might expect voting rights to be assigned to those claimants whose interests are most directly affected by marginal management decisions. If so, one might expect all "residual" shares to have voting rights.[8] As evidenced by market developments - for example - in Canada and Israel, this is not an inevitable outcome.[9] The notion of "shareholder democracy", because of the concomitant existence of other classes of claims to the corporation's assets, is perhaps less useful as a guide to policy than it might at first appear. To those who believe in market forces, the strongest evidence against the usefulness of this guide is the simple fact that non-voting or inferior-voting shares have found acceptance in Canadian and other capital markets.[10]

A final point merits note. One occasionally hears the argument that institutions such as pension funds may be "forced" to purchase restricted shares, given the limited set of equity investments in Canada and the 10% limit on their investments in foreign assets. There may, indeed, be sound economic reasons for eliminating this 10% limit. However, the concern that these sophisticated investors may be forced to buy restricted shares - a comment that only makes sense if these securities are overpriced - is quite unpersuasive. Informed investors will purchase such shares only at a price which produces an expected return commensurate with their risk. Indeed, to the extent that new issues of restricted shares must be attractive to institutional investors if they are to be successful, these investors will ultimately exert an important influence on the evolution of this financial instrument.

7. The Market for Corporate Control

The OSC suggests that a competitive market for the right to manage corporate resources is likely to contribute to the efficient allocation of real resources. Received economic analysis supports this position. Interestingly, no reference is made to the fact that the follow-up provisions in Part XIX of the Act may conflict with this objective.

In theory, the use of restricted shares could be used to facilitate take-over bids, given the follow-up provisions under Part XIX of the Ontario Securities Act. Indeed, this point is undoubtedly well understood by some issuers of restricted shares.[11] Issuers of restricted shares may prefer to think of the take-over bid mechanism as a way of ensuring that investors cannot permanently underestimate the value of their firms, rather than as a way to tap market forces designed to promote the efficient management and utilization of resources. Whatever the motivation for the desire of some issuers to facilitate the take-over mechanism, the possibility (or likelihood) remains that take-overs will serve to discipline inefficient management.

The use of restricted shares without "coat-tail" provisions may - by making them less costly - facilitate take-overs. Yet it would be premature to conclude that the <u>net</u> effect of their use is to promote take-overs. Restricted shares are used by controlling shareholders to raise equity capital without diluting control. Majority shareholders may view these shares as a means of ensuring their <u>long-term</u> control of the corporation's assets. One might thus argue that restricted shares impede the take-over mechanism, at least if management is "hostile" to the proposed take-over. (By allowing acquiring firms to make more generous bids to the common shareholders, restricted shares may reduce the incidence of "hostile" take-over bids!) This latter argument is incomplete, however, until one considers what the majority shareholders would do if they sought to retain control but were not permitted to issue restricted shares. In general, the question of the net impact on the market for corporate control of the use of restricted shares merits further investigation. Answers to empirical questions, such as the relative importance of different reasons why firms have issued restricted shares, are likely to prove important in this regard.

8. The Concentration of Power

The question of whether control does or does not contribute to the efficient allocation of real resources is beyond the scope of the present background paper. Nonetheless, at least one argument put forward by the OSC merits comment.

In its "Position Paper", the OSC argues (p. 16):

> "With the proliferation of restricted shares we can be assured that although the majority of Canadian companies may one day be widely owned, most will continue to be closely controlled".

Again, the OSC pays too little attention to the likelihood that restricted shares are appropriately priced by the market. If extant corporations are to grow, they will need continued access to new capital. If majority shareholders seek to maintain control with but a small equity position, the corporation will experience a sharp increase in the effective cost of raising new debt or equity capital. The pessimistic scenario envisioned by the OSC ignores the corrective mechanism of the marketplace.

V. Review of Additions and Amendments to Policy 1.3

The perspective of received economic analysis on the Additions and Amendments to Policy 1.3 is developed in detail in the previous discussion. It is sufficient here to summarize the precise implications for the specific initiations put forward as interim measures by the OSC.

1. Protective or "Coat-tail" Provisions

Requiring "coat-tail" provisions for restricted shares is an initiative designed to parallel the follow-up provisions to minority shareholders required under Part XIX of the Ontario Securities Act.

Because theory and evidence suggest that capital markets are efficient with regard to publicly available information, this initiative would appear to be unnecessary.

If holders of restricted shares desire to be protected from untoward management behaviour and/or to participate in any premium bid for control, then voluntary "coat-tail" or like provisions will appear as a market response. Such provisions may not be universal nor homogeneous, as market forces dictate.

To ensure continuous disclosure, and to reduce any extant concern regarding "incorrect" pricing, it might be useful to segregate restricted shares on stock exchange listings.

2. Minority Approval of Capital Reorganizations

This initiative, again motivated by the apparent desire of the OSC to pre-empt potential abuses, is unnecessary in an informationally efficient capital market.

The OSC appears to pay too little attention to the introduction by market forces of restrictive covenants and other devices designed to limit management's ability to act against the interest of various classes of claimants to the corporation's assets.

Since corporations are issuing and investors are buying restricted shares, one may conclude that the allocative efficiency of the capital market will be impaired if the use of such shares is restricted and/or made more costly.

3. Voluntary Offers for Non-Voting Shares

Until the draft amendments cited by the OSC are made public, it is not possible to analyze the thrust of this initiative.

VI. Empirical Research Necessary to Address the Concern that the Market May Fail to Understand the Attributes of Restricted Shares

There is as yet no comprehensive study of the pricing of restricted shares on the Toronto Stock Exchange. Such a study would seem to be essential if those who express the concern that these securities are "incorrectly" priced are to be persuasive in their argument.

Prior analysis suggests that the presence or absence of voluntary "coat-tail" provisions, together with the market's differential assessment of the likelihood of take-over bids, may be a major source of the cross-sectional variation in discounts assigned by the market to restricted shares. Liquidity considerations and the like would also have to be factored into the analysis. Related questions include, for example, whether restricted shares created through a capital reorganization trade at a larger discount than do primary issues. In cases in which concerns relevant to non-resident ownership influenced the decision to issue restricted shares, are price discounts smaller than when no such motives exist?

To conduct an empirical study, one could proceed as follows. First, define the universe of firms which have common and restricted shares that actively trade. Secondly, identify those measurable features of the restricted shares - "coat-tail" provisions, dividend or winding-up preferences, relative liquidity and so forth - that ought to be reflected in any price premium (or discount) assigned by an efficient market to the common shares. Thirdly, identify through regression analysis - and for different points in time - the extent to which the variations in these premiums across firms can be related to the measurable features of the restricted shares. Because of the key importance of one non-observable factor, the probability assigned by the market to a premium bid for control, one would not expect to be able to explain all (or nearly all) of the variation in premiums across firms. Nonetheless, the analysis might show, for example, that after holding constant other relevant features, restricted shares with "coat-tail" provision traded at smaller discounts than did restricted shares without "coat-tail" provisions. This and like evidence, if observed, would tend to deflect the concern that the market fails to understand the attributes of such shares.

In addition, and as a useful auxiliary to the empirical study above, it would be instructive to examine, on an issue by issue basis, both (1) the provisions accorded the restricted shares and their place in the capital structures of the issuing firms and (2) the motives behind the decision to issue restrictive shares, to the extent that they can be discerned. This exercise is crucial if one wishes to determine, for example, whether the recent acceleration in the use of restricted shares is likely to be a temporary or a permanent phenomenon. If the NEP were to change so as to eliminate penalties for non-resident ownership, how might this affect the growth of restrictive shares? What would happen if interest rates (and thus the required dividend yield on preferred shares) were to drop sharply? These and other questions draw attention to an important gap in the present debate regarding the pros and cons of restricted shares.

FOOTNOTES

1. In the capital asset pricing model (CAPM), the equilibrium return on a portfolio of common stocks will rise with its beta coefficient, which measures its systematic or nondiversifiable risk. In the arbitrage pricing theory (APT), risk is not one-dimensional and the equilibrium return on a stock portfolio will be an increasing function of its positive correlation with each of a multiple of sources of systematic risk. See any finance textbook for a detailed treatment of these models.

2. For a capsule summary of this literature, see (for example) Thomas E. Copeland and J. Fred Weston, Financial Theory and Corporate Policy (Reading, Mass.: Addison-Wesley, 1983), chapter 10. An illustrative (and widely used) introductory text which - in synthesizing this literature - explains why the presumption is that capital markets are informationally efficient is Richard Brealy and Stewart Myers, Principles of Corporate Finance (New York: McGraw-Hill, 1981).

3. Grossman and Stiglitz have noted the theoretical impossibility of completely efficient capital markets, since no agent would have an incentive to process information in such a world. Under certain circumstances, market prices will nonetheless reveal most of the information known to the informed traders, who still receive some benefit from their efforts to acquire information. See S.J. Grossman and J.E. Stiglitz, "The Impossibility of Informationally Efficient Markets", American Economic Review 70: No. 3 (June 1980).

4. M.C. Jensen and R.S. Ruback, "The Market for Corporate Control: the Scientific Evidence", Journal of Financial Economics, Volume II, April 1983.

5. The Broadcasting Act, for example, requires 80% Canadian control. It is easy to see how restricted shares may facilitate compliance with this requirement. This is not to say, of course, that restricted shares represent the only means of compliance.

6. See Haim Levy, "Economic Evaluation of Voting Power of Common Stock", Journal of Finance, 38: No. 1 (March 1983): 79-93. The use in Israel of shares with different voting rights is traced in large part to growing family businesses whose founders welcomed growth but sought to retain control. The parallel with many Canadian firms is clear.

7. The Board of Directors of Argaman, for example, adopted a resolution which directs that 4% of the profits before taxes be paid as an administration fee to the Kleer family, which are the founders of the company. See Levy, op. cit., p. 87.

8. For an elaboration of this viewpoint, see F.H. Easterbrook and D.R. Fischel, "Voting in Corporate Law", Journal of Law and Economics, XXVI (June 1983): 395-427.

9. In both Canada and Israel, the introduction of non-voting or inferior voting shares reflects - in part - the desire of growing, often family business, to obtain external equity without sacrificing control. Is it possible that the influential decision by the New York Stock

Exchange (NYSE) not to allow non-voting shares reflects the lack of like demands in the United States? More generally, is it useful to think of the NYSE's position as an endogenous response to different market forces? If mandatory "follow-up" provisions were common in the United States, or if the U.S. Government established restrictions or incentives relevant to resident ownership and control, would there be pressure on the NYSE to change its present policy? Why has the NYSE seen fit to ban non-voting preferred shares, while non-voting preferred shares are readily acceptable to Canadian regulators?

10. As noted by Levy, op. cit., firms with non-voting shares represent only a negligible fraction of all firms whose shares are listed on exchanges in the United States. The average premium for voting relative to otherwise identical non-voting shares for the 26 firms in the U.S. study cited by Levy averaged 5.44%. For reasons cited earlier in the text, this premium must reflect the potential to share in any premium bid for control if minority holders of the non-voting shares are the marginal transactors.

11. Ted Rogers, founder and controlling shareholder of Rogers Cablesystems Inc., as quoted in "OSC hears mixed views on restricted shares", The Financial Post, June 22, 1984.

Appendix A

THE PRICING OF COMMON AND RESTRICTED SHARES: SOME PRELIMINARY EVIDENCE

Listed in this Appendix are the prices of the 19 pairs of dividend-paying common and restricted shares that traded on the Toronto Stock Exchange on 29 June 1984. The following summary points merit note.

1. For 13 of the 19 pairs, the common shares traded at a premium. For the 13 pairs in which the common traded at a premium, the premium averaged 8.37%.

2. For 9 of the 12 pairs in which the restricted shares were receiving no dividend preference, the common shares traded at a premium. For these 9 pairs, the premium averaged 9.37%.

The wide range in the premiums suggests that they have multiple determinants. These presumably include measurable factors such as the presence or absence of "coat-tail" provisions, dividend or winding-up preferences and relative float, together with non-measurable factors such as the market's assessment of the likelihood of a take-over bid.

The premiums also provide an important perspective on a concern raised by the OSC, that a share reorganization or share split to create restricted shares may benefit the controlling shareholders. If the common and restricted shares have claim to the same dividends, then the controlling shareholder who sells the newly created restricted to purchase common shares must pay the market premium accorded the common shares. After the split, the expected value of any premium bid for control will be reflected <u>only</u> in the common shares, which - other things equal - will be the source of the premium in their price. <u>Each year</u>, holders of restricted shares receive higher dividend yields as compensation for their non-participation in any premium bid for control that might occur <u>in that year</u>. In short, the use of a reorganization or share split is not likely to provide the controlling shareholder with an inexpensive means to consolidate control, at least if the market deems a takeover bid to be a real possibility.

	Common Share	Dividend	Price	Restricted Share	Dividend	Price	Premium
1.	Baton Broadcasting B	.32	14.5	Baton Broadcasting A	.37	13.25	9.43%
2.	CCL Industries A	.30	18.75	CCL Industries B	.40	19.5	-3.85%
3.	Canadian Tire	.20	13.25	Canadian Tire A	.20	10.00	32.50%
4.	Cara Operations	.20	11.00	Cara Operations A	.20	11.25	-2.22%
5.	Consumer's Dist'ing A	.09	6.00	Consumers' Dist'ing B	.12	6.00	0.00%
6.	Conwest Explor. A	.36	9.75	Conwest Explor. B	.36	9.75	0.00%
7.	Crownx	.30	14.375	Crownx A	.40	14.00	2.68%
8.	Denison A	1.00	16.75	Denison B	1.00	15.00	11.67%
9.	Doman A	.025	2.45	Doman B	.025	2.25	8.89%
10.	Irwin Toy	.26	6.375	Irwin Toy	.26	6.00	6.25%
11.	Keg Restaurants	.14	5.00	Keg Restaurants A	.16875	4.45	12.36%
12.	Laidlaw Transp. A	.20	13.625	Laidlaw Transp. B	.20	12.75	6.87%
13.	Maclean Hunter	.40	18.00	Maclean Hunter Y	.45	18.00	0.00%
14.	Nfld. Capital B	.05	5.625	Nfld. Capital A	.05	5.75	-2.17%
15.	Norcen Energy	.50	16.50	Norcen Energy	.50	14.75	11.86%
16.	Revelstoke B	.10	6.125	Revelstoke B	.20	7.25	-15.52%
17.	Scott's Hospitality	.28	13.5	Scott's Hospitality	.28	13.00	3.84%
18.	Teck Corp. A	.15	9.75	Teck Corp. B	.15	9.625	1.30%
19.	Trizec B	.35	22.00	Trizec A	.35	21.75	1.15%