

Disembedding Corporate Governance: The Crisis of Shareholder Primacy in the UK and Canada

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The Global Financial Crisis (GFC) has been the subject of much academic discussion, yet there is no consensus on its root cause. This paper traces the origins of the GFC back to the effects of the Anglo-American model of corporate governance on large financial institutions, and in particular to that model's emphasis on shareholder primacy. Drawing on Karl Polanyi's notion of "embeddedness" and Hyman Minsky's financial instability hypothesis, the author notes that the emphasis on shareholder primacy creates perverse corporate incentives that are detached or "disembedded" from their economic, political and social context. He argues that these perverse incentives were the root cause of the GFC and the subsequent economic and political turmoil. The trajectory of the GFC in both Canada and the UK was shaped primarily by the relative disembeddedness of large financial institutions. In particular, excessive risk-taking by those institutions, combined with a weakening of prudential regulation, led to the emergence of a system that was divorced from its economic and social context. As Minsky predicted, the cracks that developed in this disembedded system compelled states to use fiscal and monetary policy to prevent a depression, sowing the seeds of political unrest in the aftermath of the GFC. The author concludes that long-term economic stability requires that shareholder primacy be replaced with a corporate governance model that acknowledges the economic, political and social influence of financial institutions.

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Introduction

The money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths. The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit.

—Franklin Delano Roosevelt, *First Inaugural Address*, 1933

This article explores how corporate governance laws affected the trajectory of the Global Financial Crisis (GFC) in the United Kingdom and Canada. In doing so, it seeks to clarify the uncertainty surrounding the role that the corporate governance of financial institutions plays in economic stability. Some commentators have suggested that corporate governance functioned “tolerably well” in the GFC,¹ while others have argued that it must be “rethought . . . from the . . . ground up”.² By identifying the behaviour that contributes to instability, and analyzing the extent to which different (or similar) corporate governance regimes encourage or discourage this behaviour, it is possible to better understand

1. See Brian R Cheffins, “Did Corporate Governance ‘Fail’ During the 2008 Stock Market Meltdown? The Case of the S&P 500” (2009) 65:1 *Bus Law* 1 at 3.

2. Allan C Hutchinson, “Hurly-Berle: Corporate Governance, Commercial Profits, and Democratic Deficits” (2011) 34:4 *Seattle UL Rev* 1219.

the link between corporate governance and economic outcomes. To this end, insights from heterodox economics, as well as recent economic and political events, are used to understand the incentive structure and performance of the Anglo-American corporate governance model, which this article concludes is destabilizing in the context of financial institutions.

The dominant approach to corporate governance in the English-speaking world is the “shareholder primacy” model. It places the interests of shareholders before those of all other stakeholders, and pays no heed to the wider economic, political and social context within which the corporation operates. Critics of shareholder primacy predict that when put into law, it will create perverse incentives, which lead to excessive risk-taking, undermine prudential regulation and eventually result in economic crisis and political turmoil.

Shareholder primacy is to be contrasted with a more holistic conception of corporate governance which is exemplified by Sir Adrian Cadbury’s definition:

[C]orporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, of corporations, and of society.³

As will be argued below, it is only by taking such a broad view of the objectives of corporate governance—a view which recognizes the firm’s economic and social context—that we can gain an understanding of how corporate governance contributed to the GFC.

This article’s methodology is derived from the “comparative law and economics” approach, which uses economic theory to evaluate the

3. Adrian Cadbury, “Forward” in Stijn Claessens, *Corporate Governance and Development* (Washington, DC: The World Bank, 2003) v at vii. But see Organisation for Economic Co-operation and Development, *Principles of Corporate Governance* (Paris: OECD, 2004) [OECD, *Principles*] (where the OECD defines corporate governance as providing the “structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance” at 11).

laws of different jurisdictions.⁴ This makes it possible to identify each jurisdiction's underlying assumptions and incentive structures, which can then be used to make judgments about economic outcomes.⁵ In addition, using two Anglo-American countries as comparators makes it easier to assess the contribution of corporate governance to the GFC. The fact that both the UK and Canada are "liberal market economies" reduces the number of variables at play in the analysis, allowing for more meaningful comparisons and conclusions.⁶

In terms of scope, this discussion is limited to the legal obligations of directors and officers of financial institutions. While corporate governance deals with many players within the firm, the central issue is the discipline of directors and officers.⁷ As for financial institutions, their special role within capitalism means that they have a particular capacity to affect economic stability. Limiting the analysis in this way facilitates comparisons along functional lines.⁸ Three sources of corporate governance norms applicable to financial institutions in the UK and Canada will be examined: company law, financial services regulation and securities regulation. Since the focus of this study is on the corporate governance causes of the GFC, only laws and regulations in force leading up to the Crisis will be considered.⁹

4. Florian Faust, "Comparative Law and Economic Analysis of Law" in Mathias Reimann & Reinhard Zimmermann, eds, *The Oxford Handbook of Comparative Law* (Oxford: Oxford University Press, 2006) 837 at 847–49; Ugo Mattei, *Comparative Law and Economics* (Ann Arbor: University of Michigan Press, 1997) at 96.

5. See Faust, *supra* note 4.

6. See e.g. Peter A Hall & David Soskice, eds, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001) at 19, 27–29. See also Mark Roe, "Comparative Corporate Governance" in Peter Newman, ed, *The New Palgrave Dictionary of Economics and the Law* (New York: Palgrave Macmillan, 2002) 339 at 341.

7. See Andreas Cahn & David C Donald, *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK, and the USA* (Cambridge, UK: Cambridge University Press, 2010) at 300.

8. See Konrad Zweigert & Hein Kotz, *Introduction to Comparative Law*, 3d ed (Oxford: Clarendon Press, 1998) at 34.

9. In the aftermath of the Crisis, both the UK and Canada made important reforms with respect to the corporate governance of financial institutions. For information on the UK, see e.g. *Financial Services Act 2012* (UK), c 21; for Canada, see e.g. Office of the Superintendent of Financial Institutions, *Corporate Governance Guideline* (Ottawa: OSFI, 2013).

The experiences of the UK and Canada in the GFC will also be compared. While the Crisis was less severe in Canada, both countries seem to have witnessed the same essential outcomes: the rise of financial innovation, leading to a credit crisis, stock market crash, recession and unemployment. When the Crisis hit, the UK and Canada responded with aggressive fiscal and monetary policies. The need for such intervention resulted in political turmoil in both countries: in Canada, a near constitutional crisis, and in the UK, strikes and mass protests in response to austerity.

This article attempts to fill a number of gaps in the literature on corporate governance and the GFC. Previous studies that have blamed corporate governance failures for the Crisis have not fully connected the dots between legal incentives, profit maximization and systemic failure.¹⁰ In addition, they have neglected the relationship between corporate governance and prudential regulation, which this study attempts to explain.¹¹ Other critiques do not go far enough in their analysis, reducing the problem with shareholder primacy to one of executive compensation or corporate culture.¹² Finally, the conclusions of this study challenge most official assessments of what went wrong with corporate governance during the first decade of the century.¹³ Rather than questioning the underlying assumptions of shareholder primacy, these reports recommend tweaks to the existing model, including greater director independence, more extensive risk management practices and better audit procedures.

Most commentators have also been hesitant to attribute the GFC to any one particular cause.¹⁴ Indeed, several different factors, purportedly unrelated to corporate governance, are often said to have contributed to the Crisis, namely inadequate prudential regulation, loose monetary

10. See e.g. Thomas Clarke, "Corporate Governance Causes of the Global Financial Crisis" in William Sun, Jim Stewart & David Pollard, eds, *Corporate Governance and the Global Financial Crisis* (Cambridge, UK: Cambridge University Press, 2011) 28.

11. See e.g. Marco Becht, Patrick Bolton & Ailsa Röell, "Why Bank Governance is Different" (2012) 27:3 *Oxford Review of Economic Policy* 437.

12. See e.g. Roger L Martin, *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL* (Boston: Harvard Business Publishing, 2011).

13. See e.g. UK, Her Majesty's Treasury, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (London, UK: Her Majesty's Treasury, 2009) (Sir David Walker); Grant Kirkpatrick, *The Corporate Governance Lessons from the Financial Crisis* (Paris: OECD, 2009).

14. See e.g. Becht, Bolton & Röell, *supra* note 11 at 444.

policy and global economic imbalances.¹⁵ The difficulty with these alternative explanations lies in their assumption that financial instability is an exogenous phenomenon—i.e., that it is caused by factors external to the financial system, such as various forms of public policy. As explained below, it is now increasingly accepted that financial crises develop endogenously—i.e., from the internal operation of the system—and specifically through the drive to maximize profit. Once this is recognized, the incentives faced by directors and officers of financial institutions become much more significant. While exogenous factors undoubtedly exacerbated the GFC, the role of corporate governance law, in terms of legitimizing and intensifying the profit motive, is arguably greater than most commentators have thus far recognized.

This article is presented in four parts. Part I introduces Karl Polanyi's concept of embeddedness and Hyman Minsky's financial instability hypothesis, which provide a theoretical framework for evaluating the economic rationale of shareholder primacy. Part II assesses the extent to which UK and Canadian corporate governance laws institutionalize shareholder primacy through their assumptions and incentive structures. Next, Part III looks at how the GFC unfolded in the UK and Canada, assessing the developments in both countries in light of Polanyi's and Minsky's theories. Finally, implications and conclusions are given.

I. Embeddedness as a Benchmark for Corporate Governance

This part proposes a theoretical framework for analyzing the corporate governance systems applicable to financial institutions in the UK and Canada. First, the work of Karl Polanyi and his concept of "embeddedness" is introduced. Next, Hyman Minsky's financial instability hypothesis is presented as an application of Polanyi's work to financial institutions. Finally, the benchmark of embeddedness is used to evaluate the rationale of shareholder primacy.

15. See e.g. Carmen M Reinhart & Kenneth S Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009) at 216–17, 291–92.

A. *The Principle of Embeddedness and the Self-Regulating Market*

Karl Polanyi argued that free-market capitalism would eventually crumble under the weight of its “three fictions”—the commodification of land, labour and money.¹⁶ Indeed, he blamed World War I, the Great Depression, and the subsequent rise of political extremism on attempts to impose the “self-regulating market”, which the dominant powers thought was “capable of organizing the whole of economic life without outside help or interference”.¹⁷ According to Polanyi, what makes the self-regulating market so unstable is its subordination of social imperatives to economic ones.¹⁸ Put differently, it rests on the invalid—and in his words, “radical”—assumption that markets can function independently of people and states, and that it is possible to commodify the three essential economic inputs, despite their inherently social character, and thereby maximize overall welfare.¹⁹

The notion of the self-regulating market implies faith in its ability to promote social objectives more effectively than a system subject to social control. But Polanyi’s reading of economic history indicated that this faith was misguided. He described how, during the nineteenth and early twentieth century, attempts to eliminate social control over the economy failed disastrously because the self-regulating market produced social consequences that made it unsustainable.²⁰ He took the damage caused by the self-regulating market to show that there is an inseparable tie between economy and society, an idea captured by the term “embeddedness”.²¹ In the self-regulating market, as Polanyi put it, “[i]nstead of [the] economy

16. Karl Polanyi, *The Great Transformation* (Boston: Beacon Press, 2001) at 76; *contra* FA Hayek, *The Road to Serfdom* (London, UK: Routledge, 1944).

17. *Ibid* at 45. See also Kari Polanyi Levitt, “*The Great Transformation* from 1920 to 1990” in Kenneth McRobbie & Kari Polanyi Levitt, eds, *Karl Polanyi in Vienna: The Contemporary Significance of The Great Transformation* (London, UK: Black Rose Books, 2006) 3 at 4.

18. See *supra* note 16 at 74–75, 187. See also Gareth Dale, *Karl Polanyi: The Limits of the Market* (Cambridge, UK: Polity Press, 2010) at 50.

19. Polanyi, *supra* note 16 at 42.

20. A detailed account of Polanyi’s analysis of economic history is beyond the scope of this discussion. The reader is encouraged to consult the original text and secondary literature cited herein.

21. See generally Mark Granovetter, “Economic Action and Social Structure: The Problem of Embeddedness” (1985) 91:3 *Am Jour Soc* 481 at 482.

being embedded in social relations, social relations are embedded in the economic system.”²²

Society’s response to subordination, Polanyi said, is not passive. Like trying to remove blood from a body, attempts to “disembed” the economy from society are harmful to the system as a whole, needing heroic interventions by people and states to save it. Polanyi used the term “double movement” to describe the relationship between the self-regulating market and the social response to its consequences.²³ In this way, Western civilization has been marked by instability, oscillating between periods of more and less embeddedness. These ideas are highly relevant to developments in modern financial institutions, and have important implications for their corporate governance.

B. The Embeddedness of Financial Institutions

American economist Hyman Minsky is widely credited with predicting the GFC over twenty years before it happened.²⁴ Although he did not mention Polanyi expressly, Minsky’s work reflects the notions of embeddedness and the self-regulating market in three ways. First, Minsky’s financial instability hypothesis showed how the profit-seeking behaviour of financial institutions is the source of economic crisis and its attendant social consequences. Second, Minsky predicted that the forces behind economic instability also undermine prudential regulation, which is supposed to prevent the financial system’s collapse. Third, economic crisis forces the state to use fiscal and monetary policy to prevent a depression—heroic efforts that may fulfill their short-term objective, but bring further economic instability and political turmoil in the long run.

22. *Supra* note 16 at 60.

23. *Ibid* at 138.

24. Hyman P Minsky, *Stabilizing an Unstable Economy* (New York: McGraw Hill, 2008). See e.g. Paul McCulley, “The Shadow Banking System and Hyman Minsky’s Economic Journey” in Laurence B Siegle & Rodney N Sullivan, eds, *Insights into the Global Financial Crisis* (New York: Research Foundation of the CFA Institute, 2009) 257 at 259; Marc Lavoie, “The Global Financial Crisis: Methodological Reflections from a Heterodox Perspective” (2011) 88: *Studies in Political Economy* 35 at 38; Charles J Whalen, “An Institutionalist Perspective on the Global Financial Crisis” in Steven Kates, ed, *Macroeconomic Theory and its Failings: Alternative Perspectives on the Global Financial Crisis* (Cheltenham, UK: Edward Elgar, 2010) 235 at 243–49.

(i) Minsky's Financial Instability Hypothesis

Minsky's key insight was that the economy moves endogenously from periods of greater to lesser stability.²⁵ In particular, he identified the financing of long-term investment, which is a hallmark of modern capitalism, as the root of the boom-and-bust cycle.²⁶ Since financial institutions are the principal source of such financing, Minsky saw them as the key drivers of instability.²⁷

Financial institutions borrow money from depositors—and from other financial institutions and central banks—on a short-term basis in order to make long-term loans to individuals, businesses and governments. Consequently, they have two basic strategies for generating profits: they can widen the spread between short-term and long-term interest rates, or they can increase their leverage—i.e., the ratio between assets and liabilities.²⁸ Minsky observed that after a recession, there tends to be excess liquidity in the economy—a condition he called “hedge finance”—which results in low short-term interest rates.²⁹ Eager to take advantage of this favourable interest rate differential, financial institutions begin to ramp up their long-term loans to investors.³⁰ An investment boom results, and asset prices start to rise. This validates the optimism of both lenders and borrowers, leading to even more investment and a “bubble”.³¹

However, amid the euphoria, cracks in the financial system begin to develop. The increased leverage of financial institutions and the heightened demand for investment put upward pressure on short-term

25. *Supra* note 24 at 234. See also Dimitri B Papadimitriou & L Randall Wray, “Minsky’s Analysis of Financial Capitalism” (1999) [The Jerome Levy Economics Institute, Working Paper No 275] at 9 [Papadimitriou & Wray, “Financial Capitalism”].

26. Minsky, *supra* note 24 at 222.

27. *Ibid* at 249 (Minsky defined financial institutions broadly to include not just commercial banks, but also insurance companies, pension funds, and investment banks, among others).

28. See *ibid* at 265.

29. *Ibid* at 230. See also Alessandro Vercelli, “Minsky, Keynes and the Structural Instability of a Sophisticated Monetary Economy” in Ricardo Bellofiore & Piero Ferri, eds, *Financial Fragility and Investment in the Capitalist Economy: The Economic Legacy of Hyman Minsky, Volume II* (Cheltenham, UK: Edward Elgar, 2001) 33 at 43.

30. See Minsky, *supra* note 24 at 235.

31. See *ibid* at 237; Papadimitriou & Wray, “Financial Capitalism”, *supra* note 25 at 8.

interest rates.³² Facing higher borrowing costs, the only way for financial institutions to maintain the spread—and their profits—is to make longer-term and riskier loans, which attract higher interest rates.³³ But the more risk they take on, the more assurances they must give to their creditors. Consequently, they shorten the term of their liabilities and rely increasingly on so-called “financial innovation”—the development of complex financial instruments that purportedly mitigate asset risk.³⁴ These practices make financial institutions increasingly dependent on favourable financial market conditions, namely the continued ability to refinance (or “roll over”) their short-term debt. Minsky called this the “speculative” position.³⁵

Eventually, financial institutions can no longer offset rising short-term interest rates, so they must take on more debt or sell off assets to meet their obligations. Minsky explained that when enough of the economy is in this “Ponzi” position, the bubble bursts and the crisis begins.³⁶ The liquidation of assets causes their prices to drop dramatically, leading to a series of economic problems, including a stock market crash, unemployment, recession and depression.³⁷ A depression serves to “wipe out” the economy’s bad debts, restoring it to the hedge position.³⁸

The profit-seeking behaviour of financial institutions is therefore central to Minsky’s financial instability hypothesis. In a distinctly Polanyian passage, Minsky argued that the pursuit of self-interest by financial institutions is in many ways incompatible with economic stability:

In a world with capitalist finance it is simply not true that the pursuit by each unit of its own self-interest will lead an economy to equilibrium. The self-interest of bankers, levered

32. See Minsky, *supra* note 24 at 239.

33. See *ibid* at 265; Papadimitriou & Wray, “Financial Capitalism”, *supra* note 25 at 10.

34. See Minsky, *supra* note 24 at 265.

35. *Ibid*.

36. *Ibid* at 239.

37. See *ibid*. This series of events is called a “debt deflation”. Irving Fisher, “The Debt Deflation Theory of Great Depressions” (1933) 1:4 *Econometrica* 337 at 342.

38. See Minsky, *supra* note 24 at 239; Dimitri B Papadimitriou & L Randall Wray, “The Economic Contributions of Hyman Minsky: Varieties of Capitalism and Institutional Reform” (1998) 10:2 *Review of Political Economy* 199 at 208 [Papadimitriou & Wray, “Economic Contributions”].

investors, and investment producers can lead the economy to inflationary expansions and unemployment-creating contractions.³⁹

Minsky also saw the incentives faced by senior managers as fuelling the problematic practices of financial institutions.

[F]ortune-seeking by the managers of [financial institutions] leads to an emphasis upon growth, which in turn leads to efforts to increase leverage. But increased leverage by banks and ordinary firms decreases the margins of safety and this increases the potential for instability.⁴⁰

While Minsky was referring here to the perverse incentives of stock options, other corporate governance practices may have the same effect, as shown in Part II below. By placing financial institutions within a wider economic context, Minsky's teachings link the principle of embeddedness to the origins of financial instability, and provide a basis for evaluating the corporate governance of financial institutions.

(ii) Prudential Regulation

Although Minsky endorsed the use of prudential regulation—i.e., restrictions on the growth of leverage—to maintain economic stability,⁴¹ he recognized that it is prone to failure for the same reasons that capitalism is prone to crisis. Specifically, in the immediate aftermath of a crisis there will be a tendency to strengthen prudential regulation, but as time passes and confidence recovers, there will be pressure to weaken it.⁴² As Minsky noted, market regulators and participants tend to become less vigilant just as the cycle becomes unstable:

As a previous financial crisis recedes in time, it is quite natural for central bankers, government officials, bankers, businessmen, and even economists to believe that a new era has arrived. Cassandra-like warnings that nothing basic has changed, that there is a financial breaking point that will lead to a deep depression, are naturally ignored in these circumstances.⁴³

39. *Supra* note 24 at 280.

40. *Ibid* at 266.

41. *Ibid* at 272.

42. See *ibid* at 220–21.

43. *Ibid* at 237.

There is plenty of historical evidence to support this observation. For example, in the aftermath of the Great Depression, a comprehensive set of regulations was instituted, but by the 1980s, the devastation of the 1930s was a distant memory and much of its policy legacy came under attack.⁴⁴

Minsky even suggested that an ideal regulator would likely be unable to prevent an economic crisis in the absence of more systemic reforms. The vigilance of regulators, he said, is no match for the ingenuity of financial innovators:

The entrepreneurs of the banking community have much more at stake than the bureaucrats of the central banks. . . . The profit-seeking bankers almost always win their game with the authorities, but, in winning, the banking community destabilizes the economy; the true losers are those who are hurt by unemployment and inflation.⁴⁵

In other words, profit-maximizing financial institutions are inclined to weaken or circumvent the state's efforts to maintain stability—a strategy known as regulatory arbitrage.⁴⁶ This notion that the profit motive may adversely affect regulatory outcomes brings to light another way in which the existing incentives of corporate governance law may be destabilizing.

(iii) Political Turmoil

In a trend reminiscent of the double movement, Minsky demonstrated that ever since the 1970s, public authorities have taken two types of action to prevent financial crises from spiralling into depressions. The first involves running a large deficit, a strategy that he aptly called “big government”: public spending props up business cash flows and investment, which reduces the chances of a debt deflation.⁴⁷ Importantly, financial institutions acquire most of the new government debt, which is guaranteed and marketable.⁴⁸

44. See generally James Crotty, “Structural Causes of the Global Financial Crisis” (2009) 33:4 *Cambridge Journal of Economics* 563 at 564. See also Part III-B-(ii), below.

45. Minsky, *supra* note 24 at 279.

46. See generally Adair Turner, *Economics After the Crisis: Objectives and Means* (Cambridge, Mass: MIT Press, 2012) at 59.

47. See Minsky, *supra* note 24 at 266.

48. See *ibid* at 39.

Big government does not, however, deal directly with the inability of financial institutions to refinance or liquidate their assets. This is the purpose of the second intervention, namely the central bank's acting as "lender of last resort".⁴⁹ Here, monetary policy is used to flood the market with liquidity, thereby counteracting the stricter borrowing terms and falling asset prices which emerge during the crisis. Although these monetary and fiscal interventions succeed in stabilizing the economy, Minsky observed that they also lay the foundations for future instability:

Every time the [central bank] protects a financial instrument it legitimizes the use of this instrument to finance activity. This means that not only does [central bank] action abort an incipient crisis, but it sets the stage for a resumption in the process of increasing indebtedness—and makes possible the introduction of new instruments.

...

By sustaining aggregate demand, [government deficits] sustain corporate profits and feed secure assets into portfolios. These effects of Big Government mean that an investment boom will occur quite soon after a recession, and the investment boom generates the demand for finance that leads to another bout of inflation and crisis.⁵⁰

In other words, the combined effect of big government and the central bank's role as lender of last resort is that financial institutions emerge from the crisis with both the balance sheets and the confidence they need to quickly resume their old ways. Their dependence on periodic rescues by the state is a striking example of their embeddedness.

As other scholars have recognized, there is also a political dimension to the bailouts. In the reversal of fortunes that follows the crisis, financial institutions become larger creditors of governments. This augments their political power; they can make demands on governments for the restoration of fiscal balance.⁵¹ But even in the absence of genuine pressure from creditors, governments may be inclined to quickly slash the deficit, for ideological reasons.⁵² If this program of retrenchment is pursued at

49. See *ibid* at 43. See also Papadimitriou & Wray, "Economic Contributions", *supra* note 38 at 209.

50. *Supra* note 24 at 106.

51. See Wolfgang Streeck, "The Crisis in Context: Democratic Capitalism and its Contradictions" (Discussion paper delivered at the Max Plank Institute for the Study of Societies, Cologne, 15 November 2011), [unpublished] at 15.

52. See generally Peter Burnham, "Towards a Political Theory of Crisis: Policy and Resistance across Europe" (2011) 33:4 *New Political Science* 493 at 499.

the expense of the workers, there is the potential for a political backlash against capitalism itself.⁵³

When read together, the teachings of Polanyi and Minsky suggest that financial institutions—and their directors and officers—are key economic, political and social players. The embeddedness of those institutions means that the consequences of their actions are not confined to their firms or their industry, but reverberate throughout the entire system. This leads to the hypothesis that a corporate governance regime will be destabilizing if it fails to reflect this essential characteristic of financial institutions.

C. Shareholder Primacy: A Disembedded Theory of the Firm

At a theoretical level, the shareholder primacy theory of corporate governance does not appear to come to grips with the embeddedness of financial institutions. Inspired by neoclassical economics, it conceives of the firm as a “nexus of contracts” through which parties come together to achieve productive ends,⁵⁴ and it assumes that so-called “fixed claimants”—e.g., employees, creditors and customers—can adequately protect themselves through the contracting process.⁵⁵ Conversely, the firm’s “residual claimants”—its shareholders—are believed to take on more risk than fixed claimants, because there is no guarantee that they will get what they bargained for (i.e., profit).⁵⁶ And since shareholders delegate the administration of the firm to others, they are considered vulnerable to exploitation by those delegates, who may divert resources away from profit-maximizing activities.⁵⁷ Therefore, this neoclassical theory of the

53. See *ibid.*

54. Michael C Jensen & William H Meckling, “Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure” (1976) 3:4 *Journal of Financial Economics* 305 at 311.

55. See *ibid.* at 340; Simon Learmount, “Theorizing Corporate Governance: New Organizational Alternatives” (2002) [Working Paper No 237, ESRC Centre for Business Research] at 3.

56. Eugene F Fama & Michael C Jensen, “Separation of Ownership and Control” (1983) 26:2 *JL & Econ* 301 at 302–03.

57. See *ibid.* at 304. The roots of agency theory go as far back as Adam Smith. Adam Smith, *The Wealth of Nations* (New York: Random House, 1994) at 800. During the Great Depression, Berle and Means famously argued that dispersion of share ownership resulted in a separation of ownership and control. Adolf A Berle & Gardiner C Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932) at 117–18.

firm, which assumes that wealth maximization is the sole interest of each player, is focused on resolving a principal-agent problem.⁵⁸ That is why it is often called agency theory, and the priority it gives to maximizing shareholder wealth is often referred to as shareholder primacy.

Agency theorists argue that the best protection for shareholders is the self-regulating market, to use Polanyi's terminology.⁵⁹ Specifically, the capital market raises the possibility of a hostile take over—the so-called “market for corporate control”—and the “market for managerial talent” creates competition for senior management positions. Together, they are assumed to exert sufficient discipline.⁶⁰ Furthermore, stock prices are thought to accurately reflect agency costs, provided that all necessary information is disclosed to the market.⁶¹ Therefore, if these markets are allowed to function without restraint, it is assumed that they will allow shareholders to identify and replace wasteful or corrupt managers. Thus, Polanyi might say that shareholder primacy is based on the commodification of corporate governance.

A striking feature of shareholder primacy is that it reduces corporate governance to a binary relationship; the only important actors are shareholders and managers, and the former are given pride of place. It is seen as both possible and desirable to dissociate the firm from its broader social context, an assumption reflected in the following passage from the article which serves as the intellectual foundation of shareholder primacy:

[T]he personalization of the firm implied by asking questions such as “what should be the objective function of the firm”, or “does the firm have a social responsibility” is seriously misleading. *The firm is not an individual*. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals . . . are brought into equilibrium within a framework of contractual relations.⁶²

This leaves little doubt that shareholder primacy is based on a disembedded conception of the firm. Therefore, based on Polanyi's teachings, it is

58. See Jensen & Meckling, *supra* note 54 at 309, 314.

59. See *ibid* at 328.

60. *Ibid* at 328–29; Fama & Jensen, *supra* note 56 at 312–13; David Scharfstein, “The Disciplinary Role of Takeovers” (1988) 55:2 *The Review of Economic Studies* 185 at 186.

61. See Fama & Jensen, *supra* note 56 at 313.

62. Jensen & Meckling, *supra* note 54 at 311 [emphasis in original].

appropriate to consider whether shareholder primacy can be identified as a cause of economic and social crisis.⁶³

II. Disembedding Corporate Governance in the UK and Canada

With the basic assumptions of the shareholder primacy model having been identified, it is possible to assess the extent to which the corporate governance systems of the UK and Canada institutionalize that model through legal incentives. To this end, this part considers the three primary sources of director and officer liability in each country—company law, financial services regulation and securities regulation.

A. Company Law

In the UK, financial institutions may be structured as corporations⁶⁴ and thus are subject to company law as prescribed by statute and the common law.⁶⁵ The starting point is the *Companies Act 2006*, which codifies the equitable and common law principles that apply to company directors.⁶⁶ Specifically, section 170(1) states that a director's general duties are owed to the company. Pursuant to section 172(1),

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,

63. For other critiques of shareholder primacy, see e.g. William Lazonick & Mary O'Sullivan, "Maximizing Shareholder Value: A New Ideology for Corporate Governance" (2000) 29:1 *Economy and Society* 13; Simon Deakin & Suzanne J Konzelmann "After Enron: An Age of Enlightenment?" (2003) 10:3 *Organization* 583 at 586.

64. See *Financial Services and Markets Act 2000* (UK), 2000, c 8, Schedule 6, s 1(2)(b) [FSMA].

65. See Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Hampshire, UK: Ashgate, 2007) at 79; Alastair Hudson, *The Law of Finance*, 1st ed (London, UK: Sweet & Maxwell, 2009) at 80–81.

66. (UK), c 46, s 170(1)(3).

- (c) the need to foster the company's business relationships with suppliers, customers and others,
- (d) the impact of the company's operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.⁶⁷

This list of what are commonly known as “stakeholders” would appear to capture any group, including society as a whole, that has an interest in financial stability. On the surface, therefore, one might think that UK law does not fully embrace shareholder primacy; duties are owed to the company (not just to its shareholders), and a director may “have regard” to various stakeholders when making decisions.

Upon closer examination, however, it becomes clear that shareholder primacy is alive and well in the UK. To begin with, section 172(1) defines the duty of loyalty in terms of the “success of the company”, which must be pursued “for the benefit of its members as a whole”.⁶⁸ Thus, the only constituency that is to gain from the exercise of the duty of loyalty is the company's shareholders.⁶⁹ This was precisely the intention behind the codification of that duty. Previously, the case law cast the duty more broadly, giving directors considerable discretion to pursue “what they consider . . . is in the interests of the company”.⁷⁰ By defining the duty in terms of the collective interests of shareholders, the drafters hoped to remove some of the directors' discretion, which they feared could be used to undermine those interests.⁷¹ The use of the phrase “in doing so” in section 172(1) indicates that directors are only to consider the interests of other parties to the extent that it furthers their primary obligation to

67. *Ibid*, s 172(1).

68. *Ibid*.

69. See Paul L Davies, *Gower and Davies' Principles of Modern Company Law*, 8th ed (London, UK: Sweet & Maxwell, 2008) (“the rule of shareholder primacy is reiterated in [section 172]” at 508.)

70. *Re Smith and Fawcett Ltd*, [1942] 1 All ER 542 at 543. See also *Item Software (UK) v Fassibi*, [2005] 2 BCLC 91 at 103 (CA).

71. See UK, Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (London, UK: Department of Trade and Industry, 2000) at para 3.52, online: United Kingdom National Archives <<http://webarchive.nationalarchives.gov.uk/+http://www.berr.gov.uk/files/file23248.pdf>>.

shareholders.⁷² In addition, section 172(2) suggests that the definition of “success” is within the purview of the company’s shareholders, most of whom (particularly in financial institutions) will equate success with share price and dividends, which bear directly on their wealth.⁷³ Therefore, while UK company law embraces so-called “enlightened shareholder value”, the interests of the wider community are still subordinated to the maximization of shareholder value.⁷⁴

In theory, a failure to “have regard” to stakeholder interests could give rise to liability, but in practice this is very unlikely to happen because stakeholders do not have standing to bring a claim against the board for breach of fiduciary duty. Since the duty of loyalty is owed to the company under section 170, only the company is entitled to a remedy for its breach. Furthermore, the derivative action, which allows a claim to be brought in the name of the company, is restricted to shareholders.⁷⁵ Even if a shareholder were inclined to bring such an action based on neglect of stakeholder interests, it would have to be shown that in doing so the shareholder was promoting the success of the company, as defined by section 172.⁷⁶ If this procedural hurdle were overcome, the shareholder would still face a very onerous burden on the merits; as section 172(1) indicates, the courts are to apply a subjective standard to the duty of loyalty.⁷⁷ Therefore, as long as the director “honestly believed” that he was promoting the success of the company, the court will not intervene.⁷⁸

Overall, UK courts are extremely reluctant to intervene in business decisions by corporate managers. In the words of Lord Wilberforce: “There is no appeal on the merits from management decisions to courts

72. See John Lowry, “The Duty of Loyalty of Company Directors: Bridging the Accountability Gap Through Efficient Disclosure” (2009) 68:3 Cambridge LJ 607 at 616.

73. See Davies, *supra* note 69 at 511.

74. See UK, Department of Trade and Industry, *Company Law Reform* (London, UK: Her Majesty’s Stationary Office, 2005) at 20 (this White Paper followed a long period of consultation on the state of company law in the UK and served as the basis for the *Companies Act 2006*).

75. *Companies Act 2006*, *supra* note 66, s 261(1) (the Act refers exclusively to a “member” when describing the application procedure for a derivative claim); Lowry, *supra* note 72 at 618.

76. *Companies Act 2006*, *supra* note 66, s 263(2)(a).

77. *Ibid* (“a director must act in the way *he considers*, in good faith . . .”, s 172(1) [emphasis added]).

78. *Regentcrest plc (in liquidation) v Cohen and another*, [2001] 2 BCLC 80 (Ch) at 105.

of law: nor will courts assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.”⁷⁹ This posture of judicial deference, combined with the limitations of company law remedies, means that the UK courts are very unlikely to consider stakeholder interests in applying the duty of loyalty.⁸⁰

In lieu of judicial scrutiny, UK company law relies on the market for corporate information to discipline directors and officers, and to this end it imposes certain disclosure requirements. In particular, section 417(1) of the *Companies Act* requires directors, except those of small companies, to file a business review along with their annual report.⁸¹ According to section 417(2), the purpose of the business review is to help shareholders “assess how the directors have performed their duty under section 172”.⁸² For listed companies, the business review must include information about the firm’s relationships with various stakeholders, but only “to the extent necessary for an understanding of the development, performance or position of the company’s business”.⁸³ Nor does the business review require directors to explain why stakeholder issues are not relevant to the company’s business. For these technical reasons, it is doubtful whether the business review will promote stakeholder interests in the boardroom.⁸⁴ More fundamentally, the UK’s reliance on disclosure, rather than judicial review, is evidence of its embrace of shareholder primacy, and its faith in the disciplinary power of self-regulating markets.

In Canada, federally-incorporated financial institutions are established under special statutes, each of which contains the same formulation of the duty of loyalty as is found in the general companies legislation, the *Canada Business Corporations Act*.⁸⁵ The courts have not interpreted the duty of

79. *Howard Smith Ltd v Ampol Petroleum Ltd* (1973), [1974] AC 821 at 832.

80. See Davies, *supra* note 69 at 510.

81. *Supra* note 66, s 417(1).

82. *Ibid*, s 417(2).

83. *Ibid*, s 417(5).

84. See Andrew Keay, “Tackling the Issue of Corporate Objective: An Analysis of the United Kingdom’s ‘Enlightened Shareholder Value’ Approach” (2007) 29:4 *Sydney L Rev* 577 at 605.

85. See *Bank Act*, SC 1991, c 46, s 158(1)(a); *Insurance Companies Act*, SC 1991, c 47, s 166(1)(a); *Trust and Loan Companies Act*, SC 1991, c 45, s 162(1)(a) [*Trust & Loan Act*]. See also *Canada Business Corporations Act*, RSC 1985, c C-44, s 122(1)(a) [CBCA].

loyalty in the context of the special incorporation statutes, but the case law on ordinary companies is assumed to apply to financial institutions.⁸⁶

Under Canadian legislation, the duty of loyalty is worded as follows: “Every director and officer of a corporation in exercising their powers and discharging their duties shall . . . act honestly and in good faith with a view to the best interests of the corporation.”⁸⁷ In contrast to the UK, the Canadian statutes do not define “the best interests of the corporation”, nor do they explicitly require directors and officers to consider stakeholder concerns: these details have been left to the courts.

In *Peoples Department Stores (Trustee of) v Wise*, the Supreme Court of Canada ostensibly rejected the shareholder primacy approach:

Inssofar as the [duty of loyalty] is concerned, it is clear that the phrase “best interests of the corporation” should be read not simply as “best interests of the shareholders” . . . [I]n determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, customers, governments and the environment.⁸⁸

Thus, the duty of loyalty in Canada is in principle owed to the company, rather than (as in the UK) to shareholders. Subsequently, in *BCE Inc v 1976 Debentureholders*, the Supreme Court reaffirmed this principle, but made it clear that while the directors are permitted to consider both shareholder and stakeholder interests, they are not required to do so.⁸⁹

As a result, Canadian law appears to put the interests of shareholders and stakeholders on an equal footing: both are second to the interests of the corporation. In *BCE*, the Supreme Court also held that the duty of loyalty is “not confined to short-term profit or share value. Where the corporation is an ongoing concern, it looks to the long-term interests of

86. See generally MH Ogilvie, *Bank and Customer Law in Canada* (Toronto: Irwin Law, 2007) at 98.

87. *CBCA*, *supra* note 85, s 122(1).

88. 2004 SCC 68 at para 42, [2004] 3 SCR 461.

89. 2008 SCC 69 at para 39, [2008] 3 SCR 560 [*BCE*]. There appears to be some uncertainty about whether or not consideration of stakeholder interests is mandatory. See e.g. Jeffrey G MacIntosh, “*BCE* and the Peoples’ Corporate Law: Learning to Live on Quicksand” (2009) 48:2 Can Bus LJ 255 at 259.

the corporation.”⁹⁰ Therefore, Canadian law seems to reject the imperative of shareholder value maximization.

While section 172(1) of the UK *Companies Act* mentions the long-term consequences of decisions, these consequences (like stakeholder interests) are only to be considered to the extent that it is beneficial to the shareholders. In contrast, the Canadian position appears to require directors and officers to take a long-term view, whether or not it is in the interests of shareholders. In principle these are significant differences. However, in practice, Canadian company law is still reflective of shareholder primacy, for three reasons.

First, fiduciary duties notwithstanding, directors are ultimately accountable to the shareholders who elect them.⁹¹ The rise of institutional investors, which have a tendency to favour short-term performance, implies that shareholders’ exclusive right to elect the board will be used to orient the firm towards profit maximization.⁹²

Second, in the context of takeover bids, which may be shareholder primacy’s most potent disciplinary mechanism, Canadian securities law protects only shareholder interests. Specifically, National Policy 62–202, issued by the Canadian Securities Administrators and adopted in several provinces, states that “[t]he primary objective of the take-over provisions . . . is the protection of the bona fide interests of the shareholder of the target company.”⁹³ More specifically, the Policy seeks to ensure that directors and officers do not interfere with shareholders’ right to vote on a takeover bid by abusing so-called “defensive tactics”.⁹⁴ It is important to note that shareholders are the only constituency with the power to accept or reject a takeover bid.⁹⁵ This fact alone subordinates the interests of

90. *Supra* note 89 at para 38.

91. See e.g. *Bank Act*, *supra* note 85, s 165(2).

92. See John C Coffee, “Liquidity Versus Control: The Institutional Investor as Corporate Monitor” (1991) 91:6 *Colum L Rev* 1277 at 1325; Jeffrey Larsen, “Institutional Investors, Corporate Governance and Proxy Voting Disclosure” in Poonam Puri & Jeffrey Larsen, eds, *Corporate Governance and Securities Regulation in the 21st Century* (Markham: LexisNexis, 2004) 181 at 185.

93. *Take-over Bids—Defensive Tactics*, OSC NP 62–202, 20 OSCB 3526 (4 July 1997), s 1.1(2).

94. See J Anthony VanDuzer, *The Law of Partnerships and Corporations*, 3d ed (Toronto: Irwin Law, 2009) at 368.

95. See e.g. *Bank Act*, *supra* note 85, s 284. Despite ownership and control restrictions, there has been considerable takeover activity involving financial institutions in Canada.

stakeholders to those of shareholders, despite the Supreme Court's recent efforts (referred to above) to empower stakeholders.⁹⁶

Third, like the UK courts, Canadian courts have adopted a very deferential approach to the duty of loyalty. In *BCE*, the Supreme Court said:

Courts should give appropriate deference to the business judgment of directors who take into account [shareholder and stakeholder] interests, as reflected by the business judgment rule. The 'business judgment rule' accords deference to a business decision, so long as it lies within a range of reasonable alternatives.⁹⁷

Some commentators have suggested that this deferential approach, combined with the broad scope of the duty of loyalty, will erode shareholder primacy.⁹⁸ However, any such effect will likely be minimal. As discussed above, shareholders have multiple tools for disciplining directors and officers. Given the dominance of shareholder primacy in the business world, it is hard to imagine a Canadian court taking the view that a decision to favour shareholders at the expense of stakeholders is not "within a range of reasonable alternatives". In reality, it is stakeholders who are most likely to be disadvantaged by judicial deference.

Finally, as in the UK, stakeholders in Canada face major obstacles in terms of defending their interests vis-à-vis financial institutions. While Canadian company legislation does not preclude stakeholders from bringing a derivative suit,⁹⁹ the courts have generally been reluctant to grant standing to anyone other than securityholders.¹⁰⁰ Furthermore, the special incorporation statutes that apply to financial institutions do not provide an oppression remedy, which has proven friendlier to stakeholders in ordinary firms.¹⁰¹ As a result, despite the Supreme Court's overtures to stakeholders in recent years, shareholders are the only constituency with

96. In *BCE*, the Court held that the board of directors may have to consider the legitimate expectations of various stakeholders and treat them fairly in accordance with its fiduciary duty to the corporation. *Supra* note 89 at paras 66, 81–82.

97. *Ibid* at para 40.

98. See e.g. Patrick Lupa, "The BCE Blunder: An Argument in Favour of Shareholder Wealth Maximization in the Change of Control Context" (2011) 20 Dal J Leg Stud 1 at 15.

99. See e.g. *CBCA*, *supra* note 85, s 238; *Bank Act*, *supra* note 85, ss 2, 334.

100. See VanDuzer, *supra* note 94 at 411.

101. See *ibid* at 430.

a realistic prospect of enforcing the duty of loyalty, and this is especially true for financial institutions.

In summary, company law in both the UK and Canada serves to institutionalize shareholder primacy as the dominant corporate governance model. The duty of loyalty is cast more broadly in Canada, but when it is looked at within the entire legal framework, it does very little to undermine the power of shareholders. The courts in both countries are very deferential toward business decisions, and remedies are generally restricted to shareholders. The law in the UK and Canada relies heavily on the self-regulating market to discipline directors by requiring disclosure and facilitating take overs.

B. Financial Services Regulation

While both the UK and Canada have financial regulators, their regulations are mostly procedural, leaving substantive risk to the self-regulating market. At the time of the GFC, the UK financial markets were regulated by the Financial Services Authority (FSA), which derived its power from the *Financial Services and Markets Act 2000 (FSMA)*.¹⁰² The regulatory regime's basic objectives were to increase market confidence and public awareness, to protect consumers and to reduce financial crime.¹⁰³ To accomplish these objectives, the regime used three basic legal instruments: the provisions of the *FSMA*, rules promulgated by the FSA under section 138 of the *FSMA* and guidance issued by the FSA under section 157 of the *FSMA*.¹⁰⁴ While rules were legally binding, guidance was not, although compliance with it was normally advisable.¹⁰⁵ The corporate governance aspects of this regime are presented below.

102. *Supra* note 64. See also William Blair et al, *Banking and Financial Services Regulation*, 3d ed (London, UK: Butterworths, 2002) at 16.

103. See *FSMA*, *supra* note 64, ss 3–6.

104. *Ibid*, ss 138, 157.

105. See Blair et al, *supra* note 102 at 17.

To begin with, every “authorized person”¹⁰⁶—i.e., a firm permitted to carry on a “regulated activity” under the statute¹⁰⁷—had to adhere to the FSA’s Principles for Businesses (PRIN).¹⁰⁸ The PRIN provided “a general statement of the fundamental obligations of *firms* under the *regulatory system*”.¹⁰⁹ They focused on how the firm conducted its business, treated customers, dealt with financial intermediaries and related to the FSA. In short, they constituted a supplemental corporate governance framework for financial institutions.¹¹⁰

Although the PRIN were binding, they focused on the internal management structures of the firm, rather than on outcomes. For example, PRIN 3 stated that financial institutions “must take reasonable care to organise and control [their] affairs responsibly and effectively, with adequate risk management systems”.¹¹¹ The FSA supplemented PRIN 3 with a detailed set of rules and guidance to that effect: the Senior Management Arrangements, Systems, and Controls (SYSC). While the SYSC are extensive, their basic tenor is captured by the General Requirement, which applied to all financial institutions:

A [financial institution] must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems.¹¹²

106. *FSMA*, *supra* note 64, ss 19, 31, 40–41. Schedule 6 of the statute contains the “threshold conditions” that apply to authorized persons. On December 19, 2012, the FSA was abolished and replaced by the Prudential Regulation Authority and the Financial Conduct Authority. See *supra* note 9. This analysis focuses on the regulatory regime in place leading up to the GFC.

107. See *FSMA*, *supra* note 64, ss 19, 22. Schedule 2 of the statute lists the “regulated activities”, which include most traditional financial services.

108. UK, Financial Conduct Authority, *Principles for Businesses*, (London, UK: Financial Conduct Authority, 2009), s 3.1.1R.

109. *Ibid*, s 1.1.2G [emphasis in original].

110. *Ibid*, s 1.1.9G.

111. *Ibid*, s 2.1.3R.

112. UK, Financial Services Authority, *Senior Management Arrangements, Systems, and Controls* (London, UK: Bank of England, 2013), s 4.1.1.

This provision exemplified the fact that the regulations were concerned with the mechanisms that firms had in place to mitigate risk, rather than whether firms *actually succeeded* in mitigating risk.

The FSA regime also applied to individuals who performed certain functions within the financial institution. Under section 59 of the *FSMA*, only “approved persons”—those judged to be “fit and proper” by the FSA—could perform so-called “controlled functions”.¹¹³ These included “governing functions” and “significant management functions”, which capture those of directors and officers of financial institutions.¹¹⁴ Before assuming such functions, an individual must have been vetted by the FSA. The approval process was governed by the Fit and Proper Test for Approved Persons (FIT), which had three main assessment criteria: honesty, integrity and reputation; competence and capability; and financial soundness.¹¹⁵ The burden was on the financial institution to establish that the candidate was fit and proper, and the FSA had the power to withdraw approval if an individual no longer met the standard.¹¹⁶ After they had been approved, directors and officers of financial institutions had to abide by the Statement of Principles and Code of Conduct for Approved Persons (APER). The APER largely mirrored the PRIN, imposing on individuals many of the same obligations that applied to institutions. For example, directors and officers of financial institutions had to “take reasonable steps to ensure that the business of the firm . . . [was] organised so that it [could] be controlled effectively”.¹¹⁷ The APER also described conduct that the FSA would consider to violate the principles, including the failure to take reasonable steps in apportioning and delegating responsibility.¹¹⁸

The approved persons regime was, in principle, a significant limitation on one of the prerogatives of shareholders, namely the election of directors. In this sense, it undermined shareholder primacy by dictating that only “approved persons” may be elected to the board of directors of a financial

113. *FSMA*, *supra* note 64, ss 59(1), (3), (5), 60, 61(1).

114. Financial Services Authority Handbook 2010, SI, 2010 at SUP 10.4.5R.

115. UK, Financial Services Authority, *Fit and Proper Test for Approved Persons, Release 141 2013*, (London, UK: Her Majesty’s Treasury, 2013), ss 2.1G, 2.2G, 2.3G [FIT].

116. See *FSMA*, *supra* note 64, ss 60(1), 63.

117. UK, Financial Services Authority, *Statement of Principle and Code of Practice for Approved Persons, Release 141 2013* (London, UK: Her Majesty’s Treasury, 2013), s 2.1B.3 (Principle 5) [APER].

118. *Ibid*, ss 4.5.3E, 4.5.4E, 4.5.8E.

institution. Of course, the degree to which this regulation actually interfered with shareholder primacy depended on its enforcement. In the years leading up to the GFC, the FSA did not fully exercise its authority to vet and disqualify candidates for controlled functions, focusing almost exclusively on their history of criminal or other misconduct rather than their knowledge and experience.¹¹⁹ Indeed, as of 2002, applications under section 60 of *FSMA* were being processed within seven days—hardly enough time for a thorough review—even though the statute allowed up to three months for this process.¹²⁰

In Canada, most large financial institutions are regulated at the federal level by the Office of the Superintendent of Financial Institutions (OSFI), whose powers derive from legislation bearing its name as well as from each institution’s special incorporating statutes.¹²¹ The purpose of OSFI is to “contribute to public confidence in the Canadian financial system”.¹²² Its statutory mandate covers most types of financial institutions, including federally incorporated banks, trust and loan companies, and insurance companies.¹²³ To fulfill its mandate, OSFI has the power to make guidelines, enter into prudential agreements with financial institutions and make directions to those institutions.¹²⁴

In terms of corporate governance, OSFI’s objective is “to promote the adoption by management and boards of directors of financial institutions of policies and procedures designed to control and manage risk”.¹²⁵ In addition, the special incorporation statutes give OSFI the power to disqualify, suspend or remove directors and officers of

119. UK, Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (London, UK: Her Majesty’s Treasury, 2009) at 87 [Turner Review].

120. See Blair, *supra* note 102 at 144; *FSMA*, *supra* note 64, s 61(3).

121. See *Office of the Superintendent of Financial Institutions Act*, RSC 1985, c 18 [*OSFI Act*].

122. *Ibid*, s 3.1.

123. *Ibid*. Unlike the FSA, OSFI is not a unified regulator, as some Canadian financial institutions are regulated at the provincial level, specifically non-bank, provincially-incorporated institutions. This discussion is restricted to federally-regulated financial institutions.

124. See *Bank Act*, *supra* note 85, ss 485(2), 644.1, 645(1); *Insurance Companies Act*, *supra* note 85, ss 515(2), 675.1, 676(1); *Trust & Loan Act*, *supra* note 85, ss 473(2), 506.1, 507(1).

125. *OSFI Act*, *supra* note 121, s 4(2)(c).

financial institutions.¹²⁶ In exercising this authority, it looks to a person's "competence, business record, experience, conduct or character", and to any involvement in the contravention of an applicable statute or regulation.¹²⁷ As the result, OFSI enjoys powers similar to those of the FSA with respect to directors and officers of financial institutions; in principle, it can second-guess the decisions of shareholders and boards about who should run the firm. It is unclear whether OSFI has ever used this authority. Unlike the FSA, which has issued hundreds of disciplinary rulings, none have been published by OSFI or subjected to judicial review.¹²⁸

As part of its *Supervisory Framework*, OSFI also assesses the corporate governance of financial institutions on an ongoing basis.¹²⁹ The *Supervisory Framework* states that a financial institution's "Board of Directors and Senior Management are . . . ultimately accountable for its safety and soundness and compliance with governing legislation."¹³⁰ Nevertheless, like its UK counterpart, OSFI focuses exclusively on the procedural aspects of corporate governance, rather than on the substantive outcomes it produces. In particular, OSFI's assessment criteria for boards and senior management make clear that "performance" is evaluated on the basis of how well procedures are monitored and adhered to.¹³¹ For example, OSFI looks not to a firm's financial stability, but to whether senior management "[a]ctively monitors adherence to approved policies, organizational and procedural controls, and compliance requirements."¹³² Unlike the FSA's

126. See *Bank Act*, *supra* note 85, ss 647(4), 647.1(1), (4); *Insurance Companies Act*, *supra* note 85, ss 678.1(4), 678.2(1), (4); *Trust & Loan Act*, *supra* note 85, ss 509.1(4), 509.2(1), (4).

127. *Ibid*, s 509.1(4).

128. This is explained by OSFI's view that section 22(1) of the *OSFI Act* prohibits any disclosure of information concerning specific cases in which rulings have been made against directors and officers it regulates. See email from Christine Isaacs, Correspondence Officer, Office of the Superintendent of Financial Institutions (29 March 2012) [on file with author].

129. Office of the Superintendent of Financial Institutions, *Supervisory Framework*, (Ottawa: OSFI, 2010).

130. *Ibid* at 2.

131. Office of the Superintendent of Financial Institutions, *Senior Management Assessment Criteria* (Ottawa: OSFI, 2002) [OSFI, *Senior Management*]; Office of the Superintendent of Financial Institutions, *Board of Directors Assessment Criteria* (Ottawa: OSFI, 2002) online: Office of the Superintendent of Financial Institutions Canada <<http://www.osfi-bsif.gc.ca>>.

132. *Ibid* at 4.

approved persons regime, OSFI's *Corporate Governance Guideline* did not subject directors and officers to a detailed and mandatory code of conduct, and this may leave them less exposed to liability for poor management than their UK counterparts.¹³³ Although the Canadian regulator insists that directors and officers of financial institutions are to be "accountable" for economic outcomes, the legal mechanisms that actually ensure this accountability are even less clear than under UK law.

Indeed, the absence of liability for economic and social consequences in the UK and Canada, at both the institutional and managerial levels, is a reflection of the commitment of both systems to shareholder primacy. The emphasis on procedural, rather than substantive, aspects of corporate governance apparent in both systems implies a faith in the self-regulating market. It is assumed that as long as proper procedures are in place, the market will produce desirable outcomes, so there is no need for the law to hold anyone responsible for the consequences of excessive risk-taking, be these the failure of the financial institution or the systemic consequences of that failure.

In a recent speech, the CEO of the FSA appeared to recognize this shortcoming of financial regulation: "We need to supervise to a philosophy that judges firms on the outcomes, the consequences of their actions, not on the compliance with any given individual rule."¹³⁴ The ideology of shareholder primacy may also explain another problematic feature of financial regulation common to both the UK and Canada, namely the lax supervision of director and officer qualifications. Regulators may hesitate to interfere with appointments if they believe that the market for managerial talent and the market for corporate control function efficiently. In any event, this survey of the corporate governance aspects of financial regulation in the UK and Canada suggests that both systems institutionalize the assumptions of shareholder primacy.

133. Office of the Superintendent of Financial Institutions, *Corporate Governance Guideline* (Ottawa: OSFI, 2003).

134. Hector Sants, "The Challenges Facing Bank Regulation" (Speech delivered at the Association of Corporate Treasurers, 14 May 2009) [unpublished] online: Financial Services Authority <<http://www.fsa.gov.uk>> .

C. Securities Regulation

The third major source of corporate governance norms is securities regulation. In the UK, securities regulation was the responsibility of the FSA, which was called the UK Listing Authority (UKLA) when acting in that capacity.¹³⁵ Pursuant to section 74 of the *FSMA*, the UKLA maintained an “Official List” of securities issued to the public by companies in the UK.¹³⁶ The same statutory provision gave the UKLA the authority to make Listing Rules (LRs) for the purposes of administering the Official List. According to the LRs, a company with a premium listing¹³⁷ had to state in its financial report the extent to which it has complied with the *UK Corporate Governance Code (Code)*.¹³⁸ Known as a “comply or explain” policy, the LRs made compliance with the *Code* optional, as long as that the issuer disclosed its reasons for non-compliance.¹³⁹ In addition, under the Disclosure and Transparency Rules (DTR), an issuer had to include in its director’s report a “corporate governance statement”, with information on the code and practices to which it adheres, on its internal controls and risk management systems and on its administrative management and supervisory bodies.¹⁴⁰ The focus of the UKLA rules was on ensuring that the market had sufficient information to assess the quality of corporate governance.

In terms of substance, the *Code* urged companies to abide by five “main principles”: leadership, effectiveness, accountability, remuneration and relations with shareholders.¹⁴¹ Like the FSA rules, the *Code* focused exclusively on the internal operations of the company. For example, it stated that “[t]he board should maintain sound risk management and

135. *FSMA*, *supra* note 64, Part VI; Hudson, *supra* note 65 at 1017.

136. *Ibid.*

137. Most large financial institutions in the UK will have a premium listing, which is required for inclusion on the FTSE indices. For an explanation of the UK’s two-tier listing regime, see Richard Smerdon, *A Practical Guide to Corporate Governance*, 4th ed (London, UK: Sweet & Maxwell, 2010) at 37.

138. UK, Financial Services Authority, *Listing Rules, Release 141 2013* (London, UK: Her Majesty’s Treasury, 2013), s 9.8.6 (5)R [LR].

139. *Ibid.*, s 9.8.6(6)R.

140. See Financial Services Authority Handbook 2010, SI, 2010, DTR 7.2.2R, 7.2.5R, 7.2.7R.

141. Financial Reporting Council, *The UK Corporate Governance Code* (London, UK: Financial Reporting Council, 2010) at 6–7.

internal control systems”,¹⁴² but it said very little—only five lines—on the content of that standard, and did not alter the duties of directors under statute or the common law. It made no mention of stakeholders at all.

In Canada, securities are regulated at the provincial level.¹⁴³ Nevertheless, through a collective body called the Canadian Securities Administrators (CSA), provincial regulators develop “national instruments”, which they may implement in their respective jurisdictions.¹⁴⁴ In terms of corporate governance, the CSA has issued National Instrument 58-101 concerning disclosure of corporate governance practices, which was adopted as a rule in Ontario.¹⁴⁵ Like the UK Listing Rules, NI 58-101 requires issuers to make certain disclosures in their management information circulars, including the extent of director independence, the board’s written mandate and position descriptions for the board chair and the CEO.¹⁴⁶ The issuer must also disclose whether it has adopted a code of business conduct.¹⁴⁷

In contrast to the UK, Ontario does not make reference to a standard corporate governance code, or require issuers to justify any non-compliance; all that is required of an issuer that does not adhere to a code is a description “of any steps the board takes” to ensure that directors exercise independent judgement and to encourage ethical business conduct.¹⁴⁸ As a result, even if the market for corporate information was capable of producing socially beneficial outcomes, it is doubtful that NI 58-101 would encourage adequate disclosure of corporate governance practices. More fundamentally, as in the UK, there is nothing in NI 58-101 that modifies the core duties of directors and officers or requires them to consider stakeholder interests.

Accompanying NI 58-101 are the *Corporate Governance Guidelines*.¹⁴⁹ Their status as “national policy” means they do not have the force of

142. *Ibid* at 7.

143. See *Re Securities Act*, 2011 SCC 66 at para 116, [2011] 3 SCR 837.

144. See Mark R Gillen, *Securities Regulation in Canada*, 3d ed (Toronto: Carswell, 2007) at 101.

145. See *Disclosure of Corporate Governance Practices*, OSC NI 58-101, 28 OSCB 5377 (2005).

146. *Ibid*, Form 58-101F, ss 1-3.

147. See *ibid*, s 5.

148. *Ibid*, ss 5(b), (c).

149. *Corporate Governance Guidelines*, OSC NP 58-201 28 OSCB 5383 (17 June 2005).

law.¹⁵⁰ The *Guidelines*, which Ontario adopted, are merely four pages long and deal exclusively with the firm's internal structures. For example, under section 3.1, issuers are urged to have a board with a majority of independent directors.¹⁵¹ The *Guidelines* also recommend the adoption of a written board mandate, position descriptions and a code of business conduct and ethics.¹⁵² There are recommendations with respect to director nomination and executive compensation,¹⁵³ but the *Guidelines* do not alter the basic duties of directors and officers under company law.

Therefore, the corporate governance aspects of securities regulation in the UK and Canada are entirely consistent with shareholder primacy. Both regimes are based on the assumption that the market for corporate information—i.e., disclosure—is capable of disciplining firms as well as their directors and officers. Securities regulation, like financial regulation, emphasizes the procedural aspects of corporate governance, not accountability for the consequences of excessive risk-taking.

The conclusion that flows from this comparative analysis is that it is only in the duties owed to the shareholders that the directors and officers of financial institutions find any real risk of disciplinary consequences. The incentives provided by UK and Canadian corporate governance law therefore appear to be contrary to the interests of broader financial stability, at least as explained by Minsky and Polanyi. While the markets for managerial talent and corporate control threaten to oust financial institution executives if they fail to maximize shareholder value, there is no countervailing legal incentive to avoid excessive leverage. The individuals who run financial institutions seem to have had no real stake in the systemic consequences of their decisions.

Furthermore, statistical analysis shows that the mandated corporate governance procedures not only failed to prevent the Crisis, but that some of them probably also helped precipitate it by further aligning the

150. See Jeffrey G MacIntosh & Christopher C Nicholls, *Securities Law* (Toronto: Irwin Law, 2002) at 84–85.

151. Corporate Governance Guidelines, *supra* note 149, s 3.1.

152. *Ibid*, ss 3.4, 3.5, 3.8.

153. *Ibid*, ss 3.10–3.14, 3.15–3.17.

interests of boards and shareholders.¹⁵⁴ For these reasons, the law in both countries may be described as disembedded in the Polanyian sense; it sees corporate governance as involving merely a series of discrete transactions, without acknowledging the broader economic and social context within which financial institutions operate. Minsky's hypothesis would predict an association between this disembeddedness of financial institutions and a level of economic and social stability. Whether this prediction holds is explored in the next part.

III. The Crisis of Shareholder Primacy in the UK and Canada

As explained in Part I, the economic theories adopted in this study would see the incentives of the UK and Canadian corporate governance regimes as likely having various negative consequences. Specifically, Minsky's analysis foresees the growth of leverage facilitated by financial innovation, which produces an asset price boom and eventually a stock market crash, unemployment and recession. His teachings also suggest that the pursuit of profit combined with the optimism engendered by rising asset prices will undermine prudential regulation. According to this hypothesis, in an effort to maximize shareholder value, financial institutions will develop ways to avoid compliance—a strategy called regulatory arbitrage. Regulators, mistakenly interpreting the boom as a sign of stability, will become less vigilant or interventionist—a phenomenon that may be described as the regulatory cycle.

Finally, as the latent instability of the economy develops into a crisis, public authorities will take dramatic measures to save society from the consequences of the self-regulating market. As part of this countermovement, governments will run large deficits in order to support investment, and central banks will provide liquidity to financial institutions, thereby allowing them to refinance their obligations and propping up the prices of their assets. While these interventions may restore economic stability in the short-term, they are expected to create

154. See Andrea Beltratti & René M Stulz, "Why Did Some Banks Perform Better During the Crisis: A Cross-Country Study of the Impact of Governance and Regulation" (2009) [NBER Working Paper 15180] online: NBER <<http://www.nber.org/papers/w15180>> at 2-3.

the conditions for political turmoil in the aftermath of the crisis. In this part, the empirical evidence for each of these predictions is explored based on the experience of the UK and Canada during the GFC.

A. Shareholder Primacy and Financial Instability

The GFC originated in the US housing market, but the same basic events unfolded in the UK and Canada, albeit to different degrees. In the latter two countries, the “financial innovation” that Minsky identified as a strategy for boosting leverage was rampant. Like their American counterparts, UK and Canadian financial institutions abused a practice known as “securitization” to acquire assets and quickly move them off their balance sheets, thereby allowing them to avoid increased borrowing costs or capital requirements, both of which cut into shareholder profits.¹⁵⁵ In its simplest form, securitization made it possible for loan originators to sell their loans to so-called Special Purpose Vehicles (SPVs), which would then sell Asset-Backed Securities (ABS) to investors.¹⁵⁶ This was considered a win-win-win proposition: loan originators got paid upfront for their assets, investment banks (which set up SPVs and served as their underwriters) received handsome fees and investors enjoyed a steady stream of income from supposedly risk-free assets.¹⁵⁷

However, securitization created a moral hazard since loan originators no longer bore the downside risks of their assets.¹⁵⁸ At the same time, the increased complexity of financial instruments made it more difficult for investors to evaluate the risks associated with the underlying assets. For example, through the use of collateralized debt obligations (CDOs), subprime mortgages were bundled and sold as triple-A investments.¹⁵⁹ Not surprisingly, this was a recipe for massive deterioration in lending

155. See Nouriel Roubini & Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (New York: Penguin Books, 2010) at 63–64. See also Part III–B–(i), below.

156. See Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Vintage Books, 2011) at 123.

157. See Roubini & Mihm, *supra* note 155 at 61.

158. See Joseph E Stiglitz, *Freefall: America, Free Markets and the Sinking of the World Economy* (New York: WW Norton & Co, 2010) at 90.

159. For a detailed explanation of various securitization techniques, see Andrew M Chisholm, *An Introduction to International Capital Markets: Products, Strategies, Participants*, 2d ed (Chichester, UK: John Wiley & Sons, 2009) at 113–28.

standards as profit-maximizing financial institutions took advantage of the market's faith in the new instruments to make loans to almost anyone who asked.¹⁶⁰

This was exactly as Minsky had predicted. In their quest for profit, financial institutions found ways to increase leverage, at least temporarily, without increasing their borrowing costs. More loans coincided with more demand for assets (especially housing), which led to higher prices and thus validated the new financial practices.¹⁶¹ The optimism in ever-rising prices fuelled a bubble that eventually burst when there were no more eligible borrowers.¹⁶² Over-leveraged financial institutions then saw their borrowing costs rise, pushing more of them into the Ponzi position and tilting the economy toward crisis.¹⁶³ Likewise, since their dubious mortgages were based on the assumption that housing prices would continue to rise, homeowners saw their monthly payments increase. Not surprisingly, many defaulted.¹⁶⁴ As Ponzi firms tried to rid themselves of their toxic assets, prices fell sharply.¹⁶⁵ This resulted in bank failures, stock market crashes, recessions and unemployment.¹⁶⁶

In the UK, securitization grew exponentially in the decade leading up to the Crisis, from £20 billion worth of issues in 2000 to over £180 billion in 2007.¹⁶⁷ By 2007, an estimated 18% of mortgages were being securitized in the UK.¹⁶⁸ The expected deterioration in lending standards materialized, with the spread of self-certification, buy-to-let and 100 percent mortgages.¹⁶⁹ These risky assets led a number of UK banks

160. See Johnson & Kwak, *supra* note 155 at 127–28.

161. See Crotty, *supra* note 44 at 575.

162. See McCulley, *supra* note 24 at 263.

163. See generally *ibid* at 264–65.

164. See Whalen, *supra* note 24 at 247.

165. See L Randall Wray, “The Rise and Fall of Money Manager Capitalism: a Minskyian Approach” (2009) 33:4 *Camb J Econ* 807 at 821.

166. See *ibid*.

167. See Turner Review, *supra* note 119 at 14.

168. See *ibid* at 32.

169. See UK, House of Commons Treasury Committee, *Banking Crisis: Dealing with the Failure of UK Banks* (Seventh Report of Session 2008–09) (London, UK: Her Majesty's Stationary, 2009) at 15 [Treasury Committee, *Failure of UK Banks*]. See also *ibid* at 29.

to collapse, including Northern Rock and Bradford & Bingley.¹⁷⁰ As the House of Commons Treasury Committee concluded:

The widespread . . . belief that risk was being ‘managed’ led many banks to increase the complexity of their operations and their overall risk exposure. This was manifestly a false premise. Indeed, one of the features that is key to understanding the banking crisis is that some forms of securitisation, far from mitigating risk, actually obscured it.¹⁷¹

The impact was not limited to banks. Private pension funds in the UK suffered losses of 17.4% in 2009, principally because of their exposure to equities, which took a major hit in the ensuing stock market crash.¹⁷²

In Canada, securitization wreaked havoc as well. Although there were no bank failures, most large banks reported massive write-downs, which were associated with ABS originating in both the US and Canada. By the end of 2008, CIBC’s write-downs were valued at \$9.3 billion, followed by the Royal Bank of Canada at \$5.7 billion, the Bank of Nova Scotia at \$1.7 billion and TD Bank at \$900 million.¹⁷³ But the biggest losses came in the asset-backed commercial paper (ABCP) market, which is also based on the principle of securitization. Instead of originating assets themselves, entities called “sponsors” (either banks or non-banks) established “conduits” for the purpose of acquiring assets, largely in the form of ABS.¹⁷⁴ The conduits then issued commercial paper (i.e., short-term debt with a maturity of less than one year), the proceeds of which were used to acquire more assets.

This business model was inherently unstable because the conduits were using short-term debt to finance long-term positions. Therefore, when the commercial paper matured, the conduits would have to either roll it over (by getting existing investors to renew), assume more debt (by issuing

170. See UK, House of Commons Treasury Committee, *The Run on the Rock* (Fifth Report of Session 2007–08) (London, UK, Her Majesty’s Stationary, 2008) at 13; see also Treasury Committee, *Failure of UK Banks*, *supra* note 169 at 17.

171. *Ibid* at 38.

172. See Brian Keeley & Patrick Love, *From Crisis to Recovery: The Causes, Course and Consequences of the Great Recession* (Paris: OECD Publishing, 2009) at 72.

173. See Scotia Capital, *Canadian Banks Annual Review: Fiscal 2009* (Toronto: Scotia Capital, 2010) at B16.

174. See John Chant, *The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets* online: The Expert Panel on Securities Regulation <<http://www.expertpanel.ca>> at 6.

new paper) or sell their assets.¹⁷⁵ Over the years, the conduits acquired increasingly complex assets, including CDOs and credit default swaps (CDSs); in August 2007, a portion of the ABCP market with exposure to these assets collapsed. In total, an estimated \$32 billion worth of paper effectively defaulted because conduits could not meet their obligations as they came due.¹⁷⁶ The consequences of the ABCP crisis were not confined to sophisticated investors; ABCP was sold to an estimated 1,800 retail investors.¹⁷⁷ Canada's second largest public pension fund, the Caisse de dépôt et placement du Québec, with its \$13.2 billion exposure to ABCP, accounted for over one-third of the affected market.¹⁷⁸

But the harm was not limited to pension funds and investors with direct exposure to ABCP. As Minsky's theory predicts, both the UK and Canada experienced a severe stock market crash, with their main indexes falling 44% between August 2007 and March 2009.¹⁷⁹ Then came a recession. The UK experienced five consecutive quarters of negative growth (from Q2-2008 to Q2-2009), and Canada had three (from Q4-2008 to Q2-2009).¹⁸⁰ Millions of people lost their jobs; in the UK, the unemployment rate increased from a low of 5.1% (in Q4-2007) to a high of 8.4% in (Q3-2011), and in Canada the rate went from a low of 5.5% (in Q4-2007) to a high of 8.7% in (Q4-2010).¹⁸¹ Employment levels have yet to recover in either country.

The economic instability seen during the GFC provides ample evidence that the incentive structure of shareholder primacy is destabilizing to financial institutions. In particular, the corporate governance laws of

175. See generally Christopher C Nicholls, *Financial Institutions: The Regulatory Framework* (Markham, ON: LexisNexis, 2008) at 189.

176. See Stephen L Harris, "The Global Financial Meltdown and Financial Regulation: Shirking and Learning" in G Bruce Doern & Christopher Stoney, eds, *How Ottawa Spends 2010-11: Recession, Realignment and the New Deficit Era* (Montreal: McGill-Queen's Press, 2010) 68 at 74.

177. See Chant, *supra* note 174 at 22.

178. See Nicholls, *supra* note 175 at 194.

179. Bloomberg, "Stock Market & Financial Markets Overview" online: Bloomberg <<http://www.bloomberg.com>> (comparing closing values of FTSE 100 and S&P/TSX Composite between first trading day of August 2007 and first trading day of March 2009).

180. See Organisation for Economic Co-operation and Development, "Quarterly Growth Rates of Real GDP" online: OECD StatExtracts <<http://stats.oecd.org>>.

181. See Organisation for Economic Co-operation and Development, "Labour Force Statistics" online: OECD StatExtracts <<http://stats.oecd.org>>.

the UK and Canada encourage and arguably require these institutions to maximize profit, which leads to excessive reliance on financial innovation in order to boost leverage. As Minsky predicted, this is the very behaviour that leads to recessions and unemployment.

B. Shareholder Primacy and Prudential Regulation

Minsky also predicted that the perverse incentives of shareholder primacy would undermine prudential regulation through two mechanisms: regulatory arbitrage and regulatory cycles. As explained above, the first process describes efforts by financial institutions to avoid compliance costs, particularly those associated with capital requirements. The second refers to the influence of market conditions on the strength of regulation. Each of these phenomena is addressed in turn.

(i) Regulatory Arbitrage

Regulatory arbitrage explains, at least in part, the growth of securitization in both the UK and Canada.¹⁸² In 1988, the Basel Committee on Banking Supervision (BCSC), an international body composed of central banks and regulatory authorities from most of the world's leading economies, adopted an Accord that established minimum capital requirements for financial institutions.¹⁸³ The Basel Accord sought to control risk by requiring financial institutions to maintain a certain ratio of capital to "risk-weighted" assets. In other words, the amount of capital needed was a function of the relative riskiness of the asset portfolio. The Accord set the minimum capital ratio at 8%, at least half of which would have to come from so-called "tier 1 capital": equity and

182. See David Jones, "Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues" (2000) 24:1 *Journal of Banking & Finance* 35 at 36.

183. See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (Basel: Bank for International Settlements, 1988), online: BIS <<http://www.bis.org/publ/bcbs04a.pdf>> [Basel Accord].

retained earnings.¹⁸⁴ By the beginning of 1990, both the UK and Canada had implemented the Basel Accord.¹⁸⁵

This regulatory structure had important implications in terms of shareholder value maximization. To acquire more assets, financial institutions had to either raise more equity (which dilutes the profits of existing shareholders) or increase their retained earnings (which cuts into shareholder dividends). Consequently, shareholder primacy created a powerful incentive for financial institutions to artificially reduce the value of their risk-weighted assets. This was done through securitization, which made it possible to take advantage of risk-weight discounts that applied to various off-balance-sheet transactions.¹⁸⁶ It is now widely acknowledged that regulatory arbitrage contributed to the rise of securitization seen in the last several decades.¹⁸⁷

Regulatory arbitrage may have also produced instability after Canada took steps to exceed international standards. In 2004, OFSI announced that it would no longer treat so-called “global-style” liquidity lines as off-balance-sheet assets, meaning that they would be subject to a capital requirement.¹⁸⁸ In the ABCP market, conduits bought liquidity lines from banks in order to mitigate rollover risk. With global-style lines, conduits could access liquidity whenever they found themselves without a buyer for maturing paper. Due to the growth of the ABCP market, the regulator took the view that these lines posed risks to Canadian banks that should be reflected in the capital-asset ratio.¹⁸⁹ With this change, global-style lines became more costly, both for banks and conduits.¹⁹⁰ Consequently, an

184. *Ibid* at 15.

185. See Daniel K Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Washington: Peterson Institute for International Economic, 2008) at 65.

186. See Augusto de la Torre & Alain Ize, “Regulatory Reform: Integrating Paradigms” (2010) 13:1 *International Finance* 109 at 118.

187. See e.g. *ibid*; Jones, *supra* note 182; Tarullo, *supra* note 185 at 79–82; Costas Lapavistas, “Regulate Financial Systems, or Financial Institutions?” in Philip Arestia, Rogerio Sobreira & Jose Luis Oreiro, eds, *The Financial Crisis: Origins and Implications* (New York: Palgrave Macmillan, 2011) 137 at 151.

188. Chant, *supra* note 174 at 14. Under the Basel Accord, lending commitments of less than one year were excluded from the risk assessment. See Basel Accord, *supra* note 183 at 24.

189. Canada, Office of the Superintendent of Financial Institutions, *Asset Securitization Guideline B-5* (Ottawa: Office of the Superintendent of Financial Institutions, 2004) at 7.

190. See generally Chant, *supra* note 174 at 37.

alternative, more restrictive product, which made access contingent upon “general market disruption”—i.e., illiquidity affecting the entire market—became more attractive. The use of these cheaper lines became widespread in the Canadian ABCP market; indeed, they were dubbed “Canadian-style” because credit rating agencies in most other countries refused to recognize them.¹⁹¹

When the market for non-bank ABCP collapsed, conduits found themselves unable to access their liquidity lines because the crisis was restricted to non-bank ABCP, with only 27% of conduits being affected.¹⁹² As a result, the condition of general market disruption was not satisfied and banks did not have to provide liquidity. Conduits were thus unable to meet their obligations to investors, who were left holding illiquid and plummeting assets.

Several commentators, as well as OSFI itself, have argued that Canadian-style lines were not a response to higher capital requirements.¹⁹³ In particular, they have pointed out that most affected conduits used foreign banks for their liquidity lines that were not under OSFI’s jurisdiction. Nevertheless, there is no dispute that Canadian banks did prefer the more restrictive lines,¹⁹⁴ which arguably legitimized the practice throughout the ABCP market. Furthermore, the preference of conduits for foreign banks may be related to OSFI’s overall capital adequacy requirements, which were the most onerous in the G7.¹⁹⁵ Foreign banks were thus in a position to offer conduits cheaper products than their Canadian counterparts. Therefore, it is plausible that, in response to OSFI’s vigilance, domestic banks and conduits took steps to cut costs, adopting the less prudent option available and ultimately contributing to the ABCP crisis.

191. *Ibid* at 21.

192. *Ibid* at 4.

193. See Nicholls, *supra* note 175 at 193; Canada, Office of the Superintendent of Financial Institutions, Background, “OSFI’s Role in the ABCP Market Issue” (22 April 2008) at 6–7 online: OSFI <<http://osfi-bsif.gc.ca>> .

194. See *ibid* at 6.

195. See International Monetary Fund, *Canada: Staff Report for the 2009 Article IV Consultation* (Washington: IMF, 2009) at 17.

(ii) Regulatory Cycles

The evolution of prudential regulation in the UK and Canada lends support to the prediction that the strength of regulation fluctuates with market conditions. During the 1980s, there was substantial deregulation of the financial services industry in both countries. In general, deregulation was meant to foster increased competition, which was accomplished by removing restrictions on the permissible activities of financial institutions, facilitating their participation in capital markets and loosening restrictions on their foreign ownership.

In the UK, the most extensive deregulation came between 1986 and 1987, a period that became known as the “Big Bang”.¹⁹⁶ During this time, building societies, which were organized as mutuals and restricted to the mortgage business, were given the option to “demutualize” (i.e., become corporations), and were allowed to offer a wider range of services.¹⁹⁷ In parallel, commercial banks were permitted to enter the housing market and engage in securities trading.¹⁹⁸ Foreign ownership restrictions on members of the London Stock Exchange were lifted entirely.¹⁹⁹ All of this resulted in a massive influx of foreign capital and firms, making The City a hotbed of financial competition and innovation.²⁰⁰

In Canada, the pattern was much the same. In 1980, the *Bank Act* was amended to allow foreign banks into the Canadian market.²⁰¹ Beginning in 1986, through a combination of federal and provincial initiatives, various types of financial institutions—including banks, insurance and

196. See e.g. Philip N Hablutzel, “British Banks’ Role in UK Capital Markets Since the Big Bang” (1992) 68:1 *Chicago-Kent L Rev* 365 at 371–74 (explaining the various components of deregulation).

197. See Doha M Adelhamid, *International Regulatory Rivalry in Open Economics: The Impact of Deregulation on the US and UK Financial Markets* (Aldershot, UK: Ashgate, 2003) at 206–07; Jacqueline Cook, Simon Deakin & Allan Hughes, “Mutuality and Corporate Governance: The Evolution of UK Building Societies Following Deregulation” (2001) [ESRC Centre for Business Research, Working Paper No 205] at 16.

198. See Abdelhamid, *supra* note 197 at 200.

199. See Sarkis J Khoury, *The Deregulation of the World Financial Markets: Myths, Realities, and Impact* (New York: Quorum Books, 1990) at 129.

200. See generally Hablutzel, *supra* note 196 at 375.

201. See Charles Freedman, *The Canadian Banking System* (March 1998), online: Bank of Canada <<http://www.banqueducanada.ca/wp-content/uploads/2010/01/tr81.pdf>> at 8.

trust companies—were permitted to enter the securities business.²⁰² Then, in 1992, banks were allowed to acquire trust and insurance companies, and to offer investment advice.²⁰³ These reforms led to a dramatic consolidation in the Canadian market, with banks acquiring most major trusts and brokerage firms.²⁰⁴

Therefore, in the decades preceding the GFC, both the UK and Canada had unleashed their financial markets. In doing so, they created the ideal setting for financial innovation, as firms needed to find new ways of satisfying shareholders within a hypercompetitive, globally and functionally integrated marketplace.

While such market conditions cried out for tough prudential regulation, the trend was precisely the opposite. In 2004, the Basel Accord was amended to essentially allow financial institutions to set their own capital requirements. Under the new Basel II framework, risk weights could be based on the financial institution's own internal risk assessments.²⁰⁵ The new international standard also embraced the “hands-off” approach to supervision and discipline discussed above. Financial institutions were given primary responsibility for maintaining adequate capital, with the regulator playing the more passive role of ensuring that internal procedures (rather than outcomes) were appropriate.²⁰⁶ In terms of accountability, Basel II adopted the principle of “market discipline”, under which the market is assumed to be capable of ensuring prudent management as long as there is complete disclosure of information, particularly capital-asset ratios.²⁰⁷ Basel II came into force in the UK on January 1, 2007 by virtue of the EU Capital Requirements Directive (CRD),²⁰⁸ while OSFI adopted

202. See William D Coleman, “Financial Services Reform in Canada: The Evolution of Policy Dissension” (1992) 18:2 Canadian Public Policy 139 at 147.

203. See Freedman, *supra* note 201 at 14.

204. See Murray Cooke, *Banking on Mergers: Financial Power versus the Public Interest* (Toronto: Centre for Social Justice, 2005) at 22.

205. See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version)* (Basel: Bank for International Settlements, 2006), online: BIS <<http://www.bis.org/publ/bcbs128.pdf>> at para 211 [Basel II]. See also Nicholls, *supra* note 145 at 97.

206. Basel II, *supra* note 205 at para 721.

207. *Ibid* at paras 809–10.

208. UK, Financial Services Authority, “The Basel Accord and Capital Requirements Directive” online: Financial Services Authority <<http://www.fsa.gov.uk>>.

a new Guideline on Capital Adequacy Requirements, making much of the framework effective as of November 1, 2007.²⁰⁹

As a result, the core elements of prudential regulation were delegated to financial institutions (and their boards), which had every incentive to underestimate the risk of their assets. The important point is that just as the economy was approaching its most fragile state, regulators agreed to abdicate their responsibility.²¹⁰ This is entirely consistent with Minsky's observation that the same forces which lead to crisis also undermine the very regulations that are supposed to prevent it. The role of shareholder primacy is key in this antithetical process. Driven by legal and financial incentives, directors and officers of financial institutions strive to maximize shareholder profit, temporarily boosting asset prices, investment and growth. This optimism causes regulators to let their guard down as they mistakenly attribute the economy's strong performance to prudent management.²¹¹ This gives financial institutions the opportunity to escalate their destabilizing practices, which eventually plunges the economy into crisis.²¹²

The apparent role that regulatory arbitrage and regulatory cycles played in the GFC has important implications for corporate governance. First, the perverse incentives of shareholder primacy mean that regulators are constantly playing "catch up". Second, profit maximization results in misleading market signals, which induce regulators to loosen their grip at precisely the wrong time. The ability of financial institutions to undermine prudential regulation in these ways speaks to their embeddedness; it suggests that a corporate governance system premised on a faith in self-regulating markets is destabilizing.

209. See Canada, Office of the Superintendent of Financial Institutions, *Capital Adequacy Requirements (Guideline)* (Ottawa: OSFI, 2007).

210. See generally Christopher Rude, "The Role of Financial Discipline in Imperial Strategy" in Leo Panich & Martijn Konigs, eds, *American Empire and the Political Economy of Global Finance* (Hampshire, UK: Palgrave MacMillan, 2008) 198 at 218.

211. This idea is similar to Michal Kalecki's "political business cycle" theory. See Michal Kalecki, "Political Aspects of Full Employment" (1943) 14:4 *The Political Quarterly* 322 at 330.

212. Some commentators have attributed the GFC to Basel II. See e.g. Lapavitsas, *supra* note 187; Rude, *supra* note 210. It may also explain the failure of UK and Canadian regulators to adequately monitor the qualifications of directors and officers of financial institutions. See Part II-B, above.

C. Shareholder Primacy, Bailouts, Austerity and Political Turmoil

The post-Crisis experience of the UK and Canada is also consistent with the predictions of Minski and Polanyi. In the UK, the Bank of England established the Special Liquidity Scheme (SLS), which allowed banks to substitute their illiquid assets for treasury bills.²¹³ Under the SLS, the Bank of England lent some £185 billion to financial institutions, thus fulfilling its role as lender of last resort.²¹⁴ In addition, in January 2009, the Treasury authorized the establishment of the Asset Purchase Facility, which currently allows the Bank of England to purchase up to £325 billion of assets.²¹⁵

Big government also emerged in the UK. In October 2008, the Treasury announced a series of measures, including the Bank Recapitalisation Fund, under which the government ended up with major stakes in several UK banks, including Lloyds and RBS.²¹⁶ In January 2009, the Treasury announced further rescue measures, namely the Asset Protection Scheme, pursuant to which the government has insured nearly £300 billion of assets, including residential mortgages and derivatives.²¹⁷ As a result, the UK authorities responded to the Crisis as expected, by undertaking massive fiscal and monetary interventions.

In Canada, the central bank also responded with extraordinary lender-of-last-resort measures. Beginning in early 2008, the Bank of Canada began accepting illiquid assets, such as ABCP, as collateral from a wider set of counterparties.²¹⁸ The market would not allow financial institutions to borrow against these troubled assets, but the Bank of Canada did, meaning that the downside risk of speculative and Ponzi positions was

213. See Treasury Committee, *Failure of UK Banks*, *supra* note 169 at 55.

214. Paul J Davies & Izabella Kaminska, "Lenders seek help from new set of institutions" *Financial Times* (21 December 2010), online: The Financial Times <<http://www.ft.com>>.

215. Bank of England, "Asset Purchase Facility", online: Bank of England <<http://www.bankofengland.co.uk>>.

216. Treasury Committee, *Failure of UK Banks*, *supra* note 169 at 57–58.

217. UK, Her Majesty's Treasury, "The Asset Protection Scheme" online: The National Archives <http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/apa_aps.htm>.

218. See Lorie Zorn, Carolyn Wilkins & Walter Engert, "Bank of Canada Liquidity Actions in Response to Financial Market Turmoil" in Jack Selody et al, eds, *Bank of Canada Review: August 2009* (Ottawa: Bank of Canada, 2009) at 7–8, online: Bank of Canada <http://www.bankofcanada.ca/wp-content/uploads/2010/06/review_autumn09.pdf>.

socialized in Canada, as it was in the UK. In December 2008, the amount outstanding on the Bank of Canada's liquidity facilities swelled to over \$40 billion.²¹⁹ Furthermore, the Bank of Canada lowered its overnight rate to 0.5%, reducing the cost of short-term credit.²²⁰ As in the UK, big government came to the rescue in Canada, with the Department of Finance establishing the Extraordinary Financing Framework. Under this program, the federal government has purchased \$69.35 billion in mortgage pools from financial institutions and \$4.5 billion worth of other asset-backed securities.²²¹ As a result of these interventions, both the UK and Canada emerged with bloated government deficits, leading to the imposition of austerity, which in turn sparked political opposition.

In the UK, the deficit jumped from 2.8% of GDP in 2007 to 11% in 2009.²²² After the general election of May 2010, the Coalition government announced that "deficit reduction . . . is the most urgent issue facing Britain", and vowed to pursue this objective "with the main burden . . . born by reduced spending rather than increased taxes".²²³ Making good on this promise, the government's June 2010 budget included £99 billion in spending cuts—including reductions to welfare programs—together with £29 billion in tax increases (although the corporate tax rate was decreased). These measures were all aimed at reducing the deficit to 1.1% of GDP within six years.²²⁴ The details of the government's austerity program were unveiled in October,²²⁵ sparking a series of massive protests that lasted throughout 2011; the UK also experienced its biggest strike in

219. See *ibid* at 8.

220. See *ibid* at 10.

221. Government of Canada, "Canada's Economic Action Plan, Extraordinary Financing Framework (Budget 2009 and Budget 2010)", online: Government of Canada <<http://www.actionplan.gc.ca>>.

222. See Organization for Economic Cooperation and Development, "Economic Outlook No. 90 – December 2011", online: OECD <<http://stats.oecd.org>> [Economic Outlook].

223. UK, The Cabinet Office, *The Coalition: Our Programme for Government* (London, UK: Her Majesty's Government, 2010) at 15.

224. UK, Her Majesty's Treasury, *Budget 2010* (London, UK: The Stationary Office, 2010) at 2.

225. UK, Her Majesty's Treasury, *Spending Review 2010* (London, UK: HM Stationary Office, 2010).

over three decades.²²⁶ As of early 2012, the austerity program had resulted in the loss of 270,000 public sector jobs.²²⁷

While the fiscal impact of the Crisis was less severe in Canada, its political ramifications were arguably just as significant as in the UK. The federal government's initial response to the recession nearly toppled the Harper minority and precipitated a constitutional crisis. In late November 2008, the Minister of Finance presented an Economic and Fiscal Statement that, while predicting a recession, did not contain plans for a stimulus package.²²⁸ In response to this "small government" plan, the opposition parties signed an agreement to defeat the Conservatives and form a coalition.²²⁹ In order to avoid the confidence vote, the Prime Minister obtained from the Governor General a prorogation of Parliament—an unprecedented act of self-preservation that may have violated the basic principles of responsible government.²³⁰

When Parliament resumed, the government capitulated and increased spending dramatically, eroding its surplus and producing a deficit of 5.6% of GDP by 2010.²³¹ Shortly thereafter, as in the UK, an ambitious plan to eliminate the deficit by 2015 to 2016 was introduced; to this end, the 2010 budget included \$17.6 billion in cuts over this timeframe.²³² In 2011, the Harper government announced a comprehensive spending review, which ultimately resulted in an additional \$5.2 billion in annual cuts and the

226. See e.g. Mark Townsend et al, "Anti-cuts march draws hundreds of thousands as police battle rioters" *The Guardian* (27 March 2011), online: The Guardian <<http://www.guardian.co.uk>>; Amelia Hill, "May Day protest against government cuts" *The Guardian* (1 May 2011), online: The Guardian <<http://www.guardian.co.uk>>; Brian Groom, "UK sees biggest strike for more than 30 years" *Financial Times* (1 December 2011) online: Financial Times <<http://www.ft.com>>.

227. See Heather Stewart, "Osborne's Austerity Drive Cut 270,000 Public Sector Jobs Last Year" *The Guardian* (14 March 2012), online: The Guardian <<http://www.guardian.co.uk>>.

228. See Canada, *Protecting Canada's Future: Economic and Fiscal Statement* (Ottawa: Department of Finance, 2008) at 9.

229. CBC News, "Liberals, NDP, Bloc Sign Deal on Proposed Coalition" (1 December 2008), online: CBC <<http://www.cbc.ca>>.

230. See generally CES (Ned) Franks, "To Prorogue or Not to Prorogue: Did the Governor General Make the Right Decision?" in Peter H Russell & Lorne Sossin, eds, *Parliamentary Democracy in Crisis* (Toronto: University of Toronto Press, 2009) 33 at 33.

231. See Economic Outlook, *supra* note 222.

232. See Canada, Department of Finance, *Budget 2010: Leading the Way on Jobs and Growth* (Ottawa: Public Works and Government Services, 2010) at 157.

elimination of nearly 20,000 public sector jobs.²³³ The age of eligibility for retirement benefits was increased,²³⁴ and corporate taxes have come down. This means that the burden of Canada's austerity measures has fallen largely on low- and middle-income people.²³⁵

While the magnitude of fiscal and monetary intervention differed in the UK and Canada, the experiences of both countries between 2007 and 2012 are consistent with Minsky's predictions, and demonstrate that financial institutions operate in a broader socio-political context. As a result of the embeddedness of financial institutions their actions had systemic consequences that forced both governments to intervene in order to prevent the self-regulating market from producing a depression. But, as Polanyi predicted, the countermovement was chaotic and led to political turmoil. Canada's constitutional crisis showed what can happen when a government refuses to carry out its protective function. And as both countries' austerity programs reveal, basic principles of justice and democracy were offended by the capacity of financial institutions to dictate the public agenda, both as the government's creditors and as the authors of its fiscal misfortune. This inspired mass protests, and called into question the legitimacy of capitalism itself. Although the full extent of the fallout remains to be seen, it is increasingly evident that a corporate governance regime which treats social and political outcomes as an abstraction is both unrealistic and destructive.

Conclusion

The objective of this article has been to explore, from a comparative perspective, how corporate governance law may have contributed to the GFC in the UK and Canada. While the similarities between the UK and Canadian corporate governance regimes helped trigger the Crisis in both countries, they do not explain why it was less severe in Canada. To

233. See Canada, Department of Finance, *The Next Phase of Canada's Economic Action Plan: A Low-Tax Plan for Jobs and Growth* (Ottawa: Public Works and Government Services, 2011) at 180; Canada, Department of Finance, *Jobs, Growth, and Long-Term Prosperity: Economic Action Plan 2012* (Ottawa: Public Works and Government Services, 2012) at 221 [Budget 2012].

234. See *ibid* at 197.

235. See *ibid* at 114.

understand this difference, it would be necessary to look at a range of other factors, including prudential regulation, market structure, mortgage practices and corporate culture.²³⁶ For example, it has been argued that Canada's higher capital-asset ratios lessened the impact of the Crisis,²³⁷ but Canada's financial institutions engaged in the same types of destabilizing behaviour as their UK counterparts, leading to the same types of adverse outcomes. While prudential regulation does make a difference, it is one of degree rather than kind. If stability is to be maintained in the long term, it is necessary to address incentives, which are ingrained in corporate governance law and drive financial institutions to undermine prudential regulation. A situation in which the regulatory and corporate governance systems are constantly at odds with each other is unsustainable.

The implication is that shareholder primacy must be replaced with an embedded model of corporate governance—one that reflects the economic, political and social influence of financial institutions. Accomplishing this is not simply a matter of reforming executive compensation practices; as demonstrated above, the whole legal framework through which financial institutions are governed reinforces excessive risk-taking.

It is also not clear whether adopting a “long-term shareholder value” approach would dampen the destabilizing features of Anglo-American corporate governance.²³⁸ Regardless of the time horizon used, shareholders will always have an incentive to maximize leverage because most of the money used to acquire financial assets is borrowed from depositors and wholesale lenders.²³⁹ For this reason, shareholders reap the full upside risk of leverage (i.e., profit), but only a small fraction of its downside risks (e.g., bankruptcy, stock market crash, recession, unemployment, etc.).

Some scholars have questioned whether shareholder primacy is really the culprit. They point out that continental European countries, which adhere in varying degrees to the “stakeholder” model of corporate

236. See Tony Porter, “Canadian Banks in the Financial and Economic Crisis” (Paper delivered at the Policy Responses to Unfettered Finance Workshop, North-South Institute, June 2010) [unpublished] at 3–5.

237. See Kevin Lynch, “Avoiding the Financial Crisis: Lessons From Canada” (May 2007) Policy Options 12 at 13; Carol Ann Northcott, Graydon Paulin & Mark White “Lessons for Banking Reform: A Canadian Perspective” (2009) 19:4 *Central Banking* 43 at 46.

238. See e.g. Kirkpatrick, *supra* note 13 at 13.

239. See Roubini & Mihm, *supra* note 155 at 70.

governance, were also affected by the GFC.²⁴⁰ However, this argument neglects the convergence toward the Anglo-American model in these and other countries, especially in the financial sector.²⁴¹ The global adoption of shareholder primacy and self-regulation likely also explains the transnational scope of the GFC. Lasting reform of financial institutions necessitates discarding the idea that shareholders should be the focal point of the governance of these institutions.

Two potential alternatives to shareholder primacy are worthy of exploration. The first is to cut shareholders out of the equation entirely by organizing financial institutions as mutuals (i.e., credit unions), such as building societies in the UK. Evidence from the GFC demonstrates that building societies, which are beholden to their members (i.e., customers), fared much better than banks, which serve the interests of shareholders. As the House of Commons Treasury Committee concluded: “Certain features of the building society model, including the . . . focus on the protection of members rather than the service of shareholders, have left building societies better equipped to defend against the shockwaves of the current Crisis.”²⁴²

The second alternative is to expand the scope of director, officer and perhaps shareholder liability to cover adverse economic and social outcomes. In theory, this would give decision-makers within financial institutions a reason to care about the systemic implications of their actions; in economic parlance, it would more fully “internalize” risk. However, although it is arguably consistent with the principle of embeddedness, its implication would be complicated by several major issues, including the determination of the applicable standard of care and the prospect of indeterminate liability for directors and officers.

Evidently, much more work is required to flesh out the details of a practicable replacement for shareholder primacy. This work should proceed with haste; as long as shareholder primacy governs “the temple of our civilization”, it will lead us to crisis. But this work should also

240. See Peter O Mülbert & Ryan D Citlau, “The Uncertain Role of Banks’ Corporate Governance in Systemic Risk Regulation” (2011) [Law Working Paper No 179/2011, European Corporate Governance Institute] at 34.

241. See Christel Lane, “Changes in Corporate Governance of German Corporation” (2003) [Working Paper No 259, ESRC Centre for Business Research] at 10. See also Part I-C, above.

242. Treasury Committee, *Failure of UK Banks*, *supra* note 169 at 31.

proceed with optimism because, as the legacies of Franklin D. Roosevelt and the New Deal testify, it is possible to “restore that temple to the ancient truths”.²⁴³

243. Franklin D Roosevelt, “First Inaugural Address” (4 March 1933) online: The Avalon Project <<http://avalon.law.yale.edu>> .