

Equity Derivatives and the Challenge for Berle's Conception of Corporate Accountability

*Janis Sarra**

I. INTRODUCTION

With the proliferation of equity derivatives¹ and related structured financial products, the North American conception of corporate governance faces a new and distinct challenge to its underlying premises. The shareholder-primacy model rests largely on the linkage between economic interest and legal rights. Yet, the introduction and rapid growth of equity swaps, contracts-for-difference, and equity monetization² has meant that many significant equity investors have fully hedged their economic interest in the corporation, substantially altering relationships between corporate directors and their equity investors. Equity derivatives separate shareholder votes from economic interest³ and, in that respect, challenge the underlying premise of shareholder primacy, which is that default control rights and accountability of corporate officers should be directed toward the equity investors who have the greatest economic stake in the corporation.

This Article analyzes these developments with a focus on the implications for director and officer accountability and corporate sustainability, using the occasion of the third symposium of the Adolf A. Berle, Jr. Center on Corporations, Law & Society to consider whether Berle's analysis of corporate accountability offers any insights into how to address the uncoupling of economic interest and legal rights in corporate governance. Part II of this Article sets the context for the discussion, dis-

* Dr. Janis Sarra, Professor of Law, Faculty of Law, University of British Columbia, Vancouver, Canada, and Director, Peter Wall Institute for Advanced Studies.

1. Equity derivatives are generally over-the-counter structured financial products and include equity swaps, options, and futures. *See infra* Part III.

2. Contracts-for-difference are, in essence, an agreement between the buyer and seller to exchange the difference in the current value of a share and its value at the end of the contract, while equity monetization is a form of hedging risk of equity investments. *See infra* Part III.

3. Janis Sarra, *New Governance, Old Norms, and the Potential for Corporate Governance Reform*, 33 *LAW & POL'Y* 576 (2011).

tinguishing the model of corporate governance prevalent in the United States from models applied elsewhere. It also briefly discusses why Berle's shareholder-accountability model resonated with governance challenges at the time Berle wrote. Part III examines how the introduction of equity swaps and similarly structured financial products has, in a number of instances, uncoupled legal rights and economic interests, fundamentally challenging some of the underlying rationales for the shareholder-primacy model. Part IV discusses director and officer accountability in jurisdictions where equity swaps have become prevalent, and Part V considers directors hedging their own risk through derivatives activities. Part VI briefly examines why some of the current regulatory initiatives do not address the accountability concerns raised by derivatives activities, and Part VII provides some initial thoughts as to how Berle's original reasoning might be adapted to a more nuanced model of corporate governance and accountability. Part VIII concludes by noting that Berle's analysis that the exercise of corporate power is subject to the equitable limitation that it cannot harm the interests of equity holders can potentially be applied to a broader set of stakeholders, and that the good faith conduct of directors and officers may play a role in determining what economic interest is actually at risk.

II. OVERALL CONTEXT OF CORPORATE ACCOUNTABILITY

The equity derivatives issues discussed below implicate only particular types of corporate-governance regimes, most specifically in the United States and, to a lesser degree, Canada, the United Kingdom, and other countries that have adopted various iterations or forms of a shareholder-primacy model. Globally, there are many types of corporate-governance frameworks that link the management and oversight of corporations to a variety of objectives. While most, but not all, companies share a wealth-maximizing objective, the fiduciary and other relationships they have with their multiple stakeholders temper those objectives in a myriad of ways across jurisdictions. The behavior of directors and officers reflects cultural, social, and political norms. The United States' model is generally less concerned with continuing relationships with employees, relationships of trust, and business dealings with commercial counterparties than the governance structures used in countries such as Japan and Korea.⁴

4. Janis Sarra & Masafumi Nakahigashi, *Balancing Social and Corporate Culture in the Global Economy: The Evolution of Japanese Corporate Structure and Norms*, 24 *LAW & POL'Y* 299 (2002).

Companies protect and take greater account of the interests of employees, creditors, the community, the environment, and other stakeholders in very different ways, and there are numerous multi-stakeholder models of corporate accountability across the globe. In jurisdictions such as India and Canada, pyramid capital structures mean that controlling shareholders' influence over decision-making and the board selection process is disproportionate to their actual equity holdings.⁵ Yet, when the controlling group has familial or other close relationships, they are often also more committed to the long-term sustainability of the company, even if there is a potential conflict of interest regarding decisions that could extract value for their personal reward to the detriment of the company. Employee participation in governance is the norm under the governance models used by some countries, such as the codetermination model in Germany or the employee-board-appointee model in Japan. In some instances, it is linked to shareholding; in others, it is not. Such corporations are often operated in the best interests of a broad set of stakeholders.

The United States has historically had a much narrower conception of corporate accountability and governance. The structure of corporate accountability has operated on a more limited understanding of director and officer obligations; specifically, corporations are to be operated in the best interests of the corporation and its shareholders, often collapsing shareholder and corporate interest in what is referred to as the "shareholder-primacy" model.⁶

The approach was premised on the notion that shareholders have direct economic interests at risk in the corporation. Hence, the traditional corporate law norm in the United States is that shareholders have a bundle of rights that reflect their status as residual economic claimants of the corporation, including voting rights, as well as the right to have an appraisal conducted or a disclosure made, receive any dividends declared, trade or sell shares, and bring personal or derivative claims for either personal harms or harms against the corporation.⁷ In Canada, shareholders also have the ability to bring oppression claims against the directors and officers for acting in a manner that is oppressive or unfairly prejudi-

5. CHRISTOPHER NICHOLLS, TASK FORCE TO MODERNIZE SEC. LEGISLATION, THE CHARACTERISTICS OF CANADA'S CAPITAL MARKETS AND THE ILLUSTRATIVE CASE OF CANADA'S LEGISLATIVE REGULATORY RESPONSE TO *SARBANES-OXLEY* 127 (2006), available at <http://www.tfmsl.ca/docs/V4%283A%29%20Nicholls.pdf>.

6. JANIS SARRA, CORPORATE GOVERNANCE IN GLOBAL CAPITAL MARKETS 22 (2001).

7. ROBERT YALDEN & MARY CONDON, BUSINESS ORGANIZATIONS, PRINCIPLES, POLICIES AND PRACTICE (2007); Sarra, *supra* note 3.

cial, or that unfairly disregards the interests of shareholders.⁸ On wind-up of a financially solvent company, shareholders enjoy the right to a proportional share of the company's economic value. This bundle of rights was designed to reflect the residual economic interests of investors arising from their equity investment.⁹ The degree of economic interest in the company is traditionally viewed as commensurate with the number of shares held. Thus, the shareholder-primacy model suggests that shareholders have the greatest incentive to hold managers accountable for their actions due to their interest in the corporation, and directors and officers are to make decisions in the best interests of shareholders.

There has historically been greater incentive to explore different mechanisms through which to influence corporate governance for equity investors with significant holdings at risk, particularly where the investors are interested in long-term investment in the firm. Large institutional shareholders, such as pension funds, have directly engaged corporate boards in their governance practices and oversight, having determined that active engagement is in the best interests of the investors whose assets they manage.¹⁰ They have often served as lead shareholders in proxy fights or lead plaintiffs in legal actions to hold the corporation and its officers accountable for particular decisions or conduct.¹¹ Controlling and institutional shareholders have brought their own normative values and preferences for governance to their efforts to influence corporate behavior and hold directors and officers accountable.¹²

A. Berle's View of Corporate Accountability to Shareholders

As Berle observed, corporate managers in the United States have historically had to run their affairs in the interests of their security holders.¹³ He argued that large-scale production has necessitated a high degree of financial concentration that has clothed itself in the corporate form, and as a result, there are large entities, the task of whose administration is fundamentally that of industrial government.¹⁴ Berle was concerned with the absolute control and power that would be acquired by

8. Canada Business Corporation Act, R.S.C. 1985, c. C-44, s. 229(2)(b) (Can.). Creditors in some Canadian jurisdictions can seek an oppression remedy but only with leave from the court.

9. JANIS SARRA, CREDITOR RIGHTS AND THE PUBLIC INTEREST 30–53 (2003).

10. *See, e.g.*, CalPERS, <http://www.calpers.ca.gov/> (last visited May 17, 2012); Ontario Teachers' Pension Plan, <http://www.otpp.com> (last visited May 17, 2012).

11. *See id.* (discussing annual proxy reporting).

12. State-ownership jurisdictions, such as China, pose another entire set of challenges for governance and accountability that are beyond the scope of this Article. *See SARRA, supra* note 6.

13. A. A. Berle, Jr., *For Whom Corporate Managers are Trustees: A Note*, 45 HARV. L. REV. 1365, 1365 (1932).

14. *Id.* at 1366.

managers if the fiduciary obligation of corporate management and “control” owed to shareholders was weakened or eliminated.¹⁵ While he acknowledged the powerful impact of corporations on the lives of multiple stakeholders, he was concerned that absent shareholder primacy, directors and officers would engage in self-interested conduct rather than act in the best interests of the corporation, and he believed that shareholders were best-situated to hold officers accountable for their decisions.¹⁶

Berle argued that all powers granted to corporate managers were necessarily to be exercised in the best interests of shareholders at all times.¹⁷ His view was that the exercise of corporate power was subject to the equitable limit that it could not harm the interests of equity holders, even if the power had been exercised within the mandate of the directors.¹⁸ Thus, he argued, corporate powers must be tested twice: first to verify that corporate officers are acting within the authority granted to them, and then to verify that they are making decisions that benefit the shareholders.¹⁹ He observed that with power comes responsibility, and with the increasing range of powers and complexity of corporate activity, the overriding concern was to act in the best interests of shareholders.²⁰

As is well-known to corporate-governance scholars, Berle tested his thesis against particular powers, such as the duty not to issue new shares without protecting the rateable interest of existing and prospective shareholders.²¹ He traced the jurisprudence with respect to noncash consideration for shares and the courts’ assessment of the good faith actions of corporate officers, which he found to be a short-form expression for the obligation by directors and officers to protect shareholders’ equities by giving them the right to purchase any new shares in an amount that protected their proportional interest in the company.²² Thus, “preemptive” remedies arose from an attempt to impose an equitable limitation on the power of corporate officers to issue new stock.²³

Berle also analyzed the power to declare or withhold dividends in the best interests of the corporation as a whole and in a manner that bene-

15. *Id.* at 1367.

16. *Id.*

17. A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931).

18. *Id.*

19. *Id.*

20. *Id.* at 1050.

21. *Id.* at 1051 (noting that existing shareholders had an economic interest in the payment made by incoming shareholders). Berle also acknowledged the “equity cushion for creditors” rationale for the rule, but it was not the focus of his argument. *See id.* at 1067 n.44.

22. *Id.* at 1056.

23. *Id.* at 1059.

fits all its shareholders to the extent possible.²⁴ The power must be exercised in a manner that does not discriminate between shareholders in the same class, and discriminates between shareholders in different classes only when the corporate charter allows for such differential treatment.²⁵ Berle suggested that the power to acquire stock must be exercised in the best interests of the corporation as a whole and not to advance the enterprises of the directors and officers.²⁶ Hence, the takeover of another company must be justified in terms of the benefits to the corporation, a limitation imposed by the courts on the power that corporate officers hold.²⁷ Similarly, rights to effect a merger are subject to a requirement that the respective interests of shareholders in all classes are respectively recognized and substantially protected.²⁸

Finally, the power by the majority of shareholders to amend the corporate charter, which in Berle's view was to be exercised in a manner that benefited the corporation as a whole, equitably distributed any benefit or sacrifice between all shareholding groups in the corporation "as their interests may appear."²⁹ Rights of the minority were not to be confiscated or unreasonably oppressed. Berle observed that the courts uniformly reason that both the governing statute and the equities must be examined in making such determinations.³⁰

B. Developments in the Years since Berle

In the years since Berle's observations, the nature of shareholding has shifted, as has the capital structure of corporations. In addition to pension funds, influential shareholders now include hedge funds, private equity funds, and other significant wealth-equity investors who bring different norms to their relationship with the corporation, including frequent preferences for short-term investment. Many are highly active in hedging their equity investments through derivatives products. The incentive effects of equity swaps and related products can exacerbate the already short-term interest that some of these investors have in a corporation.³¹

24. *Id.* at 1060–61.

25. *Id.* at 1063.

26. *Id.*

27. *Id.* at 1066.

28. *Id.* at 1069.

29. *Id.* at 1066.

30. *Id.* at 1067.

31. JANIS SARRA, CREDIT DERIVATIVES MARKET DESIGN, CREATING FAIRNESS AND SUSTAINABILITY 3–5 (2008).

These developments are not confined to the United States.³² As multinational enterprises (MNE) grow in number and size, the structure of corporate governance has necessarily evolved. Often, corporations incorporate separate entities in the local jurisdictions in which they operate, ostensibly with separate corporate structures, directors, and officers, but frequently with the parent or holding company as the sole or controlling shareholder. Decision-making in those entities has increased in complexity; the degree of control over subsidiaries ranges across a broad spectrum, creating new challenges for director and officer accountability.³³ Even when subsidiaries are publicly traded in regional or international markets, directors and officers working in subsidiaries in the host nations have often been heavily influenced by parent-company choices. Parent corporations influence governance through the transfer of norms and practices, including notions of accountability, responsibility, and sustainability.³⁴

Just as MNE have proliferated, hedge funds and other large investors have become international in the scope and complexity of their investments, holding interests in multiple jurisdictions. Host countries and their regulators must deal with foreign investors who are beyond easy reach of their domestic corporate and securities laws. Widespread foreign investment has implications for host countries; as such investors often use their influence on parent companies in the home jurisdiction to lobby for particular norms or practices, such as uploading profits earned in the subsidiary on a daily or weekly basis to the parent corporation, leaving insufficient assets in the host-country entity.³⁵ Their commitment to sustainability³⁶ and protection of domestic stakeholders and communities may be fleeting or nonexistent given the pressure for high short-term returns on their principals. Equity investment can be highly dynamic, such that share ownership is changing rapidly, reducing incentives to monitor corporate officers.

Even with the increase in advocacy for corporate social responsibility, corporate sustainability, triple bottom-line accounting, and other mechanisms that recognize that corporations' position within society provides them with a powerful influence over multiple aspects of the environmental, social, and economic lives of individuals, the shareholder-

32. *Id.* at 5.

33. Sarra, *supra* note 3, at 578–82.

34. Janis Sarra & Vivian Kung, *Corporate Governance in the Canadian Resource and Energy Sectors*, 43 ALTA. L. REV. 905 (2006).

35. Sarra, *supra* note 3, at 582.

36. FED'N OF EUROPEAN SEC. EXCHS., *SHARE OWNERSHIP STRUCTURE IN EUROPE* (2008), available at http://www.bourse.lu/contentu/docs/commun/societe/Actualites/2008/FESE_SHARE_OWNERSHIP_SURVEY_2007.pdf.

primacy norm has maintained its dominance in both North American case law and board rooms.³⁷ While this notion has been tempered slightly through corporate constituency statutes in the United States (which do not have effective remedies) and appellate case law in Canada,³⁸ concerns about director and officer accountability have firmly entrenched the notion that corporate interests can often, if not largely, be measured on a quarter-by-quarter basis through each corporation's success in delivering financial returns to equity investors.

Both in the United States and elsewhere, corporations and institutional shareholders who are interested in the development of effective corporate-governance norms have concluded that numerous factors influence effective oversight, including independent decision-making, financial-literacy skills, relationships with internal and external stakeholders, and other indicia of effective governance.³⁹ Most of those indicia can be measured against the benchmark of shareholder interest or broader stakeholder interest. There rests a normative question of whether, in reality, directors and officers in their governance decisions consider only the interests of shareholders, and not the more complex interests and considerations relating to markets, creditors, employees, and communities with which the corporation is involved. Even advocates of the simplistic manager-shareholder, economic agent-principal dichotomy face significant challenges to their underlying assumptions with the introduction and proliferation of equity derivatives.

III. ENTER EQUITY DERIVATIVES

The development of equity derivatives is a significant change to the nature of economic interest held by shareholders of a corporation. In some respects or situations, it can fundamentally challenge the underlying premises of the shareholder-primacy approach to corporate accountability.

Equity derivatives are generally over-the-counter (OTC) structured financial products, and include equity swaps, options, and futures. An investor can purchase equity derivatives to manage the economic risk of purchasing traditional shares. Equity derivatives and credit derivatives, the latter of which are not discussed in this Article, have experienced an

37. Sarra, *supra* note 3, at 599–602.

38. Peoples Dep't Store Inc. (Trustee of) v. Wise [2004], 3 S.C.R. 461 (Can.). For a discussion of the case, see generally JANIS SARRA & RONALD DAVIS, DIRECTOR AND OFFICER LIABILITY IN CORPORATE INSOLVENCY, A COMPREHENSIVE GUIDE TO RIGHTS AND OBLIGATIONS (2d ed. 2010).

39. Janis Sarra, *Corporate Social Responsibility in the Global Economy: Canadian Domestic Law and Legal Processes as a Vehicle for Creating and Enforcing International Norms* (Canadian Inst. for the Admin. of Justice, Participatory Justice in a Global Economy: The New Rule of Law Conference Paper No. 668) (2004); Sarra & Kung, *supra* note 34, at 917.

exponential growth in recent years;⁴⁰ the products are opaque, complex, and continually developing. Canadian regulators also use the term “equity monetization” to refer to a variety of sophisticated derivative-based strategies that permit investors to dispose of equity risk without transferring ownership.⁴¹ In some cases, the products are essentially the same, with different terminology used to describe them. In other instances, the products hold different bundles of economic and legal rights.⁴² The actual economic interest held in such products as a hedge against the performance of a corporation is difficult to quantify at any given moment.⁴³

What Canada and the United States refer to as equity derivatives are called contracts-for-difference (CFD) in the United Kingdom.⁴⁴ CFD are derivative products that allow investors to speculate or hedge on the underlying security movements. They are used by both shareholders and other investors with no direct shareholdings, as there is no need for ownership of the underlying security.⁴⁵ CFD are generally traded over-the-counter and mirror the economic performance of the underlying security based on its price movement. CFD offer all the benefits of trading shares without having to physically own them, and they are in essence an agreement between the buyer and seller to exchange the difference in the

40. For a discussion of credit derivatives, see Elizabeth Murphy, Janis Sarra & Michael Creber, *Credit Derivatives in Canadian Insolvency Proceedings*, “*The Devil will be in the Details*,” in ANNUAL REVIEW OF INSOLVENCY LAW 187 (2006).

41. Staff Notice, Ontario Sec. Comm’n, Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario, Staff Notice No. 91-702 (Oct. 27, 2009) [hereinafter Staff Notice, Ontario Sec. Comm’n], available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/sn_20091030_91-702_cdf.pdf.

42. *Id.*; see also CANADIAN SEC. ADM’RS, CONSULTATION PAPER 91-401 ON OVER-THE-COUNTER DERIVATIVES REGULATION IN CANADA (2010) [hereinafter CSA], available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20101102_91-401_cp-on-derivatives.pdf; ONTARIO SEC. COMM’N, REFORM OF OVER-THE-COUNTER (OTC) DERIVATIVES MARKETS IN CANADA: NOTICE AND DISCUSSION PAPER (2010), available at <http://www.osc.gov.on.ca/en/29910.htm>.

43. CSA, *supra* note 42, at 14. The opacity of derivatives markets means that those parties hedging risk do not have information to assess the default risk of the counterparty or to appropriately price risk. Regulators do not have access to information that would assist in monitoring or address any build-up in systemic risk.

44. FIN. SERVS. AUTH. & HM TREASURY, REFORMING OTC DERIVATIVE MARKETS, A UK PERSPECTIVE 11 (2009) [hereinafter REFORMING OTC DERIVATIVE MARKETS], available at http://www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf; FIN. STABILITY BD., IMPLEMENTING OTC DERIVATIVES MARKET REFORMS (2010), available at http://www.financialstabilityboard.org/publications/r_101025.pdf; INV. DEALERS ASS’N OF CAN., REGULATORY ANALYSIS OF CONTRACTS FOR DIFFERENCE (CFDs) (2007) [hereinafter REGULATORY ANALYSIS OF CFDS], available at http://sdocs.iroc.ca/English/Documents/2007/CF983987-B0A4-49C8-81DF-CF5EDC640E99_en.pdf.

45. REGULATORY ANALYSIS OF CFDS, *supra* note 44. Contracts-for-difference (CFD) are typically a contract between the investor and the issuer. They have varying brand names depending on who issues them, such as Turbo Certificates, Waves, or in Hong Kong, Callable Bull/Bear Contracts (CBBC). *Id.* at 4.

current value of a share and its value at the end of the contract.⁴⁶ “If the difference is positive, the seller pays the buyer. If it is negative, the buyer is the one who loses money.”⁴⁷ While prevalent in the United Kingdom, the first CFD were not approved in Canada until 2009, and only then in two provinces.⁴⁸ Additionally, Canadian regulators have restricted such products to accredited investors only.⁴⁹

The widespread use of equity derivatives, particularly equity swaps—one of the most common forms of derivatives—poses significant questions for corporate governance. As noted above, the bundle of shareholder rights assumes a direct link between the shareholder’s legal and economic interests. Yet, derivatives challenge that fundamental notion, as they uncouple economic and legal interest in specific circumstances. Equity swaps can be cash-settled or physically settled. For cash-settled equity swaps, the shareholder retains legal title to the shares and thus the bundle of shareholder rights but is paid out the cash value of the swap on the occurrence of certain events. For example, the swap will specify a particular triggering event like a default by the company on a payment to a creditor, a management change, or the loss of a particular contract. On the event occurring and settling of the swap, the shareholder continues to hold legal title in the shares and continues to vote those shares, even though it has no further economic risk, having recouped the original investment plus any current value assigned to payout of the swap. The shareholder can still reap any upside gains. Thus, the shareholder’s legal claim under its shares has become uncoupled from its economic risk. With no financial investment at risk, the shareholder may act in ways that appear contrary to what would normally be in its economic interest, such as to press for decisions about corporate direction or activity that would benefit competitor corporations in which it does have a direct financial investment at risk.

Moreover, shareholders can over-hedge their risk by purchasing swaps of greater value than the underlying shares on which the swaps are based, in effect creating a negative economic interest in the corporation if the trigger for payment is an adverse event with respect of the corpora-

46. *Id.* The reference asset can also be a currency, commodity, or index.

47. *Contracts for Difference and CFD Trading*, CONTRACTS FOR DIFFERENCE, <http://www.contracts-for-difference.com/> (last visited May 22, 2012).

48. Staff Notice, Ontario Sec. Comm’n, *supra* note 41.

49. *What are CFDs?*, CMC MARKETS CANADA, <http://www.cmcmarkets.ca/cfd/what-are> (last visited May 22, 2012). CFD issuers must also establish cumulative-loss limits for each client’s account under Ontario and Québec securities law, including \$1 million in financial wealth other than real estate or a salary of \$200,000 over the past three years, and on condition that sellers disclose the risks of CFDs and evaluate client’s investment knowledge and trading experience. Issuers of CFDs must be registered as investment dealers and regulated by the Investment Industry Regulatory Organization of Canada (IIROC).

tion. For example, Shareholder A may have an estimated one million USD value in shares in Corporation B and equity swaps valued at two million. In such circumstances, it may be in the shareholder's interest to assist in precipitating a triggering event because the cash payout on its shares is double the value of the shares in the market. If the triggering event would have an adverse economic impact on the corporation, it would appear to an observer that the shareholder was acting contrary to its interests by depressing the value of its shares.

In a takeover situation or other fundamental transaction for which shareholders are given a vote, the equity-swap-holding shareholder may hold a significant percentage of the votes as registered owner but may have no economic interest at risk, as it has fully hedged its risk through the purchase of equity swaps. In the case of a fully or over-covered equity swap, these shareholders do not have to disclose the lack of any economic interest or risk in most jurisdictions. Directors and officers do not necessarily know whether it is the registered shareholder or the equity-swap seller who holds the economic interest in the company;⁵⁰ and yet, under the shareholder-primacy model, their governance decisions may be highly influenced by these shareholders.

Equity swaps can also be physically settled, rather than cash-settled, although such settlement mechanisms are on the decline.⁵¹ Physically settled equity swaps are less problematic for corporate accountability concerns. On the occurrence of a specified event, the swap pay-out conditions are triggered and the ownership and voting rights of the shares are traded for cash in the settlement of the equity swap. In such cases, the new shareholder has acquired the economic interest in the corporation, and as with all shareholders, it is required to disclose its shareholdings when the concentration reaches a specified amount.⁵² The corporation has new shareholders that it is accountable to, but the shareholders are now known to corporate officers or other investors. But even here, there can be some issues with respect to an investor holding a sizeable number of swaps, and then at settlement, the corporation finds it has a very significant new shareholder, say with 10 to 20% or more of holdings, that the directors and officers were unaware of until settlement of the swap.⁵³ Securities or financial services legislation in many jurisdictions requires disclosure of incremental changes in equity ownership through the

50. SARRA, *supra* note 31; Henry Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Important Extensions*, 156 U. PA. L. REV. 625, 642, 708–09 (2008); Murphy, Sarra & Creber, *supra* note 40.

51. SARRA, *supra* note 31, at 8.

52. *Id.* at 7.

53. Hu & Black, *supra* note 50, at 646–48.

threshold disclosure requirements,⁵⁴ but the transparency sought by such requirements is negated by this increasingly common practice.

Cash-settled equity swaps create a lack of transparency because the investor who holds the economic benefit of the shares but not the voting rights is frequently unknown. An investor can unwind an equity swap as per a prior agreement with the dealer and acquire voting rights, or it can, in some cases, instruct the dealer how to vote the shares.⁵⁵ When there are formal rights to unwind a swap or to direct the dealer to vote a particular way, the shareholder will likely come within the disclosure requirements of securities or financial services law if the shareholdings meet the legislative threshold.⁵⁶ But when the voting rights are not legally enforceable and relational-based or implicit, there is often no requirement for disclosure.⁵⁷

Equity swaps are primarily a North American phenomenon used to hedge or speculate on equity investment and are used to a lesser degree in the United Kingdom for that purpose. Internationally, equity derivatives are also commonly used to hedge currencies or other commodities.⁵⁸ Equity swaps are not considered securities in many jurisdictions, and are frequently not subject to disclosure and investor-protection provisions unless they fall within materiality requirements in issuer-disclosure obligations or management-disclosure requirements.⁵⁹ Alternatively, they are considered securities but are part of the exempt market, the assumption being that they are traded only among very sophisticated parties and are thus not of regulatory concern. Even if one accepts that they are not the concern of regulatory oversight, they still have implications for corporate governance and accountability.

In addition to the incentive effects created by hedge funds and similar investors over-hedging risk of their investments, parent corporations are also engaged in the equity swaps market to hedge risks associated with their wholly-owned subsidiaries or other companies in which they are directly invested. Through equity swaps, the parent corporation is controlling some of its economic risk, but such products can create new incentives to govern or influence particular subsidiaries in the short- or

54. For example, in Switzerland, the amount is 3%. *Regulation*, SWISS FED. BANKING COMM'N, <http://www.finma.ch/archiv/ebk/e/regulier/index.html> (last accessed May 22, 2012).

55. Hu & Black, *supra* note 50, at 648.

56. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78a.

57. Hu & Black, *supra* note 50, at 655.

58. Currency swaps, much more prevalent internationally, involve a much larger discussion that is beyond the scope of this Article.

59. Directors and insiders must, however, disclose all of their swaps. *See infra* Part V.

long-term interests of the parent, rather than of the subsidiaries, notwithstanding that they are separate legal entities.⁶⁰

The degree of this hedging is arguably influenced by the economic and social culture of the parent company. For example, in jurisdictions with strong blockholding corporate ownership structures, banks and other financial institutional shareholders integrated their derivatives activities on both the equity and debt side of the investment, yet their activities in this respect have been tempered by their jurisdiction's corporate norms, in terms of using such derivatives to protect or defend particular stakeholder interests. In family-owned or dominated corporations, equity derivatives might be less frequently used because the governance structure may have different sensitivities toward long-term economic sustainability and employee protection. Contractual relations might be influenced by a more nuanced understanding of fiduciary and statutory obligations to stakeholders, and thus, the incentive to over-hedge risk reduced. Therefore, governance risks from derivative activity are influenced by both the corporation's capital structure and the degree to which hedging by shareholders through equity swaps skews the behavior of shareholders actually able to influence corporate decision-makers.⁶¹

A variety of other strategies currently uncouple legal and economic interest in equity investment. Hu and Black observed that such uncoupling practices have become prevalent on a low-cost and large-scale basis in the United States. For example, the market for share lending includes 20% or more of all the outstanding shares of most large United States corporations.⁶² Hu and Black suggested that this "soft parking" of shares means that shares are held in friendly hands that have voting rights but no economic ownership and that provide access to shareholder rights when desired under an informal arrangement to either vote as directed or unwind the shares back to the hidden owner.⁶³ The parties holding these kinds of shares are often derivatives dealers or banks, allowing the hidden owner to avoid disclosure of its interest in the corporation, as well as other regulatory requirements such as mandatory bid rules.⁶⁴ The

60. Sarra, *supra* note 3, at 601.

61. CSA, *supra* note 42, at 15. AIG's financial distress and subsequent bailout in September 2008 was an instance where counterparty risk in credit-default swaps transformed into systemic risk. The lack of transparency in derivatives markets contributes to systemic risk because market participants cannot accurately measure their counterparties' exposures, and regulators cannot identify areas of concentrated risk or systemically important entities before it is too late to prevent a shock in the capital markets.

62. Hu & Black, *supra* note 50, at 701.

63. *Id.* at 639.

64. *Id.* at 639. Hu and Black also discussed "record date capture," in which the investor borrows the shares in the stock loan market just before the record date and then returns the shares after-

Hedge Fund Working Group in the United Kingdom has recommended a ban on the use of borrowed shares for empty-voting purposes.⁶⁵

Why are these trends a problem? The assumption that voting power reflects economic interest at risk is no longer valid. Shareholders with significant shareholdings are in a position to influence the decisions of directors and officers because of their voting power, even though they may have no economic risk in the outcome of those decisions. When formal votes are required, such as in respect to fundamental changes, this disconnection may skew voting results because the votes will not truly represent the wishes of investors whose interests are allied with the corporation's fortunes.

As equally important as formal voting power, significant shareholders are in a position to informally influence directors and officers through meetings, media statements, and policy positions. When those shareholders have little or no economic interest, this influence may yield results that are not in the best interests of shareholders or the corporation. When a shareholder has fully hedged its interest in the company and has an economic interest in a competitor company, the shareholder may actively press for a decision that advances its economic interests in that competitor entity. Directors and officers who seek to engage in dynamic and responsive governance practices may find it difficult to discern which investors truly have an economic interest in the corporation.

Potential takeovers create additional issues. The laws in many jurisdictions currently require disclosure of holdings above specified thresholds so that corporate stakeholders are alerted to the fact that a company is "in play." In Canada, that threshold is 10% of the target's voting stock; in the United States, the threshold is 5%.⁶⁶ Such pre-bid notifications alert other shareholders to the potential for a takeover bid and may lead to an increase in the market price of the target company's shares. But equity derivatives that allow for conversion into shares permit an investor to collect shares without technically meeting disclosure requirements of securities laws in a number of jurisdictions.⁶⁷

In 2008, Hu and Black documented more than eighty cases of using equity derivatives to skew corporate behavior in this manner.⁶⁸ One example was the case of Sulzer, a major Swiss engineering firm subject to a secret amassing of shares through use of equity derivatives. Swiss rules

ward. In such a case, the investor has no economic interest at risk but has acquired the voting rights for the purpose of the particular meeting or transaction for which the record date was set. *Id.* at 641.

65. U.K. HEDGE FUND WORKING GRP, FINAL REPORT (2008), <http://hfwg.webalistic.co.uk/?section=10352>.

66. Sarra, *supra* note 3, at 468.

67. Hu & Black, *supra* note 50, at 639–42.

68. *Id.*

at that time required disclosure of share holdings of 5% or more, capturing physically settled call options but not cash-settled equity derivatives. An Austro-Russian group was able to amass a 32% stake in the company through cash-settled call options provided by two banks, at least one of which had Sulzer as a client.⁶⁹ When the group had a sufficient stake to make a bid to acquire the company, it unwound its swaps and obtained the dealers' matched shares.⁷⁰

Thus, equity swaps are being used to bypass securities law requirements. When an investor is ready to make a bid for the company, the investor exercises the options, acquires the percentage of shares it wishes to use to make the takeover bid, and then is required to disclose. There can be considerable amassing of shares before corporate officers or other investors are aware that there is a new significant shareholder. These practices are also prevalent in Canada and the United States, although given the failure of securities regulators to require full disclosure, the extent of the practices are unknown.⁷¹

IV. DIRECTOR AND OFFICER ACCOUNTABILITY IN AN EQUITY SWAPS WORLD

The uncoupling of shareholder and corporate economic interest that occurs through equity directives can create new agency issues with respect to decision-making by directors and officers. The rapid settlement of swaps in successive waves and with minimal transparency can mean that directors and officers have little sense of where the true economic investment in their business lies. As they become more aware of the disconnect between legal voting rights and the economic interests at risk, it may affect their incentives to act in the best interests of the corporation or its shareholders, as the likelihood of being held accountable may diminish. Such an outcome is precisely what Berle sought to avoid by advocating that accountability of directors and officers be exclusively in the hands of shareholders.

Equity swaps have thus created in some instances a misalignment between the shareholders' and corporation's interests. A shareholder can invest and then purchase a swap to hedge its risk. For smaller investors, this strategy does not really have an impact on corporate governance, as the amount of holdings hedged does not affect control rights. But for hedge funds and other larger institutional investors, the disconnect be-

69. *Id.*

70. *Id.*

71. See CAROL HANSELL ET AL., DAVIES WARD PHILLIPS & VINEBERG LLP, THE QUALITY OF THE SHAREHOLDER VOTE IN CANADA, (2010), available at http://www.dwpv.com/Sites/shareholder_voting/media/The-Quality-of-the-Shareholder-Vote-in-Canada.pdf.

tween legal ownership of the shares and economic risk creates disincentives for the shareholders to monitor the activities of directors and officers. It also arguably creates negative externalities, in that small shareholders who could previously rely on the monitoring and governance role of institutional shareholders will not be aware that their incentives to monitor have been reduced. The previous signaling by institutional shareholders, either from their proxy activities, media statements, or shifting of significant investment, may no longer be reliable and may remove an important part of the synergistic aspects of investor oversight of the activities of directors and officers.⁷²

Executive compensation practices have also influenced these trends. For corporations involved in the business of swaps,⁷³ in addition to their other commercial activities, such as insurance or financial services, the high short-term earnings in the swaps market created incentives for managers not to consider the liquidity risk if there was a mass call to settle swaps, and the swaps activities may place the entire corporate group at risk.

V. DIRECTORS HEDGING THEIR OWN RISK HAS GOVERNANCE IMPLICATIONS

A frequent practice to help ensure effective corporate governance during the past several decades has been to align the interests of directors, officers, and shareholders by structuring compensation packages to provide appropriate incentives. In recent years, the effort has been to include long-term equity investments in the corporation, shifting share options, warrants, and issuance practices to ensure that corporate officers are not incentivized to act only in a manner that increases the immediate or short-term price of the shares. Requirements to hold shares for a period of time before selling and other similar initiatives are viewed as mechanisms to align manager and shareholder interest. The growing practice of directors and officers hedging their equity investments in their own corporations undermines the ability of such compensation practices to truly align interests.

Such hedging must be disclosed to investors under most corporate law statutes in North America,⁷⁴ however, there may be an issue with respect to the quality of the disclosure as to both its content and transparency within the financial disclosure documents. Moreover, it assumes that both internal and external audit functions are monitoring and correcting the quality of such disclosures and, where necessary, linking the

72. SARRA, *supra* note 31, at 468.

73. For example, corporations like Lehman Brothers or AIG.

74. *See, e.g.*, Staff Notice, Ontario Sec. Comm'n, *supra* note 41, at 15.

quantum of hedging with an assessment of the performance of the directors and officers.

Hence, the purchase of equity swaps and similar products by directors raises director accountability issues. Directors and insiders of publicly traded companies must disclose all of their swaps, but investors may not appreciate the incentive effects of directors hedging their own equity investment in the company. Corporate officers may use equity-derivative strategies to defeat changes in control by facilitating the ability of insiders or friendly third parties to vote shares with little or no economic exposure. Officers create the incentives for the voting shareholder to vote pursuant to the officers' interests, but do not directly have that control, as it would run afoul of corporate and securities laws in a number of jurisdictions.⁷⁵ Moreover, employees participating in stock-purchase programs or investing their pension benefits in the economic fortunes of the company may not understand that directors are hedging their own personal risk through equity swaps because even if disclosed, employees do not often read company financial statements. The shareholder-primacy norm already leads to a discounting of the value of employee labor and other inputs, even though employees are important stakeholders in the overall sustainability of the corporation. This discounting may be heightened when directors have hedged their own risk through equity swaps, in the sense of incentives to make decisions about the company.

If equity swaps in their current iteration are a barrier to holding directors and officers accountable, then to what extent should equity swaps be regulated or left to a self-regulatory regime? Hu and Black argued for shareholder attestation requirements, which would require large shareholders to file federal ownership-disclosure reports attesting that voted shares do not exceed economically owned shares by a specified amount or threshold.⁷⁶ They suggested that corporate law should be amended to allow firms to adopt provisions in their corporate charters to limit empty voting.⁷⁷ Arguably, the shareholder with a negative interest may be voting against the interests of general shareholders in order to trigger the settlement of swaps or for other reasons, given that it has no investment at risk.

Yet, any regulatory intervention will need to grapple with the more fundamental notion that shareholders can vote as they choose and corpo-

75. Hu & Black, *supra* note 50, at 702. Even when derivatives arrangements have not been made, these friendly relationships, such as between officers and pension-fund investment managers, can skew voting in favor of management. *See generally* RONALD B. DAVIS, *DEMOCRATIZING PENSION FUNDS, CORPORATE GOVERNANCE AND ACCOUNTABILITY* (2008).

76. Hu & Black, *supra* note 50.

77. *Id.*

rate law does not intervene to require disclosure either of their reasons for voting a particular way or to temper such behavior, aligning any policy decisions with the historical reasons for such nonintervention.

VI. CURRENT REGULATORY EFFORTS DO NOT ADDRESS THESE ACCOUNTABILITY INCENTIVES

Regulators across the world have determined that derivatives are important to the global economy, as they facilitate the transfer and mitigation of risks that could otherwise limit the ability of manufacturing companies to enter into long-term contracts or to contract in different currencies.⁷⁸ There has been some initial regulatory intervention to make swap holdings more transparent, such as the United Kingdom Financial Services Authority (FSA) changing its disclosure requirements to include cash-settled derivatives in its takeover regulation, requiring disclosure of economic ownership of 1% or more in a target company, including cash-settled CFD.⁷⁹ That increased transparency may reduce the incidence of self-dealing transactions, but it does not necessarily address corporate accountability issues, as discussed in this Part. Regulators in the G20 countries have also concluded that speculative derivatives activity is necessary, as such counterparties serve as the liquidity providers willing to accept the risks.⁸⁰ They also now realize that the risks that market participants wish to hedge can be isolated to the counterparties or can create systemic risks.⁸¹

A. Regulation of Equity Swaps in the United States

There are many regulatory issues to be debated, such as transparency, counterparty risk, central counterparty clearing facilities (CCP), creation of trade-repository creation, capital and collateral adequacy, and anti-abuse practices in the OTC market. All of these issues are important but beyond the scope of this short Article.⁸² One question of direct rele-

78. CSA, *supra* note 42, at 7.

79. REFORMING OTC DERIVATIVE MARKETS, *supra* note 44; THE PANEL ON TAKEOVERS & MERGERS, THE TAKEOVER CODE (2006), available at <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf>; Insider Reporting for Certain Derivative Transactions (Equity Monetization), CSA Multilateral Instrument 55–103 (Can. 2003).

80. CSA, *supra* note 42, at 7.

81. *Id.* at 10.

82. For example, in the United States, the Dodd-Frank Act imposes new capital requirements on swap dealers, which are defined as persons who (i) hold themselves out as dealers in swaps; (ii) make a market in swaps; (iii) regularly enter into swaps with counterparties in the ordinary course of the business for their own account, or (iv) engage in other activities that would cause it to be known as a dealer or market maker in swaps. 7 U.S.C. § 1a(49) (2008). It also imposes such requirements on major swap participants, which are defined as persons that are not swap dealers but who hold substantial positions that create counterparty exposure to the point that they could have a serious

vance, however, is whether the current regulatory measures address the governance incentive effects discussed above. The United States Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) mandates the clearing of many swap and security-based swap transactions by a clearinghouse.⁸³ A “swap” is defined by the Dodd-Frank Act to include a broad range of contracts, including equity swaps.⁸⁴ The definition of “security-based swap” in the Dodd-Frank Act includes any transaction based on a narrow-based security index, single security, or loan.⁸⁵ The Dodd-Frank Act allows a swap to be exempted from the mandatory clearing requirement if one of the two counterparties (1) is not a financial entity; (2) is using swaps to hedge or mitigate commercial risk; and (3) notifies the SEC or CFTC how it generally meets its financial obligations associated with entering into noncleared swaps.⁸⁶ Such risk-management strategies make sense to a degree, as hedging direct commercial risk does not create a systemic risk in and of itself,⁸⁷ but they

impact on financial markets. 7 U.S.C. § 1a(4)(A). The Dodd-Frank Act establishes margin requirements on uncleared swaps applicable to nonbank entities. As the result of concerns that the margin requirements may cause swap dealers to increase the prices of swap instruments or require clients to post margin, the drafters of the Act clarified that it was not intended to impose additional costs on end-users and urged regulators to consider the impact on end-users when determining margin requirements. CSA, *supra* note 42, at 41–42.

Québec Derivatives Act, R.S.Q., c. C-1, s. 14.01 (Can.) gives the AMF jurisdiction over all derivatives contracts, with a clear definition of a derivative and a regime separate from securities oversight. The Ontario Securities Act, R.S.O. 1990, c. S.5 (Can.), and the Commodity Futures Act, C.R.S.O. 1990, c. C.20 (Can.), share jurisdiction. The Canadian OTC Derivatives Working Group (OTCDWG), formed in December 2009, provides advice and coordinates efforts to meet Canada’s G20 commitments related to OTC derivatives in a manner consistent with the continuing stability of the Canadian financial system. CSA, *supra* note 42, at 9; *see also* FED. SERVS. AUTH., *supra* note 44.

83. Much of the detail will be developed through rulemaking by the United States Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC).

84. Dodd-Frank Wall Street Reform and Consumer Protection Act § 721(a)(47), 7 U.S.C. § 1a(47) (2010) [hereinafter Dodd-Frank Act]. A “swap” is defined in the Dodd-Frank Act to include a broad range of contracts, agreements, and transactions, including options that are based on other rates, currency commodities, securities, debt instruments, indices, quantitative measures, and other financial and economic interests. *Id.* Swaps also include transactions that provide for a purchase, sale, payment, or delivery that is dependent on the occurrence or nonoccurrence of a contingency associated with financial consequences; transactions that provide for payments based on interest or other rates; and transactions that are commonly known in the trade as swaps or swap agreements. *Id.*

85. Dodd-Frank Act § 761, 7 U.S.C. § 1a(42).

86. *See* Dodd-Frank Act § 723, 7 U.S.C. § 2(h)(7)(A). The Dodd-Frank Act gives a nonfinancial end-user the choice as to whether to clear or not, and where to clear the trade. *Id.* § 2(h)(7)(B). The CFTC and SEC must review on an ongoing basis all swap contracts to determine if a swap or category of swap contract should be required to be cleared. Clearinghouses must submit any swap it plans on accepting to the CFTC or SEC for clearing, and the regulator then determines if the swap should be required to be cleared.

87. The CSA is currently considering whether the requirement for clearing and collateral should apply if the derivative contract is not unique or is essentially equivalent to a standardized contract, and whether the availability of an exemption should depend on the counterparty to the derivatives transaction or the volume of derivative transactions. Press Release, Can. Sec. Adm’rs,

generally fail to account for the incentive effects on the directors and officers created by such exemptions.

Corporations, significant and institutional investors, directors, and officers using equity swaps are exempted from many provisions, as they do not fall within the definition of a financial entity. Moreover, there is a lack of clarity on how “hedging of commercial risk” is defined, as well as how it will be disclosed, measured, or monitored for those entities that are swept under the provisions. The measures do not address the uncoupling of economic interests and legal rights. Thus, the very incentive effects that negate the force of the shareholder-primacy argument have not been addressed.

The Dodd-Frank Act requires that registered swap dealers and major swap participants conform to business conduct standards prescribed by the CFTC and SEC relating to fraud, supervision, and adherence to position limits.⁸⁸ Among other measures, disclosure of material conflicts of interest will be required, which could in some small measure serve to temper the negative externalities associated with corporate officers or significant shareholders over-hedging risk through swaps.

Arguably, though, other transparency requirements are necessary. Until we can better see how equity swaps and other derivatives transactions may be skewing director and officer accountability mechanisms, it is difficult to conceptualize either a governance model or regulatory strategy to remedy the most egregious problems.

B. Swaps North of the Border

Canadian regulators have concluded that most companies that participate in the OTC derivatives market do so to hedge their risk—to mitigate or offset the financial risks that arise from their activities. But standardized OTC derivative products may be harmful to such risk mitigation.⁸⁹ In Canada, as in the United States, regulators are concluding that

The CSA Seeks Comments on the Regulation of Over-the-Counter Derivatives Surveillance and Enforcement (Nov. 25, 2011), *available at* <http://www.securities-administrators.ca/aboutcsa.aspx?id=997&terms=derivatives>.

88. The requirements specifically include the following: reporting and recordkeeping, including maintenance of daily trading records and a complete audit trail; verification of counterparty eligibility as an eligible contract participant; documentation and back office standards; disclosure to counterparties of contract characteristics, any material incentives and conflicts of interest; core principles for compliance and designation of compliance officers; antitrust considerations; and disclosure. 7 U.S.C. § 6s(h)(1).

89. CSA, *supra* note 42, at 24–25. The CSA has concluded that the use of OTC derivatives by these end-users is focused on transferring a risk arising from the end-user’s business to a third party, and is not intended to create a profit through speculation. And the OTC derivative is tailored to the business of the end-user and in some situations may not be considered to be a standardized OTC derivative for the purpose of applying various regulatory proposals. *Id.* at 46.

regulatory reform should not hinder such risk-offsetting activities, including efforts by corporations to avoid volatility in their income statements through hedge accounting.⁹⁰ The result is a move to exempt individual corporations from CCP clearing if the regulator concludes that central clearing is not appropriate, although these exemptions are currently in the process of being defined both in Canada and elsewhere.⁹¹

Canadian securities regulators have concluded that an exemption should not be available to speculative transactions, which could limit the “over-hedging” that currently occurs.⁹² It anticipates fulsome reporting without exemptions for trades to a trade repository, which enables regulators to monitor all market activity, including potential systemic risks and use of exemptions. Regulators will retain authority to remove a market participant’s exemption in cases where it is in the public interest.⁹³

The regulatory reforms in the United States and Canada address the systemic problems with allowing the hedging of risk, but the exemptions used by corporations and shareholders mean that the incentive effects for corporate governance of equity swaps created by the uncoupling of legal rights and economic interest are not addressed. Hence, the question is whether Berle’s analysis can offer any insights.

VII. USING BERLE’S IDEAS TO RECONCEPTUALIZE DIRECTOR AND OFFICER ACCOUNTABILITY

When powers are granted to directors and officers to act in the interests of the corporation as a whole, Berle argued that the tacit assumption is that those powers are to be used only for the benefit of all, and not to favor one set of shareholders over another.⁹⁴ Significantly, Berle observed the following:

90. *Id.* Canadian securities regulators observed in their market participants report: Hedge accounting seeks to reflect the results of effective hedging activities, in particular hedging using derivatives, by reporting the effects of the derivative and the risk being hedged in the same period. Hedge accounting “avoids much of the volatility that would arise if the derivative gains and losses were recognized in the income statement, as required by normal accounting principles.”

Id. at 25 (internal citations omitted).

91. *Id.* at 26.

92. *Id.* at 48.

93. The exercise of public-interest jurisdiction by regulator would include situations when there is evidence of trading activity that is effectively equivalent to the nature and type of business conducted by regulated market participants, as well as situations that involve the trading of an OTC derivative that presents a significant risk to the market or that results in a material risk to an entity that is systemically important to the market or the overall economy. *Id.* at 48.

94. Berle, *supra* note 17, at 1073; *see also* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

Now I submit that you cannot abandon emphasis on “the view that business corporations exist for the sole purpose of making profits for their stockholders” until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.⁹⁵

Hence, his rejection of a stakeholder model of accountability was in part driven by the lack of clearly enforceable corporate officer responsibility mechanisms to replace direct shareholder economic interest.

In Berle’s conception of corporate accountability, the link between the economic interest and legal rights held by shareholders was significant.⁹⁶ If directors or officers act in a manner contrary to shareholder interests, then shareholders would have the incentive to hold them to account through exit from the corporation, exercise of voting power to replace managers, or exercise of legal claims for financial redress from harms caused by particular decisions.⁹⁷ It is the coupling of economic interests and incentives to hold managers accountable that have been at the heart of the shareholder-primacy approach.

A principal objective of corporate governance is to maximize the wealth-generating capacity of the corporation. The unifying notion is that directors have a fiduciary obligation to act in the best interests of the corporation and thus to maximize enterprise value through the oversight of managerial activity in the effective use of corporate assets. Juxtaposed against these norms are statutory standards.⁹⁸ In 2004, the Supreme Court of Canada in *Peoples Department Stores v. Wise* held that the “best interests of the corporation” should not be read simply as the “best interests of shareholders” and that from an economic perspective, the best interests of the corporation means maximizing the value of the corporation.⁹⁹ The Supreme Court held that various factors and stakeholder groups may be relevant in determining what directors should consider in soundly managing with a view to the best interests of the corporation.¹⁰⁰ In a subsequent case, the Supreme Court held that “deference should be accorded to business decisions of directors taken in good faith and in the performance of the functions they were elected to perform by the shareholders.”¹⁰¹

The ability to mask the accumulation of shares creates incentives for investors to use equity derivatives to avoid requirements of securities

95. Berle, *supra* note 13, at 1367.

96. Berle, *supra* note 17, at 1073.

97. *Id.*

98. *Peoples Dep’t Store Inc. (Trustee of) v. Wise* [2004], 3 S.C.R. 461 ¶ 42 (Can.).

99. *Id.*

100. *Id.*

101. *BCE, Inc. v. 1976 Debentureholders* [2008], 3 S.C.R. 560 ¶ 99 (Can.).

regulation, defeating the public policy objectives of such disclosure rules. Moreover, the separation of formal voting rights and economic interest may create negative externalities with respect to corporate decision-making, where shareholders exercise voting rights on fundamental-change transactions and there is a need for transparency through additional disclosure. But the extent of that disclosure, the policy rationales of requiring disclosure, and any sanctions stemming from a failure to disclose require discussion of their associated public policy considerations. Given the lack of transparency of the extent of equity derivatives, rulemaking in this respect is difficult. We do not know precisely the harms that may be attributable to the disconnect between legal voting rights and economic interest.

Regulatory intervention may be the answer in both corporate and securities regulation, but the nature and scope of such intervention is unclear. What are the underlying policy objectives and principles that should be set with respect to the incentive effects of equity derivatives? Given Berle's caution that with power comes responsibility, which has been amplified by the increasing range of powers and complexity of corporate activity, how can policy help align the decisions of corporate officers with stakeholders that have the most economic interests at risk?¹⁰² Only then it is possible to determine whether there should be prohibitions on the voting of shares when a particular shareholder has no economic interest, or limitations on voting when particular thresholds above real economic interest are not met. If intervention is warranted, what outcome should be sought and do principles of conduct meet those objectives, or is more detailed regulation required? Should any intervention be facilitative—for example, allowing companies to change their constating documents¹⁰³ to prohibit voting of shares when there is no economic interest at risk—or should it be more standards-based, imposing the same standards across all companies? Shareholders could decide that an effective practice would be to develop a capacity to monitor share lending, ensuring that the borrowing parties generally meet good governance standards or at least do not intend to use the shares to advance interests contrary to those of the lending company and its shareholders.

The equity swaps example is not an isolated one. Other forms of equity derivatives and a massive number of credit derivatives create similar agency and externality problems. Given that the underlying notion of corporate governance is that those with economic interests influence decisions, the uncoupling of legal and economic interests needs to

102. Berle, *supra* note 17, at 1050.

103. Depending on the Canadian jurisdiction, such documents are corporate articles or corporate memoranda. See YALDEN & CONDON, *supra* note 7.

be made transparent and included in future models of director and officer accountability.

Equity derivatives also represent a challenge for advocates of socially responsible investing. To the extent that socially responsible investing attempts to expand the number of factors considered in the governance of companies and the sustainability of their economic and productive activities, it must account for the growing and nontransparent practice of uncoupling economic interest from shareholder voting rights. The wealth-maximization goals of corporate officers are, for socially responsible investing, overlaid with the goal of maximizing wealth in a manner that is socially responsible and aimed at long-term economic, social, and environmental sustainability. The unifying notion is that directors have a fiduciary obligation to act in the best interests of the corporation and thus maximize enterprise value through oversight of managerial activity in the effective use of corporate assets. These objectives may require new transparency and accountability norms to ensure that directors and officers do act in the best interests of the corporation through the use of long-term socially responsible and sustainable activities.

The range of corporate accountability problems raised by the existence of equity derivatives echo those discussed by Berle when he suggested that shareholder primacy is the solution to the unaccountability that would be created by a broader stakeholder-accountability structure. The disparate and conflicting interests of shareholders are now as complex and difficult as those of stakeholders once were. Hedging through equity derivatives results in a potential shift of interests by some shareholders, creating a lack of incentive to monitor managers or to act, as well as incentives for managers to engage in self-dealing or shirking. It challenges us to reconceptualize the type of interests, economic or otherwise, at risk in corporate activity, to make those relationships transparent, and to shift governance and officer accountability to reflect that new paradigm.

The notion that directors and officers are able to operate the corporation solely for one set of stakeholders—shareholders—is outdated. In widely held corporate structures, relationships have fundamentally shifted since Berle wrote about shareholder primacy because of the range of shareholder types, the time that shareholders hold their equity interests, and highly varying levels of shareholdings. Derivatives are one of many important changes that need to be addressed in any revised conception of corporate accountability.

VIII. CONCLUSION

What can be drawn from Berle's analysis? His notion that the exercise of corporate power is subject to the equitable limit of not being able to harm the interests of equity holders can potentially be applied to a broader set of stakeholders.¹⁰⁴ The electronic and other mechanisms now available to communicate with stakeholders and to receive their direct input address some of the concerns Berle articulated back in 1931. Building on his analysis, corporate powers could be measured against the authority granted to directors and officers by statutes and corporate charters. They could also be scrutinized to see if corporate officers are making decisions that are sensitive to the equities in the particular situation, particularly when decisions harm the economic security of those making a significant contribution to the corporation. Those equities might be subject to a proportionality assessment that weighs the potential economic benefits and the social good to be achieved, and that considers who is bearing the costs of corporate decisions.

There may also be a greater role for good faith conduct on the part of directors and officers, which Berle observed was a short-form description of the need to consider the equities of particular decisions based on what economic interest is really at risk. There are now cognitive-neuroscientific explanations for the relationship between directors, officers, and the multitude of stakeholders impacted by the corporation's activities, in addition to cultural and social norms that influence the conduct of directors and officers.¹⁰⁵ These explanations include the capacity of corporate officers to fully understand risk, particularly the risk posed to others by certain decisions, and weigh current short-term wealth generation with long-term obligations of the corporation to the communities in which their activities are located.

The challenge of equity derivatives allows us to think about the best interests of the corporation and its stakeholders and to consider accountability structures that reflect real interests at risk. It would allow a range of accountability models that reflect the differing cultural, social, and governance norms across and between jurisdictions. The conversation is just beginning.

104. *Id.*

105. Tania Singer et al., *Empathic Neural Responses Are Modulated by the Perceived Fairness of Others*, NATURE, Jan. 26, 2006; see also Peter B. Reiner, *Public Attitudes Towards Fairness: Cognitive Enhancers as an Exemplar* (forthcoming 2012).