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# The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications

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# Articles

## THE FUTURE AS HISTORY: THE PROSPECTS FOR GLOBAL CONVERGENCE IN CORPORATE GOVERNANCE AND ITS IMPLICATIONS

*John C. Coffee, Jr.\**

What forces explain corporate structure and shareholder behavior? For decades this question has gone unasked, as both corporate law scholars and practitioners tacitly accepted the answer given in 1932 by Adolf Berle and Gardiner Means that the separation of ownership and control stemming from ownership fragmentation explained and assured shareholder passivity.<sup>1</sup> Over this decade, however, corporate law scholars have recognized that this standard answer begs an essential prior question: if ownership fragmentation explains shareholder passivity, what explains ownership fragmentation? Although the Berle and Means model assumed that large-scale enterprises could raise sufficient capital to conduct their operations only by attracting a large number of equity investors, contemporary empirical evidence finds that, even at the level of the largest firms, dispersed share ownership is a localized phenomenon, largely limited to the United States and Great Britain. Not only does the latest comparative research demonstrate that concentrated, not dispersed, ownership is the dominant worldwide pattern,<sup>2</sup> but in-depth studies of individual countries show that share-

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\* Adolf A. Berle Professor of Law at Columbia University Law School. The author wishes to acknowledge helpful comments and assistance from his colleagues Melvin A. Eisenberg, Ronald Gilson, Victor Goldberg and Jeffrey Gordon, and also from Merritt Fox, as well as from participants at law and economics seminars at the Universities of Kansas and Michigan. This Article is intended as a first installment of the lectures that the author will deliver in early 2000 as part of the Julius Rosenthal Foundation Lecture Series at Northwestern University School of Law.

<sup>1</sup> See ADOLF A. BERLE & GARDINER C. MEANS, JR., *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932). For the first reconsiderations of this thesis, see Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117 (1988).

<sup>2</sup> For the fullest discussion of this point and detailed evidence from the 27 principal corporate law jurisdictions, see Rafael La Porta et al., *Corporate Ownership Around the World* (June 1998) (visited March 3, 1999) <<http://nberws.nber.org/papers/W6625>> (unpublished manuscript, available on the Web). This study examines the ownership structure of the largest firms in 27 different countries, those with the 26 largest Gross National Products and Mexico. Compiling data on the 10 largest publicly traded nonfinancial companies in each country, the authors found that (i) slightly less than 40% qualified as widely held, (ii) 30% were family controlled, (iii) 18% were state controlled, and (iv) the balance fell into different categories not involving dispersed ownership. See *id.* It should be underscored that this

holder activism increases in direct proportion to ownership concentration.<sup>3</sup> As a result, these findings, in turn, suggest that the conventional governance norms in the United States may be more the product of a path-dependent history than the "natural" result of an inevitable evolution toward greater efficiency.

Propelling this new inquiry into whether the Berle/Means corporation—with its famous "separation of ownership and control"—is the inevitable and efficient endpoint of economic evolution, or only the artifact of political forces and historical contingencies, is the unavoidable reality of increased global competition in both the product and capital markets. As a result, dispersed and concentrated ownership structures not only differ, but they may be forced to compete. Although scholars have debated the relative merits of these rival models for a decade or more, this prospect of an evolutionary competition—with its implication of a Darwinian "survival of the fittest" struggle—is very new. Ultimately, the issue thus posed is which system will dominate, and why: the stock market centered-system of dispersed ownership first described by Berle and Means, or the blockholder and cross-shareholding systems that now prevail across Europe and Asia? Of course, a clear winner does not necessarily have to emerge. The more one believes that political forces are likely to constrain and override purely economic forces, the more one is likely to expect a more muddled and contextual outcome. Thus, the current debate has two levels that can often become confused: (1) Which system of corporate governance is superior?, and (2) Which set of forces—economic or political—is likely to prove more powerful?

To appreciate this distinction, it is useful to understand that the current debate has progressed through several discrete stages. First, beginning ear-

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study focused only on the very largest firms. Once the threshold is lowered, the extent of concentrated ownership becomes even clearer. Estimates differ, but the basic picture is the same across a variety of recent studies. Julian Franks and Colin Mayer found that 85% of large German firms had a shareholder with at least a 25% ownership interest. See Julian Franks & Colin Mayer, *Ownership, Control and the Performance of German Corporations* (April 1997) (unpublished manuscript prepared for a Sloan Conference at Columbia Law School, on file with the author). Another recent study estimates that 64% of large German firms have a majority owner, while in France the corresponding figure is 59%. See Paul Windolf, *The Governance Structure of Large French Corporations: A Comparative Perspective*, in *CORPORATE GOVERNANCE TODAY* 695, 714 (1998) [hereinafter *CORPORATE GOVERNANCE TODAY*]. An even more recent study estimates that 75% of all German listed companies have a majority owner, while 23% had a blockholder group holding in excess of ninety percent of the firm's equity capital. See Tim Jenkinson & Alexander Ljungqvist, *Hostile Stakes and the Role of Banks in German Corporate Governance*, NBER Discussion Paper No. 1695, at 6 (1997); see also discussion *infra* note 13.

<sup>3</sup> For recent commentary on the impact of ownership concentration on shareholder behavior, see, for example, Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993); Mark J. Roe, *Some Differences in Company Structure in Germany, Japan and the United States*, 102 YALE L.J. 1927 (1993).

lier in this decade, a provocative new wave of law and economics scholars advanced "political" theories that explained dispersed share ownership in large American corporations as the product of political forces and historical contingencies, not economic efficiency.<sup>4</sup> An undercurrent in this criticism was the theme that political constraints had produced a suboptimal system of corporate governance, with dispersed ownership implying inherently inadequate corporate monitoring. Some of these scholars argued that the Anglo-American pattern of dispersed ownership was clearly inferior to the bank-centered capital markets of Germany and Japan, because the latter enabled corporate executives to manage for the long run, while U.S. managers were allegedly forced to maximize short-term earnings.<sup>5</sup> Still, with the burst of the "bubble economy" in Japan, the more recent Asian and Russian financial crises, and notable monitoring failures by German universal banks, the tide of opinion has lately turned against the presumed superiority of banks as monitors. In their wake, some scholars have rediscovered the advantages of a stock market-centered system of corporate governance, concluding that it represents a more objective system of external monitoring that can more quickly compel firms to respond to major changes in their economic environment.<sup>6</sup>

More recently, this initial debate about the relative merits of bank-centered systems of governance versus stock market-centered systems has expanded to focus on the relationship between a jurisdiction's ability to finance economic development and growth and its legal system.<sup>7</sup> Initially, scholars started with the question: Why does the size of equity capital markets vary so extraordinarily across otherwise similarly situated countries?

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<sup>4</sup> Many of these efforts explicitly stressed that they were "political" theories. See John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 103 (1993); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991). Without question, Professor Roe's work has been the dominant influence in this field and has spurred a new generation of scholars to search for "political" issues and divisions in the area of financial institutional structure.

<sup>5</sup> Michael Porter has long been the leading advocate of this point of view. See Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept-Oct. 1992, at 65.

<sup>6</sup> For the strongest recent statement of this view, see Jonathan R. Macey, *Measuring the Effectiveness of Different Corporate Governance Systems: Toward a More Scientific Approach*, 10 J. APPLIED CORP. FIN. 16 (1998) (arguing that prevalence of hostile takeovers in stock market centered systems ensures their long-run superiority over blockholder dominated systems); see also Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327 (1996) (comparing stock market centered versus bank centered systems of corporate governance and emphasizing roles of industrial organization and path dependency). For an earlier view that bank centered systems might have efficiency advantages, at least in connection with particular production systems, see Gilson & Roe, *supra* note 3.

<sup>7</sup> See Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); see also Asli Demirguc-Kunt & Voslislav Maksimovic, *Law, Finance and Firm Growth*, 53 J. FIN. 2107, 2134 (1998) (finding that firms in countries with active stock market and well-developed legal system were able to obtain greater funds to finance growth).

Their answer has been that these differences correlate closely with corresponding differences in legal systems.<sup>8</sup> In particular, common law legal systems seem to outperform civil law legal systems in establishing an environment in which securities markets can prosper and grow. For example, common law countries have on average a ratio of publicly held stock, or stock held by non-insiders, to gross national product ("GNP") of sixty percent, whereas the same ratio is only twenty-one percent for French civil law countries and forty-five percent for German civil law countries.<sup>9</sup> Similarly, while the United Kingdom has thirty-six listed firms per million citizens and the United States has thirty, France, Germany, and Italy have only eight, four, and five, respectively.<sup>10</sup> Such data understandably fascinates legal scholars because it suggests a conclusion that financial economists tend to slight: namely, *law matters*.

The most convincing explanation for this sharp disparity is that only those legal systems that provide significant protections for minority shareholders can develop active equity markets.<sup>11</sup> Few legal regimes meet this norm, and hence the United States and the United Kingdom stand apart. But once this explanation is accepted, it amounts to a rejection of the "political" theory of American corporate finance offered by Professor Mark Roe and others. Instead, a rival hypothesis crystallizes to replace it: namely, dispersed share ownership may be the product not of political constraints on financial institutions, but of strong legal protections that encourage investors to become minority owners. Absent such protections, most investors will be reluctant to make equity investments, except to the extent they can participate in a powerful blockholder group or buy at sharply discounted prices—thereby accounting for concentrated ownership as a protection against expropriation.<sup>12</sup>

This Article will examine the implications of this alternative "legal" hypothesis. Does it provide a better explanation for why powerful financial intermediaries are observed in Europe and Japan and stock markets in the United Kingdom and the United States? Does it suggest which of these alternative systems is more likely to be the evolutionary survivor? Or is some synthesis of both theories possible? In addressing these questions, this Ar-

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<sup>8</sup> See La Porta et al., *supra* note 7.

<sup>9</sup> See *id.* at 1137.

<sup>10</sup> See *id.*

<sup>11</sup> This is the explanation given by La Porta et al., *supra* note 7; see also Andrei Schleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997). In addition, it is, of course, possible that first mover advantages could account for the relative size of stock markets and publicly traded equity, but in this respect it is noteworthy that some European stock exchanges are older than either the London or New York exchanges (Amsterdam is generally recognized as the oldest stock exchange).

<sup>12</sup> While some investors may be willing to buy at greatly discounted prices, the preference of the entrepreneurs running the firm will be logically to organize blockholder structures that thereby maximize the prices they receive for their shares. In short, voting control is the only substitute for legal protections that enables the firm's founders to maximize the value of the shares they wish to sell.

title will particularly focus on recent developments within Continental Europe. Because broad similarities are obvious in terms of the relative development and maturity of legal institutions across Europe and the United States, this focus allows us to concentrate on the most striking difference between these two economic systems: namely, the structure of share ownership.<sup>13</sup> In addition, the first destabilizing signs have now surfaced that the traditional system of concentrated ownership is changing across the European context. Still, where this incipient transition will lead remains controversial. Some predict that increased global competition will force a quick convergence in corporate governance and structure towards the U.S. pattern.<sup>14</sup> From this perspective, increased global competition in both the

<sup>13</sup> A good sense of the high level of concentration of corporate ownership in European economies is provided by a recent detailed survey by the European Corporate Governance Network. See EUROPEAN CORPORATE GOVERNANCE NETWORK, *THE SEPARATION OF OWNERSHIP AND CONTROL: A SURVEY OF SEVEN EUROPEAN COUNTRIES* (submitted to the European Commission on October 27, 1997) [hereinafter ECGN SURVEY]. For example, in Austria, a survey of the 600 largest firms found that the "average fractional ownership of the largest shareholder . . . is over 80%." Klaus Gugler et al., *The Separation of Ownership and Control: An Austrian Perspective*, in ECGN SURVEY 1. For a world-wide survey that concludes that family controlled firms remain the dominant pattern worldwide (with state controlled firms being the second most observed pattern), see La Porta et al., *supra* note 2. Other recent studies are discussed *supra* note 2.

The following table, taken from a recent Dutch study, reveals the fundamental differences in share ownership patterns between those Continental European countries characterized by concentrated ownership, here, Germany and the Netherlands, and the Anglo-American market centered systems:

<u>Share Ownership (%)</u>	<u>Germany</u>	<u>NL</u>	<u>UK</u>	<u>US</u>
-households	16.6	20.0	17.7	50.2
-nonfinancial enterprises	38.8	9.6	3.1	14.1
-banks	14.2	0.7	0.6	0.0
-investment funds	7.6	1.5	9.7	5.7
-pension funds	1.9	7.9	34.2	20.1
-insurance companies	5.2	5.5	17.2	4.6
-government	3.4	0.0	1.3	0.0
-foreign shareholders	12.2	54.8	16.3	5.4
<u>Ownership of largest shareholder</u>				
greater than 25%	85	—	13	—
greater than 50%	57	22	6	—

See William Bratton & Joseph McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference* (working paper January 1999) (citing CPB NETHERLANDS, BUREAU FOR ECONOMIC POLICY ANALYSIS, *CHALLENGING NEIGHBOURS, RETHINKING GERMAN AND DUTCH INSTITUTIONS* 357 (1997) (table 10.3) (copy on file with the author)).

<sup>14</sup> It is impossible to list all the scholars who have made or examined this claim in the 1990s. But for the earliest prediction of corporate convergence on an international scale that I have found in this decade, see Roberta S. Karmel, *Is it Time for a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 90 (1991).

capital and product markets makes corporate governance simply another battlefield on which firms must compete or die. The premise here is that corporate governance differs little from other forms of technology: choose the wrong form, and if it is important, you will suffer at the hands of competitors who choose a superior form. For others, including this author, corporate governance is more than simply a technology. Infused with politics and shaped by history, it is not a variable that a firm can simply elect or contract around. Rather, it is an important constraint that limits and channels corporate evolution, even in very transitional times.

Viewed from afar, this debate may be reduced to the usual disagreement between neoclassical economists and other scholars over the relative strength of the forces that shape corporate evolution. At one pole, neoclassical economists have long argued that efficiency considerations ultimately prevail and determine corporate structure.<sup>15</sup> From this perspective, the prediction follows that the increasing globalization of the world's economy will inexorably compel at least large-scale firms to adopt a common set of structural characteristics. The boldest of these scholars have even predicted an "end to history" in the corporate world, paralleling the triumph of the market economy and democratic capitalism a decade ago at the end the Cold War.<sup>16</sup> Under this view, firms that employ a suboptimal system of corporate governance will be punished by the product and capital markets until they adapt or disappear.

This view—which this Article will call the "Strong Convergence Thesis"—is matched by a rival polar position, which sees not competition but political forces and path dependency as principally shaping and constraining economic evolution. Consistent with their earlier work,<sup>17</sup> Mark Roe and Lucian Bebchuk have stressed the importance of path dependency in predicting the future evolution of corporate governance, arguing that it will constrain and probably overcome the competitive forces pushing for corporate convergence.<sup>18</sup> Even earlier, other scholars have claimed that, regardless of whether a more efficient regime of corporate governance could be demonstrated to exist, inertial political forces would still be sufficiently

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<sup>15</sup> This theme that efficiency considerations shape corporate structures has a long history. See generally Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375 (1983); FRANK EASTERBROOK & DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 212-18 (1991).

<sup>16</sup> See Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law* (Nov. 19, 1997) (unpublished manuscript, prepared for a Sloan Conference at Columbia Law School).

<sup>17</sup> See Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996) (arguing that conditions existing at the time when an institution is formed will influence its functioning far into the future, without respect to efficiency considerations).

<sup>18</sup> See Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Governance and Ownership* (forthcoming in Stanford Law Review).

powerful to preserve the less efficient status quo.<sup>19</sup> In short, efficiency may be only a relatively weak force in politically constrained environments.

Between these two rival positions, the third view—that shareholder dispersion depends on the ability of the legal system to protect minority shareholders—occupies an intermediate position. It can accept both the reality of evolutionary competition and the inevitability of political constraints, but still object that neither side has adequately explained the exceptional conditions that must exist before truly liquid securities markets can develop to provide an alternative monitoring force. From its vantage point, more factors must be introduced to account for the basic global dichotomy between dispersed ownership and concentrated ownership. One critical factor is the desire for liquidity, which inhibits potentially powerful financial intermediaries from holding large stock positions in individual companies.<sup>20</sup> From this perspective, even in the absence of political constraints, institutional investors would rationally hesitate before investing their portfolio in a manner that costs them liquidity. Thus, the fact that powerful financial intermediaries arose in Europe and Japan may be better explained less by the existence of confining regulations in the United States than by the absence of deep and liquid equity markets elsewhere. Denied liquidity by thin markets, financial intermediaries in Japan and Europe arguably had no relevant option other than to hold controlling blocks.

Although this perspective emphasizes liquidity, law remains the critical variable in fostering the growth of securities markets. From its vantage point, concentrated ownership becomes the consequence of weak legal protections for public or minority investors.<sup>21</sup> Starting from the empirical observation that minority shareholders are subject to exploitation and expropriation in most legal regimes outside the Anglo-American world, this position postulates that the shareholders' primary protective response to the risk of exploitation is to invest only through the protective medium of a substantial block—whether assembled through a family group, a holding company, or a reciprocal cross-shareholding arrangement. Once these controlling blocks are created, control is often thereafter maintained by a variety of techniques—stock pyramiding, cross-holdings, supervoting stock—that permit the control group to retain a majority of the corporation's voting rights while holding only a minority of its equity, that is, the rights to the corporation's cash flow. These new studies also suggest that the prevalence

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<sup>19</sup> See Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145 (1998).

<sup>20</sup> See Coffee, *supra* note 3, at 1281 (arguing that institutional investors' preference for liquidity explains in part their failure to hold concentrated blocks); see also Amar Bhide, *The Hidden Costs of Stock Market Liquidity*, 34 J. FIN. ECON. 31 (1993) (same); Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1 (1997) (same).

<sup>21</sup> See La Porta et al., *supra* note 7, at 1132; see also La Porta et al., *supra* note 2.



of such control groups, and their degree of concentration, is greatest to the extent that the legal protections for public shareholders are the weakest.<sup>22</sup>

In overview, this "fear of exploitation" explanation for concentrated ownership is virtually the mirror image of the overregulation hypothesis that Professor Roe and other scholars have advanced to account for the seemingly fragmented holdings of American institutional investors.<sup>23</sup> Under their overregulation explanation, political constraints produce suboptimal corporate governance, and thus dispersed ownership is implicitly seen as evidence of the law's failure. Conversely, the legal hypothesis views dispersed ownership as evidence of the law's success in fostering the trust and confidence necessary to convince minority shareholders to make and hold an equity investment. In this latter view, ownership dispersion becomes instead a measure of the achievement of Anglo-American law in protecting minority shareholders.<sup>24</sup> In short, "strong" regulation permits "weak" owners, while "weak" regulation necessitates "strong" owners.

To be sure, all three hypotheses—political constraints, liquidity preferences, and fear of minority exploitation—could coexist and contribute to a fuller theory of ownership structure. Nonetheless, while a synthesis is possible, it should not obscure the inevitability of tradeoffs and tensions. That dispersed ownership requires a protective legal regime, while concentrated ownership structures tend to arise in the absence of legal protections as the default rule, does not ultimately prove the superiority of one system to the other. From an efficiency perspective, the tradeoff is straightforward: concentrated ownership may yield better direct monitoring of management, while dispersed ownership encourages the development of a more efficient market with greater liquidity.<sup>25</sup> From a normative perspective, the tradeoffs may be subtler: concentrated ownership probably depends upon blockholders receiving undisclosed side payments in return for their monitoring services—often euphemistically referred to as the "private benefits of control"—thereby resulting both in a less transparent market and likely overpayments to the controlling blockholders. Conversely, concentrated ownership may free the firm from the obligation to maximize short-run profits

<sup>22</sup> See La Porta et al., *supra* note 7, at 1132.

<sup>23</sup> See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994); see also Joseph A. Grundfest, *Subordination of American Capital*, HARV. BUS. REV., Sept.-Oct. 1992, at 65.

<sup>24</sup> Note that an underlying assumption here is that ownership dispersion is the "natural" state for investors in recognition of their preferences for liquidity and diversification. This is consistent with the view taken in Coffee, *supra* note 3, at 1281.

<sup>25</sup> See *infra* notes 39-56 and accompanying text. In turn, enhanced liquidity is believed to facilitate investment in longer-run, higher return projects, such as high technology start-ups, that may spur greater economic growth and productivity. See Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AMER. ECON. REV. 537 (1998) (citing Valerie R. Bencivenga et al., *Transaction Costs, Technological Choice, and Endogenous Growth*, 67 J. ECO. THEORY 53 (1995) and Maurice Obstfeld, *Risk-Taking, Global Diversification, and Growth*, 84 AMER. ECON. REV. 1310 (1994)).

and thus permit both greater stability, greater investment in human capital, and more attention to the concerns of nonshareholder constituencies.<sup>26</sup>

These tradeoffs can be endlessly debated, but they may also be highly transitional, if the forces of corporate evolution are moving us inexorably in the direction of dispersed ownership.<sup>27</sup> Various scenarios for such a transition can plausibly be offered, but the most plausible is the following: if concentrated ownership is attributable principally to the vulnerability of minority shareholders to exploitation under most legal systems, then those legal systems that do effectively protect minority shareholders should have an important competitive advantage in the global marketplace. Given that stronger legal protections necessarily imply higher stock market prices for the public, or noncontrolling, shares of such firms, corporations organized under Anglo-American legal regimes that confer such stronger legal protections should correspondingly have higher stock market prices and so can more easily use their equity securities to make stock-for-stock acquisitions.<sup>28</sup> If this premise is correct, then companies with "protected minorities" should find it easier to acquire firms organized under other legal regimes that provide only weaker protections, while the reverse transactions will be generally infeasible.<sup>29</sup> Hence, to the extent that mergers become a necessary path to global scale, firms having higher stock market values for their minority shares are more likely to be the survivors in any wave of consolidations.

This debate over what may happen has not yet shifted to its next predictable stage: a policy-oriented discussion of the tradeoffs and the most ef-

<sup>26</sup> See *infra* notes 51-56 and accompanying text.

<sup>27</sup> A possibly intermediate position should be acknowledged here. Ronald Gilson has predicted that formal institutional variations in corporate law and practice will remain, but will be overshadowed by an increasing degree of functional convergence. See Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function* (December 5, 1998) (unpublished manuscript, prepared for a Sloan Conference at Columbia Law School). Indeed, it is virtually true by definition that if existing corporate governance systems possess sufficient plasticity so that their efficiency can be improved within their existing legal and regulatory parameters, then very different governance systems could exhibit approximately equivalent performance characteristics. But this position frames more of a question than an answer: is there sufficient plasticity within institutional forms to permit functional convergence?

<sup>28</sup> See La Porta et al., *supra* note 2. This theme is further addressed *supra* notes 138-48 and accompanying text.

<sup>29</sup> At the same time, however, weaker legal protections appear to imply higher control premiums to the controlling shareholder. Much evidence supports the proposition that, under "weaker" legal regimes, the controlling shareholders will be able to command a greater control premium for their shares. See Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. 125 (1994) (finding a high 82% premium for control blocks on the Milan Exchange, against an international average of 10 to 20%, and a United States average of 5.24%) [hereinafter Zingales, *Voting Right*]; Luigi Zingales, *What Determines the Value of Corporate Votes*, 110 Q.J. ECON. 1047 (1995) [hereinafter Zingales, *Corporate Votes*]. Such a disparity seems strong evidence of the relative value of control and the relative exposure of the minority. However, such evidence also implies that controlling shareholders outside the United States will resist a premium that could cause U.S. controlling shareholders to sell.

fective policy levers by which the law can influence the course and pace of this transition. The overriding policy question seems obvious: if concentrated ownership reflects the vulnerability of public shareholders in most of the world but may still yield superior monitoring in some contexts, should legal decisionmakers attempt to facilitate a transition to dispersed ownership? Or, given the difficulty of exporting Anglo-American legal institutions, should regulators recognize concentrated ownership as the logical equilibrium position for most of the world?

To date, most commentators have approached these questions only obliquely by assuming that sweeping worldwide legislative reforms are unlikely. But legislation is not the only route to functional convergence. Although this Article agrees with the path dependency perspective that *formal* convergence faces too many obstacles to be predicted, it argues that *functional* convergence can be facilitated by a much more feasible and largely voluntary route.<sup>30</sup> That route runs through the international securities markets and, in particular, involves the growing migration of foreign firms to the U.S. equity markets. Whether through the integration of markets, the harmonization of standards across markets, or the migration of firms to foreign markets, chiefly in the United States or the United Kingdom, a substantial degree of convergence seems predictable. This is so for a variety of reasons that ultimately rest on both the need for many firms to grow in scale in order to exploit global markets and the desire of public shareholders for a credible commitment from these firms that they will not be exploited.

Initially, this Article will seek to identify the forces at play. Part I reviews the objections to the Strong Convergence Thesis. In so doing, it emphasizes an aspect of the problem that has to date received little attention. Although U.S. commentators tend to assume corporate mobility and consequent regulatory arbitrage, this assumption rests largely on the fact that an American business corporation that is dissatisfied with the corporate legal regime under which it is incorporated can reincorporate fairly easily in another jurisdiction.<sup>31</sup> As a result, for most of this century, a vigorous competition has been waged by at least some American states, each motivated by the goal of maximizing corporate franchise tax revenues, to offer the most attractive terms for incorporation. Although commentators have disagreed as to whether this competition led to a race to the top or to the bottom,<sup>32</sup> the fact of an interjurisdictional competition has been undeniable,

<sup>30</sup> I borrow this rhetorical distinction between "formal" and "functional" convergence from Professor Gilson. See Gilson, *supra* note 27.

<sup>31</sup> The term "regulatory arbitrage" is a more neutral term for what others call the "race to the bottom," that is, the migration of legal entities to the more lenient regulatory regime, with consequent pressure for regulatory relaxation on all regulators. For the view that migration from incorporation in one U.S. state to another state is relatively costless, see Bernard S. Black, *Is Corporate Law Trivial?: A Political And Economic Analysis*, 84 NW. U. L. REV. 542, 586-88 (1989).

<sup>32</sup> The original debate was between William Cary and Ralph Winter. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (arguing that competi-

and this in turn implies relatively free corporate mobility among jurisdictions.

In contrast, most other major industrial nations do not have federal systems, or at least systems that permit such charter competition to develop among local jurisdictions,<sup>33</sup> and reincorporation outside the national jurisdiction is generally not permitted. Corporate mobility, at least via the traditional route of reincorporation, therefore cannot be assumed. Equally important, to the extent that corporate governance systems outside the United States frequently seek to promote the interests of nonshareholder constituencies, these regimes have also sought to prevent attempts to contract around or otherwise escape these norms.<sup>34</sup> Thus, a German, French, Japanese, or British firm does not face the same menu of options as to the possible legal rules under which an American firm can organize or to which it can migrate. In turn, the absence of such competition has probably given the substantive corporate law of these jurisdictions a mandatory character that contrasts with the more "enabling" style of corporate law in the United States.

Part II examines other alternatives to reincorporation, with a special focus on the motives and prospects for migration to foreign stock exchanges. Large firms can choose the stock exchange or exchanges on which they are listed, and in so doing can opt into governance systems, disclosure standards, and accounting rules that may be more rigorous than those required or prevailing in their jurisdiction of incorporation. This process of migration may over time prove to be as important as the standard American interjurisdictional competition for corporate charters. In theory, migration should give rise to a form of regulatory arbitrage, under which

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tion for charters produces a race to the bottom); Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Firm*, 6 J. LEGAL STUD. 251, 254-62 (1977) (arguing that competition produces a race to the top). Judge Winter's views have been more fully articulated by Professor Roberta Romano. See Roberta Romano, *Corporate Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985). In contrast, Professor Lucian Bebchuk has emphasized the likely divergences between the incentives of managers and shareholders with the resulting prospect that charter competition could produce at least marginally inefficient outcomes. See Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992). Besides the debate over efficiency, the other major approach in this literature has been to relate regulatory competition among the states to an interest group theory of the states' real interests. For a leading effort, see Jonathan R. Macey & Geoffrey P. Miller, *Toward An Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

<sup>33</sup> Although Australia and Canada are also federal systems, competition for corporate charters among their provinces does not appear to be vigorous. See Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 150 (1991). Within the European Community, only a constrained form of competition is possible, as minimum standards, set forth in directives issued by the Council of the EU bind all members states. See sources cited *infra* notes 82-89 and accompanying text.

<sup>34</sup> German courts have struck down a variety of efforts perceived by them as attempts to contract around codetermination. See Mark J. Roe, *Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167.

firms seek to play one legal regime against another by threatening to migrate to less "regulatory" jurisdictions. Yet, the most visible contemporary form of migration seems motivated by the opposite impulse: namely, to opt into higher regulatory or disclosure standards and thus to implement a form of "bonding" under which firms commit to governance standards more exacting than that of their home countries.<sup>35</sup>

Part III turns to the prospects for functional convergence. If institutional forms and legal rules are resistant to change in part for reasons analyzed in Part I, what degree of convergence in corporate norms can arrive through migration and securities market harmonization? Here, this Article's essential claim is that the experience of American corporate legal history is likely to be replayed on the international stage. That experience, as here interpreted, is for variations in local corporate law to persist but to be overshadowed by the relative uniformity in the federal law applicable to securities markets. Thus, while the law of Delaware may differ from that of California, these differences have been effectively marginalized by the degree to which the federal securities laws force disclosure of fiduciary misconduct and provide special remedies by which to reduce agency costs.

Correspondingly, as the law applicable to securities markets is either globally harmonized or as foreign issuers migrate to list in U.S. markets and so become subject to U.S. standards, the variations between the corporate laws of, say, Germany and Italy may persist, but their relative importance should decline. Thus, precisely in those contexts where the large blockholder in Europe or Asia has the greatest discretion to act to its own advantage and to the minority's disadvantage, the application of U.S. securities law, or some "harmonized" model largely based on it, would instead impose transparency and significantly constrain opportunism by controlling shareholders.<sup>36</sup> This special focus of the federal securities laws on constraining the controlling shareholder explains not only why the competition among American states for corporate charters has not produced great divergences in U.S. corporate law,<sup>37</sup> but also why the existing and often great divergences among the corporate laws of other nations might not impede movement toward convergence at the securities markets level. By no means, however, will concentrated ownership patterns disappear. Rather, the likelihood is for different markets to become specialized in trading the securities of different types of firms, with dispersed ownership firms trading principally in markets in the United States and the United Kingdom.

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<sup>35</sup> See *infra* notes 107-128 and accompanying text.

<sup>36</sup> Others have asserted that this function of reducing agency costs is the historic and most important goal of the federal securities laws. See Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1047-51 (1995).

<sup>37</sup> The latest evidence suggests that American corporate law is relatively uniform, whether despite or because of interjurisdictional charter competition. See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 728 (1998); *infra* notes 223-32 and accompanying text.

Finally, this Article argues not only that a high degree of convergence can emerge through corporate migration and stock exchange harmonization, but that convergence at this level is far more politically feasible than at the level of corporate law reform. This is both because of the common interest of all participants in securities market harmonization—coupled with the corresponding fear of exclusion—and the extraterritorial reach of American law. Because American securities law will be applicable to most firms that grow through mergers and acquisitions to achieve global scale, it will similarly constrain—at least at the margin—the ability of controlling shareholders and blockholders to engage in conduct long permitted under local law. In this view, the U.S. securities laws should achieve what corporate law cannot easily do: namely, accommodate functional convergence—both through migration and harmonization—so as to raise, rather than lower, governance and disclosure standards. Ironically, such an outcome is precisely the opposite of what regulatory arbitrage is usually thought to produce.

The other side of the coin on this issue of political feasibility involves the major looming downside on the contemporary horizon: the prospect for backlash.<sup>38</sup> Although it tends to be assumed that convergence will simply promote efficiency, the possibility also exists that there will be a counter-reaction to the perceived domination of corporate governance by American forms and norms. Once again, however, this Article will argue that the prospect for backlash can be significantly reduced to the extent that corporate governance is chiefly implemented through securities market integration rather than through mandatory corporate law reform.

### I. THE BARRIERS TO CORPORATE CONVERGENCE

Most observers today believe that an active monitoring board, staffed by outside directors with substantial and varied business experience, is a critical element in corporate governance and has contributed to the relative efficiency of the American business corporation.<sup>39</sup> Why then do not the forces of global competition in both the product and capital markets impose similar governance structures on the boards of Japanese, German, and French corporations? Answers can be grouped under the following headings.

<sup>38</sup> On this theme, see generally Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998).

<sup>39</sup> For a recent consensus statement of this view and an attempt to provide empirical support for the proposition that such a board increases corporate efficiency and market value, see Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998). But see Sanjai Bhagat & Bernard S. Black, *Board Composition and Firm Performance*, in CORPORATE GOVERNANCE TODAY, *supra* note 2, at 291, 292 (“no convincing evidence” exists that firms with majority-independent boards perform better than firms without such boards).

*A. Rent-Seeking and the Persistence of Inefficient Rules*

Even if a particular governance structure would make firms relatively more efficient, it is not necessarily in the interest of all groups in society to modify existing law to permit or require such reforms. Political coalitions within a country may have an interest in maintaining existing legal rules, even if they are inefficient. The history of takeover regulation in the United States provides an obvious example, as individual states have sought, with some success, to chill hostile takeovers for firms incorporated within their jurisdiction. Even though such legislation may penalize shareholders, those shareholders are typically not residents of the local jurisdiction—indeed, more than half of the shares of the typical large, public corporation in the United States are owned by institutional investors. Such out-of-state shareholders will have little, or at least less, impact on legislative outcomes within that jurisdiction.

More generally, shareholders seem the classic example of Mancur Olson's "inchoate group,"<sup>40</sup> namely, a group that, although large in number, is not well organized and hence has less ability to influence political decisions than smaller but better organized groups such as labor or corporate managers. Olson later extended this theory to suggest that interest group coalitions could produce national decline by blocking efficiency-enhancing reforms. The recent inability of Japan to adopt needed banking reforms or of Russia to stabilize its economy—each in the face of a world-wide consensus that reforms were needed—seem to illustrate the blocking power of entrenched groups that, even at the cost of national paralysis, are able to stall reforms that would adversely affect them.

Next, add to this pattern the political reality that the power of labor seems today stronger in the European than in the American context. A useful example is supplied by the 1997 surprise hostile attempt by Krupp, the German steel and engineering group, to take over its larger rival, Thyssen. The bid "sent shock waves through corporate Germany and caused political outcry . . . [and] triggered heated worker protests."<sup>41</sup> Thyssen's unions organized demonstrations that at one point brought as many as thirty thousand demonstrators out in protest—protests that were focused at not only Krupp but also its politically more vulnerable investment adviser, Deutsche Bank.<sup>42</sup> Ultimately, the hostile bid was abandoned, and political leaders in Germany brokered a long-term consolidation and merger between the two

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<sup>40</sup> See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965). Olson later extended his theory to show how interest groups could (and would) maintain inefficient rules in place even at the cost of national decline. See MANCUR OLSON, *THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION AND SOCIAL RIGIDITIES* (1982).

<sup>41</sup> See *Survey—German Banking and Financing 98: A Unique Perspective*, FIN. TIMES, June 24, 1998, at 7.

<sup>42</sup> See Jeffrey N. Gordon, *Deutsche Telekom, German Corporate Governance, and the Transition Costs of Capitalism*, 1998 COLUM. BUS. L. REV. 185, 200.

firms, which is scheduled to be completed in 1999. Critical to this compromise was the reduction of threatened job losses.<sup>43</sup>

Although coalitions of labor unions and target firm managers have sometimes goaded state legislatures in the United States to adopt rushed antitakeover legislation in response to hostile bids, no parallel exists in modern United States history in which a takeover battle has required the intervention of national political leaders in order to avert social disorder. Indeed, in the United States, although there are "Rust Belt" jurisdictions that are extremely skeptical of takeovers for fear of job loss and injury to local communities, there is also Delaware, home to more than one half of the largest U.S. corporations, which has always been skeptically resistant to claims that corporate law should reflect or protect the interests of nonshareholder constituencies. Given its federal system, the United States is a mixed bag, with some jurisdictions that will, and others that will not, seek to frame their corporate laws to protect nonshareholder interests.

In contrast, European corporate law has long protected nonshareholder interests at the national level. The clearest, but not the only example of such a policy is codetermination, which in its German form requires that half of a large firm's supervisory board be made up of employee representatives. Commentators have long opined that codetermination cripples the German board as a monitoring body. Even if the actual impact of codetermination can reasonably be debated, the policy is deeply rooted in German law and supported by a strong coalition of labor and employee interest groups. Predictably, these interest groups will not be moved by the claim that such a legal rule reduces the value of the ownership interests in a German firm. Rather, their interest as employees lies in minimizing job loss, which, at least over the short run, codetermination may achieve.

Why does corporate governance rank high on labor's agenda in Europe but not in the United States? Although a number of historical reasons could be discussed, the critical economic fact is that labor is less mobile in Europe than in the United States. If employment prospects are brighter elsewhere, U.S. workers can migrate from New York to California at relatively low cost, but a German worker cannot as easily move to Italy or Great Britain. Language and culture are important constraints. Even after the Common Market, Europe is criss-crossed by national borders that, as a social matter, restrict the mobility of labor. Hence, labor is more resistant to corporate migration in Europe than in the United States. In contrast, U.S. workers, being more mobile, behave as if they had less need for unions and in fact join them at a lower rate.

Even given greater labor rigidity in Europe or Asia, the neoclassical economist might still reply that over the longer run the market will still punish a firm whose corporate governance system gives any significant voice to nonshareholder constituencies. Predictably, such a governance

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<sup>43</sup> See *id.*



system will raise the cost of capital to its subject firms and render them less able to compete with firms with superior corporate governance systems. There are several practical answers to this response.

First, the political ability to modify or update inefficient legal rules in any country may ironically decline precisely as capital markets become more complete in that country. Assume, as a simplifying assumption, that today, German firms are basically owned by German shareholders, with relatively few foreign investors owning shares in German corporations; as a result, the cost of inefficiency largely falls on German citizens, who have every incentive to pursue political means of redress. But as capital markets become more global, the largest German firms will become increasingly owned by a homogenized class of institutional shareholders, most of whom will be non-German. This is probably already true for a very few German firms, such as Daimler-Benz. At this point, the increasing lack of overlap between shareholders and citizens has political implications. On the simplest level, German citizens have increased incentive to vote to maintain inefficient legal rules that protect local jobs to the extent that the costs of such action fall increasingly on foreign shareholders. Indeed, this fact pattern parallels that of an American Rust Belt state, whose state legislature votes to bar takeovers to protect local jobs, in part because the shareholders thereby injured do not reside or vote in that jurisdiction. Much like institutional shareholders in the United States, foreign shareholders understandably tend to avoid local political controversies. The one important difference between the two contexts is that the American firm could ultimately migrate from the jurisdiction to a more takeover "friendly" state if its shareholders insisted. Such flight is not possible from a nation if, as is typical, the corporation's laws do not permit it to reincorporate abroad.

Economic self-interest is not the only force at work in resisting corporate convergence. National cultural traditions, nationalism, and xenophobia—always strong political forces—may also play a role here. One can imagine French citizens with no other interest in the topic voting against laws that would reform French corporate governance—simply because they were suspicious as a general matter of the Anglo-American model of anything. Here, history truly matters.

The neoclassical economist may well concede that such a political reaction could persist for a time but will still question whether it will continue once local firms begin to fail. Once the firm's competitors begin to surpass it because of their access to lower-cost capital, the fear of economic failure may motivate even labor to agree to modify inefficient legal rules. Implicit here, however, are several debatable assumptions. First, this model implicitly assumes that other forces acting on the firm and its competitors will remain equal. Yet, political forces within the particular country may seek to protect the failing firm. The legislature could adopt protectionist trade policies or otherwise seek to hobble more efficient competitors, perhaps by restricting plant closings or layoffs within its borders. Although such efforts

may just cause the more efficient competitor to move its plants outside that country's borders, the reality of transportation costs and logistical problems suggests that such efforts could shelter the noncompetitive firm within a local zone of relative safety. More importantly, the domestic firm subject to the inefficient legal rule may search for second-best substitutes that reduce the significance of its competitors' superior corporate governance technology. In the case of codetermination, it has been reported that German firms have adapted to it by employing alternative measures, including informal meetings between the management board and large stockholders. The use of such substitutes, even if marginally inferior, in turn reduces the incentive for shareholders to pressure or lobby for change.

To generalize, corporate evolution is likely to follow the path of least resistance. Thus, Professor Gilson has predicted the persistence of formal deviations from the governance norms that one observes in the United States or the United Kingdom, but he still foresees a functional convergence that is sufficient to achieve competitive equivalence and maintain the local firm's cost of capital at a basically comparable level.<sup>44</sup> Functional convergence may well trump formal convergence, but the open question that his analysis leaves unresolved is how far functional convergence can proceed before it encounters inflexible legal barriers. When these barriers are encountered, the problem here noted is that the globalization of capital markets actually increases the disconnect between economic ownership and political representation. In turn, this dissociation disables shareholders from becoming effective political actors. Concomitantly, globalization may increase the competitive pressures for convergence, but it also may heighten some of the political barriers to convergence.

### *B. Control Premiums and the Risk of Expropriation*

To this point, we have focused largely on legal rules and the prospect for rules convergence. Yet, not all (or even most) inefficient corporate governance practices are legally mandated. Nontransparent accounting, passive boards, and self-dealing transactions are never truly required, and firms by a variety of techniques could credibly promise to end such practices. For example, by listing on the New York Stock Exchange and adopting by-laws requiring an activist audit committee, a firm might credibly signal that it would no longer engage in certain types of transactions that expropriated wealth from minority shareholders.

Still, it may not be in the interest of those who control the firm to make such a commitment. To illustrate, assume hypothetically that the consequence of such a reform package would be to increase the stock market capitalization of the firm from \$90 million to \$100 million, or more than ten percent. At first glance, this would seem to benefit those in control of the

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<sup>44</sup> See Gilson, *supra* note 27.

firm. But, on closer inspection, the answer is indeterminate. Suppose a control block (possibly, owned by a family) of this firm has received and declined a recent offer of \$50 million for its one-third block. This offer does not truly imply that the value of the firm as a whole is \$150 million; rather, it implies only that the value of the control block, under a particular set of legal and institutional arrangements, is at least \$50 million. The fact that this offer was declined also implies that, regardless of any synergy gains that the buyer foresaw, the control holder saw greater value in its control block. The stock market's seeming original valuation of this firm at \$90 million before the adoption of the reform package may only be its valuation of the two-thirds of this stock in the hands of dispersed public shareholders, which the market therefore valued at \$60 million. The remaining control block could therefore be worth \$50 million or more, implying a total firm value of at least \$110 million or more.

Hence, when we say that the stock market capitalization of the firm will rise from \$90 to \$100 million, this may really imply only that the adoption of the corporate governance reforms will simply increase the value of the two-thirds of the firm's stock in public hands from \$60 million to \$70 million. But these same reforms might reduce the value of the control block, hypothetically, from \$50 million to \$40 million or less. On this zero-sum assumption, which is, of course, not the only possibility, the *de facto* control group would have little interest in adopting these reforms. Only a Coasian bribe from the public shareholders or from a third party could induce the control block to adopt such reforms. In short, to the extent that corporate governance reforms increase the value of publicly held shares by reducing the value of a control block, there may be little movement in this direction. This would remain true even if the gains to the public shareholders more than offset the loss to the control block holders.

This point has a generalized significance, because a well-known economics literature has shown that the average size of control premia is larger in those economies characterized by concentrated ownership and weak minority protections.<sup>45</sup> This difference in the typical size of control premia cannot logically be attributed to differences in the relative prospect for synergy gains, which is usually the preferred explanation for control premiums, because the potential for these gains is greater in economies having the more active mergers and acquisitions markets—which the United States and the United Kingdom certainly have. Rather, the more logical explanation is that the ability to expropriate wealth from minority shareholders is greater in those countries having on average higher control premiums. This conclusion is reinforced by the finding reached by Professors Shleifer and Vishny that civil law countries provide significantly weaker protections for minority shareholders than do common law countries.<sup>46</sup> Similarly, a 1997

<sup>45</sup> See Zingales, *Voting Right*, *supra* note 29; Zingales, *Corporate Votes*, *supra* note 29.

<sup>46</sup> See La Porta et al., *supra* note 7, at 1132; Schleifer & Vishny, *supra* note 11.

report prepared for the European Commission identifies the discretionary powers given to the controlling shareholder as the central characteristic of Continental corporate law that most differentiates it from American corporate law and practice.<sup>47</sup> Against this backdrop, the greater control premia in civil law jurisdictions reflects the lesser likelihood that courts will intervene to protect minority (or public) shareholders from actions by the control holder that either seek to eliminate the minority at a less-than-proportionate value or to otherwise transfer wealth to the control holder.

If this is the case, the difficulties in changing this pattern are formidable. As opposed to simply revising inefficient corporate legal rules that may have an uncertain future impact, this type of reform effects a present wealth transfer from the controlling shareholder to the public shareholders. In addition, the law must not only be changed, it must be enforced. To give minority shareholders the realistic expectation that corporate wealth will not be diverted to those in control of the firm, it is necessary to create adequate enforcement mechanisms and a much stronger judiciary. Those who paid a control premium at midstream in the corporation's life to gain control will resist such a change fiercely, sincerely believing that they purchased the right to eliminate the minority at a discount off proportionate value. Correspondingly, they may also claim that because the public shareholders purchased at a "bargain" price which reflected the likelihood of future wealth expropriation by the controlling shareholder, the public shareholders would receive an undeserved "windfall" if legal rules were revised to entitle them to a proportionate share of corporate assets and distributions. From an efficiency perspective, it may be clear that the economy will do better if the minority is protected, but from a normative perspective, the respective entitlements of the majority and the minority can be debated endlessly.

### *C. Complementarity*

The foregoing point about the ubiquity of patterns of concentrated share ownership in much of the world leads to a more general observation: what is efficient in one context may not be efficient in another, especially if reforms are implemented on a piecemeal basis. Any specific corporate governance practice—for example, the majority outsider board—is embedded in a broader institutional matrix, including a characteristic ownership structure. Thus, a particular practice or legal rule probably can only be efficient in any given context if it is compatible with the other practices, including ownership structure, that prevail in that context. To illustrate, consider whether it would be efficient for a firm based in an Asian country to adopt an American-style monitoring board of outside directors when the firm's major competitors had management teams and boards largely staffed with personnel having close contacts with the government then in power.

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<sup>47</sup> See ECGN SURVEY, *supra* note 13.

Even if one does not rely on the perhaps overly cynical assumption that "crony capitalism" prevails in much of the world, it could still be true that, in an economy characterized by cross-ownership and a preference for dealing (either as a lender, borrower, supplier, or customer) with established trading partners, it would be useful to have a board populated by representatives of such trading partners and economic allies. In short, having an independent board when other firms are using their boards to knit together a closely linked web of interlocking alliances may be a counterproductive innovation. Innovations, even if copied from a well-recognized model, must be able to adapt to local conditions if they are to survive. In turn, this requires that even a potentially efficient reform fit into the complicated jigsaw puzzle of existing institutional arrangements, and this implies that corporate evolution needs to be gradual and incremental, because most abrupt mutations do not survive.

#### *D. Path Dependency*

Much national variation in corporate governance reflects the impact of path dependency upon the evolution of economic systems. Although a complex concept, the core idea in path dependency is that initial starting points matter. Whether established by historical accident or political compromise, initial conditions direct an economy down a particular path of development from which there is no easy return. Possibly the best known example of path dependency producing an outcome that is seemingly inefficient is that given by Professor Roe: the relatively small scale of financial intermediaries in the United States seems in substantial part to be the consequence of a U.S. political tradition that was profoundly skeptical of concentrated financial power.<sup>48</sup> Much smaller than their European and Japanese counterparts, both proportionately to domestic GNP and in absolute terms, U.S. financial institutions were dwarfed by the interaction of a federal system that long denied banks the ability to spread beyond a single state, and by a populist distrust of concentrated financial power that resulted in part in the Glass-Steagall Act's divorce of commercial and investment banking. The upshot was a proliferation of local financial intermediaries in the United States that were too small and too legally constrained to serve as effective monitors of U.S. industrial corporations.

Nor is the United States unique. Political compromises, sometimes in long-forgotten battles, resulted in the lifetime employment system in Japan and codetermination in Germany. Neither practice appears to be an efficient adaptation,<sup>49</sup> but both have persisted.

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<sup>48</sup> See ROE, *supra* note 23.

<sup>49</sup> Some have argued that the system of lifetime employment in Japan created a desirable incentive to invest in human capital, but the most recent review doubts that the practice had such an impact and finds that the actual motivation was to reduce worker influence in the factory and to minimize the prospect of socialist electoral victories in post-war Japan. See Ronald Gilson & Mark J. Roe, *Lifetime Em-*

The important implication of path dependency is that, once events have been set in motion and historical forces have produced significant national variations in the structure and design of economic institutions, there may be no universal answer to the question of what incremental changes are most efficient. Indeed, the same market forces could produce inconsistent evolutionary adaptations in different economic environments. A good illustration of this possibility has been suggested by Professor Jeffrey Gordon. He begins with the fact that "thin" equity markets in Germany have not generated significant equity capital for German corporations (at least in percentage terms), and that German corporations have consequently placed greater reliance on debt financing.<sup>50</sup> But his real point is that a natural "fit" exists between reliance on debt and a system of bank monitoring. In a heavily leveraged firm, he observes, Anglo-American-style corporate governance would not work well. Indeed, the standard corporate finance literature recognizes that in such a world, if corporate control were assigned to a board of directors responsible only to the shareholders, perverse incentives would arise for the equity shareholders to pursue inefficient strategies (from the standpoint of the firm as a whole) that transferred wealth from the creditors to the equity. Professor Gordon's point is not that bank monitoring is inherently superior to monitoring by equity representatives, but that the optimal answer to the monitoring problem is contingent on the characteristic capital structure that firms in a particular economic environment have. If the starting point is heavy reliance on debt, for any of a number of exogenously determined reasons, then the optimal governance solution is unlikely to be the characteristic Anglo-American one of a board responsible only to its shareholders. Instead, financial structure and governance structure must be jointly determined. If path dependent factors predetermine the issue of financial structure, then governance structure becomes the dependent variable. In turn, the prospect of convergence towards a single system of corporate governance begins then to look increasingly remote.

#### *E. The Possible Superiority of Blockholder Governance*

The most subversive possibility has been held for last. Although concentrated ownership aggravates a host of normative problems and inherently produces both a thin and nontransparent securities market, it may yield better monitoring of management. Large blockholders are inherently superior monitors than dispersed shareholders, because dispersed shareholders are subject to a free rider problem: small shareholders lack the in-

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ployment: *Labor Peace and the Evolution of Japanese Corporate Governance* (forthcoming in the Columbia Law Review).

<sup>50</sup> Gordon, *supra* note 42, at 196.

centive to incur monitoring costs that primarily benefit other shareholders.<sup>51</sup> Blockholders will rationally incur larger costs, given their larger ownership. Unfortunately, controlling blockholders are also able to engage in private rent-seeking that benefits themselves as management, but not other shareholders. For some scholars, this combination of superior monitoring and private rent-seeking represents an efficient solution. They argue that concentrated ownership essentially subverts blockholder monitoring "by permitting blockholders to reap private benefits through self-dealing and insider trading."<sup>52</sup> The problem with this rationale is that there is little assurance that this subsidy is cost-effective; rather, the remedy of blockholder "monitoring" may be worse than the disease of managerial opportunism. Worse yet, in many forms of concentrated ownership the blockholder is a family group, and the line between the blockholder "monitor" and the management team, which may also involve family members, often breaks down.<sup>53</sup> On such occasions, minority shareholders may experience the worst of both worlds: self-dealing blockholders who overlap with a family-based management.

Market-centered systems clearly make a more determined effort to restrict such private rent-seeking by blockholders.<sup>54</sup> But, at least as a theoretical matter, it is unclear whether the greater ability of a market centered system to police conflicts of interest fully compensates for its lesser ability to monitor for inefficiency. Further, it can at least be argued that market-centered systems tend to be characterized by inefficient pressures to maximize profits over the short term<sup>55</sup> and by an inability to protect firm-specific investments in human capital by managers.<sup>56</sup> In principle, these tradeoffs are indeterminate, at least in the absence of better empirical data. This Article will argue, however, that, even if the optimal structure of corporate

<sup>51</sup> For example, even a large institutional investor holding 1 to 2% of a firm's stock must recognize that 98% of the benefit of any gains that flow from its monitoring efforts will be enjoyed by other shareholders. For an 80% blockholder, however, this is a less serious problem.

<sup>52</sup> See Bratton & McCahery, *supra* note 13; see also Milhaupt, *supra* note 19, at 1179-84.

<sup>53</sup> The extreme example is probably Italian corporate governance which relies on small family held firms and has minimized the role of outside investors. See Jonathan R. Macey, *Italian Corporate Governance: One American's Perspective*, in CORPORATE GOVERNANCE TODAY, *supra* note 2, at 677, 692 (noting also that Italian economy "is dominated by small efficient family firms"). French corporate governance also seems to be characterized by "an interpenetration of kinship structures (family owners) and managerial bureaucracy." See Windolf, *supra* note 2, at 695.

<sup>54</sup> Revealingly, Germany uses the last major financial marketplace to prohibit insider trading, and it did so two years late in complying with an EU directive requiring such a prohibition. See Roberta S. Karmel, *Transnational Takeover Talk—Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany, and Australia*, 66 U. CIN. L. REV. 1133, 1149-52 (1998).

<sup>55</sup> See Bratton & McCahery, *supra* note 13, at 8.

<sup>56</sup> See *id.* at 9; see also Arnold W.A. Boot & Jonathan R. Macey, *Objectivity, Control and Adaptability in Corporate Governance*, in CORPORATE GOVERNANCE TODAY, *supra* note 2, at 213, 214-15 (1998). This latter problem is a corollary of the greater frequency of hostile control consists in market centered systems.

governance cannot therefore be confidently stated, the instability of the blockholder system can be predicted for reasons that are next addressed.

## II. THE MECHANISMS OF CORPORATE CONVERGENCE

Although the foregoing discussion has stressed the barriers to convergence in corporate governance, significant legal and economic transitions are clearly in progress. Some involve changes in the governance structure of economies formerly characterized by concentrated ownership and a reliance on bank monitoring; other transitions involve the decisions of individual firms to migrate abroad and to opt into foreign governance standards through either listing agreements or initial public offerings ("IPOs"). Most importantly, the pace of change is very uneven. As will be seen, much more progress has been made towards convergence at the level of securities regulation than at the traditional level of corporate law and structure. The possible reasons for this disparity will be assessed after recent developments are first reviewed.

### A. The Growth of European Stock Markets

European stock markets have traditionally been regarded as "thin"—that is, both illiquid and volatile.<sup>57</sup> The traditional pattern has been one of relatively few IPOs on either an annual basis or based on the jurisdiction's population. Typically, local stock market capitalization has amounted to no more than a small percentage of gross domestic product ("GDP"). For example, Germany has Europe's largest economy and GDP, but in 1995 just three issuers accounted for a third of the trading volume in German equity markets, and the top six issuers accounted for nearly 50%.<sup>58</sup> Similarly, the ratio of total stock market capitalization to GDP contrasts sharply between Germany and the United Kingdom. In Germany, stock market capitalization was 17% of GDP, but the corresponding ratio was 132% in Great Britain.<sup>59</sup> In the United States in 1995, the stock capitalization of the New York Stock Exchange ("NYSE") and NASDAQ were, respectively, 80.4% and 16.5% of U.S. GDP, or nearly 87% in total.<sup>60</sup> Nor is the German situation unique. For Italy, the corresponding 1995 ratio of stock market capitaliza-

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<sup>57</sup> See Gordon, *supra* note 42, at 187; Marco Pagano et al., *Why Do Companies Go Public? An Empirical Analysis*, 53 J. FIN. 27 (1998).

<sup>58</sup> See Peter Gumbel, *Cracking the German Market: The Hard Sell, Getting Germans to Invest in Stock*, WALL ST. J., Aug. 4, 1995, at A4.

<sup>59</sup> See Gordon, *supra* note 42, at 196 (citing study by Theodor Baums, a German law professor); see also *The 1996 Guide to Germany*, EUROMONEY, June 1996, at A4 tbl. 1 (for 1995, 23.9% for Germany, 130.7% for Great Britain).

<sup>60</sup> See Roberta S. Karmel, *Italian Stock Market Reform*, N.Y. L.J., Aug. 20, 1998, at 3.



tion to GDP was 19.3%.<sup>61</sup> More importantly, almost no Italian companies were publicly held.<sup>62</sup>

From a path dependent perspective, the anemic status of German stock markets is easily explained by an obvious "interest group" explanation: banks do not want rivals and so retard the growth of the securities industry. The power of the banking industry is particularly strong in Germany, and thus one would expect it to keep securities markets underdeveloped, particularly for smaller businesses that would have to depend on bank financing. The problem with this logical story is that its validity is rapidly waning. The German financial landscape is in rapid transition, and there is already a "widespread sentiment among political actors that the system of bank-centered finance is hindering German economic development."<sup>63</sup> Several recent privatizations, most notably of Deutsche Telekom in 1996, have been aimed at developing a "shareholding culture" among German citizens.<sup>64</sup> Across Europe, both 1997 and 1998 have been years of record IPO activity, and the approaching arrival of an eleven nation "Euro zone" is widely expected to spur further increases in trading volume and probably result in a true pan-European equity market.<sup>65</sup> Although much of this activity has been the product of large privatizations of formerly state-owned firms, a closer look at the data reveals that the majority of the new offerings (in dollar volume) in 1998 have been corporate offerings, not privatizations.<sup>66</sup> This means that firms that typically have been privately held within families for many years have opted to sell minority stakes to the public in this new environment.<sup>67</sup>

Particularly noteworthy has been the success of the German Neuer Market, a new small company market, patterned after NASDAQ's small capitalization market, to attract listings by start-up companies.<sup>68</sup> Over the last year, it has tripled its listings to forty-three.<sup>69</sup> Although venture capital and entrepreneurial start-ups have long been absent from the German and

<sup>61</sup> See *id.*

<sup>62</sup> As of 1989, only seven Italian corporations had offered more than 50 % of their shares to the public, and in five of these, voting control remained locked in a small family group. See Macey, *supra* note 53, at 687-88.

<sup>63</sup> Gordon, *supra* note 42, at 186-87.

<sup>64</sup> *Id.* at 186.

<sup>65</sup> See Thane Peterson et al., *The Euro's Warm-Up Act: IPOs*, BUS. WEEK, June 22, 1998 at 24 (noting that new share offerings exceeded \$91 billion in 1997 on European exchanges, a record level, and may exceed this in 1998).

<sup>66</sup> See *id.* (noting that 53% of the \$31 billion in new offerings in 1998 have been corporate offerings unrelated to privatizations).

<sup>67</sup> See *id.* (discussing success of the Neuer Market).

<sup>68</sup> See Thane Peterson, *A High-Tech Europe Is Finally In Sight*, BUS. WEEK, Aug. 31, 1998, at 120 (noting also that this market was up 150% in 1998).

<sup>69</sup> See *id.* Several of these listings appear to have done IPOs in the United States and then listed on the Neuer Market. See Graham Bowley, *A Success Worth Replicating*, FIN. TIMES, Sept. 3, 1998, at 21 (discussing Quiagen, Germany's first biotech startup).

Continental landscape, they now appear to be making a vigorous appearance.

The pace of change has been even more dramatic in Italy. Italian corporations have typically been family-controlled and have raised capital through bank loans and retained cash flow. But between 1995 and 1997, the ratio of the capitalization of the Italian Stock Exchange to Italian GDP rose from 19.3% to 31.3%, an increase of more than 50%.<sup>70</sup> Behind this rise lie two important developments: (1) a major privatization program, which began in 1993 and which was impelled in large measure by the desire of the Italian government to reduce budgetary deficits in order to qualify for the European Monetary Union, and (2) major changes in the laws governing the Italian securities industry, partly in order to comply with a European Community Investment Services Directive that was designed to encourage cross-border competition among securities firms.<sup>71</sup> Until well into this decade, there were ten separate stock exchanges in Italy (although the Milan exchange was by far the dominant market), each operating as an "open outcry" trading floor with little regulation. Over the past two years, they have been consolidated into a single computerized market, which is now privately owned and operated as a for-profit company, and regulated by the Commissione Nazionale per la Società e la Borsa ("CONSOB"), an SEC-like administrative agency. A 1991 legislative reform also authorized the formation of securities firms (where previously only natural persons could qualify for stock exchange membership). It also established capital requirements, and restricted conflicts of interest.

The development of European securities markets has been partially fueled by a liberalization of cross-border activities by securities firms. The Investment Services Directive authorized all European Union ("EU") securities firms to conduct cross-border operations anywhere in the EU based only on the license issued by their home state.<sup>72</sup> Thus, well-capitalized British firms or subsidiaries of American firms licensed to do business in Britain can now enter the Italian market, or any other EU market with limited capital, and add liquidity.

The last chapter in the Italian story is perhaps the most relevant to this Article's concerns. In 1998, Italian Prime Minister Romano Prodi pushed a package of reforms through the Italian Parliament that increased disclosure standards, strengthened the regulatory powers of CONSOB, and revised Italian corporate governance to increase protections for minority sharehold-

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<sup>70</sup> See Karmel, *supra* note 60, at 3.

<sup>71</sup> See Manning G. Warren III, *The European Union's Investment Services Directive*, 15 U. PA. J. INT'L BUS. L. 181 (1994). The "Investment Services Directive" is more technically referred to as Council Directive 93/22 on Investment Services in the Securities Field, 1993 O.J. (L141) 27, (L70) 32, (L94) 27.

<sup>72</sup> See *id.*

ers.<sup>73</sup> Chief among these governance reforms was a provision that required a mandatory takeover bid by any person or group who acquires thirty percent or more of a publicly listed company. This provision, which roughly parallels British and French law, is both a paradigmatic example of rule convergence and a protection designed to reduce the ability of insiders and others to assemble control blocks cheaply. Press accounts noted that the reform was intended to discourage a common Italian phenomenon: "covert alliances of shareholders who own less than fifty-one percent of the share capital between them."<sup>74</sup> Other reforms halved from twenty percent to ten percent the required percentage of shares necessary to call a special meeting of shareholders and otherwise enhanced proxy voting.<sup>75</sup> Equally important, a proposal that business groups advanced was rejected which would have protected large firms from hostile takeovers by denying any hostile bidder the ability to cross the fifteen percent threshold without making a full public offer.

Of course, it remains to be seen whether these protections will prove adequate to assure minority shareholders, but one measure of success has been the upsurge in Italian IPOs. It is estimated that there will be more than twenty-five IPOs in Italy in 1998, almost double the number in 1997.<sup>76</sup>

More generally, an IPO boom spread across Europe in 1998, with the demand for IPO shares regularly outstripping the supply.<sup>77</sup> Although this rosy scenario for increased European IPOs has since been clouded by the Russian financial crisis,<sup>78</sup> some factors encouraging the growth of European equity markets seem likely to persist: (1) across Europe, a significant number of major privatizations—particularly in the telecommunications field—are planned and in the pipeline, thus assuring a continuing supply of IPOs and a probable increase in the aggregate European stock market capitalization;<sup>79</sup> (2) the adoption of the "Euro" as the common currency unit in early 1999 will facilitate pan-European equity trading and the cross-listing of shares on multiple exchanges; (3) corporate governance reform, including both greater protections for minority shareholders and increased financial

<sup>73</sup> See Alan Friedman, *Prodi Rolls Out Reforms*, INT'L HERALD TRIB., Feb. 19, 1998, at 1.

<sup>74</sup> James Blitz, *Italian Takeover Reforms Take Shape*, FIN. TIMES, Feb. 12, 1998, at 2.

<sup>75</sup> See *id.*

<sup>76</sup> See Karmel, *supra* note 60, at 3. There had been at least 17 such IPOs as of mid-August 1998. See *id.*; see also Deborah Ball, *New Entrepreneurs Fuel IPO Bonanza in Italy*, WALL ST. J., July 22, 1998, at B7A (estimating that another five hundred private Italian firms could qualify for stock exchange listing).

<sup>77</sup> See Suzanne McGee, *Europe's IPO Game May Get Tougher*, WALL ST. J., Aug. 25, 1998, at C1 (noting that "it became almost routine for new stock issues to be sold well above the price range at which they were marketed. Issues have been outscribed tenfold routinely, and many rally in after-market trading").

<sup>78</sup> See *id.*

<sup>79</sup> See McGee, *supra* note 77, at C1 (noting approaching major privatizations in Switzerland, Poland, Greece, and France).

transparency, has proved to be popular with the center-left political coalitions that today hold power in a number of European states;<sup>80</sup> and (4) EU regulation will continue to fight local protectionism and seek to open up securities and financial markets to cross-border competition. Whatever the short-term movements in financial markets, all these forces are likely to produce increased competition and convergence.

The foregoing developments have been emphasized at some length because they fly in the face of the conventional wisdom. That wisdom held that active stock markets could not easily develop in economies long organized around strong banks. Thus, a path dependency theorist could logically predict that opposition from banks would stifle any potential competition from stock exchanges. Nonetheless, the recent evidence shows that securities markets are developing and convergence at this level is occurring, even in the face of a mature banking industry. Possibly, this is because European political leaders have recognized that the development of securities markets robustly correlates with future economic growth.<sup>81</sup> If so, at least within this context, the proponents of the claim that competition will force convergence seem currently to have the better of the argument with the proponents of path dependency.

### *B. Disclosure Harmonization versus Corporate Law Reform*

For more than a decade, the European Community has pursued harmonization of its securities regulation and disclosure rules in order to achieve a common market for securities.<sup>82</sup> In principle, harmonization can be pursued by one of two alternative approaches: reciprocity or commonality. Under the former approach, all member states agree to recognize and to permit use of a disclosure document that qualifies in the issuer's home country, while under the latter, common rules and disclosure documents are

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<sup>80</sup> See Friedman, *supra* note 73 (noting that corporate governance and financial transparency reform seem to be issues that are particularly attractive to center-left coalitions in Italy and possibly Holland and Sweden).

<sup>81</sup> See Kent Hargis, *Do Foreign Investors Stimulate or Inhibit Stock Market Development in Latin America*, 38 Q. REV. ECON. & FIN. 303 (1998) (reviewing literature); Levine & Zervos, *supra* note 25; Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559 (1998). These studies do not demonstrate the superiority of securities markets over a banking system as an engine of growth, but they do suggest that securities markets stimulate investment in longer term and higher risk projects (such as high technology investments) that have a higher return over the long run.

<sup>82</sup> For overviews of this process, see generally Uri Geiger, *Harmonization of Securities Disclosure Rules in the Global Market—A Proposal*, 66 FORDHAM L. REV. 1785 (1998); David Reid & Andrew Ballheimer, *The Legal Framework of the Securities Industry in the European Community Under the 1992 Program*, 29 COLUM. J. TRANSNAT'L L. 103 (1991); Andreas J. Roquette, *New Developments Relating to the Internationalization of the Capital Markets: A Comparison of Legislative Reforms in the United States, the European Community, and Germany*, 14 U. PA. J. INT'L BUS. L. 565 (1994); Manning G. Warren III, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L L.J. 185 (1990) (describing the development of the disclosure system in the European Union).

agreed upon. Harmonization in the EU has largely compromised these two approaches: a single disclosure document can be used for the offering of securities in any member state, so long as the disclosure requirements mandated by the issuer's home country satisfy EU-mandated minimum standards.<sup>83</sup> Beginning in 1979, the EU has adopted a series of securities-oriented directives governing (1) the minimum requirements for the admission of securities for trading on a stock exchange in any EU member state, (2) the minimum disclosure requirements for securities offerings in any member state, and (3) periodic reporting requirements.<sup>84</sup> Alone, these steps represent substantial convergence at the level of securities regulation, although member states remain free to impose more stringent requirements upon domestic issuers.

While these directives addressed traditional areas of securities regulation and did not attempt to harmonize corporate law norms, the European picture changes dramatically once the focus shifts from securities regulation to traditional corporate law. Attempts by the European Union during the 1980s to adopt directives dealing with takeover bid procedures, board structure of publicly held companies, and employee rights have all largely failed amidst considerable controversy.<sup>85</sup> In general, either Great Britain would object to attempts to place employee representatives on the corporate board<sup>86</sup> or Continental countries would object to attempts to generalize the British takeover rules. By 1997, an expert panel reported that cultural attitudes differed so fundamentally within Europe on these questions that attempts to develop a harmonized single standard were destined to fail.<sup>87</sup>

This tendency for harmonization efforts to become controversial once the focus shifts to substantive corporate law continues to date. In October 1998, efforts to draft a takeover directive again ended in deadlock, as the United Kingdom's Takeover Panel valiantly resisted the proposed draft.<sup>88</sup> The takeover directive may yet be salvaged,<sup>89</sup> but possibly at the cost of framing it in extremely generalized and nonconfining terms. To some extent, this has been the prior history of corporate control directives in the

<sup>83</sup> See Geiger, *supra* note 82, at 1788-89.

<sup>84</sup> See Geiger, *supra* note 82, at 1789-90; Reid & Ballheimer, *supra* note 82, at 124.

<sup>85</sup> For reviews of these efforts, see generally Terence L. Blackburn, *The Societas European: The Evolving European Corporation Statute*, 61 *FORDHAM L. REV.* 695 (1993); Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 *CARDOZO L. REV.* 227, 239-40 (1998).

<sup>86</sup> See Proposal for a Fifth Directive, Foundation Article 54(3)(g) of the EEC Treaty Concerning the Structure of Public Limited Companies and the Powers and Obligations of Their Origins, 1983 O.J. (C240) 2. This draft proposed two optional structures for providing employee representation, but both encountered intense British opposition.

<sup>87</sup> See *Corporate Governance Update*, 5 *CORP. GOVERNANCE INT'L REV.* 256 (1997).

<sup>88</sup> See Jane Martinson, *Takeover Directive in Deadlock*, *FIN. TIMES*, Oct. 9, 1998, at 2.

<sup>89</sup> See *More Talks on Defining Takeovers Bids Directive*, *EUR. REP.*, Jan. 9, 1999, available in LEXIS, Nexis Library, cumwvs file.

European Union. While the takeover in the United States has functioned as a device for downsizing oversized and inefficient conglomerates, the European Union's Acquired Rights Directive severely limits the ability of a bidder to lay off excess employees or reduce wages in the wake of an acquisition.<sup>90</sup> Hence, whatever the fate of the current takeover directive, the hostile takeover may never play the same disciplinary role in Europe that it has in the United States. Again, this softening of the takeover's potential impact reflects the greater political power of labor across Europe and the more powerful legacy of the European social welfare state.

The line between corporate law and securities regulation is fuzzy at best, and it is revealing that proposals which have fallen into the gap between these two fields have encountered considerably more opposition than have pure disclosure proposals—but they have still been adopted. A good example is provided by the Transparency Directive.<sup>91</sup> Less an attempt at harmonization of existing legal rules than a bold attempt to adopt a new rule that would require public disclosure of the often very nontransparent ownership structures that characterize the European system of concentrated ownership. Issued in 1988 by the Council of Europe, the Transparency Directive was intended "to increase investors' confidence in securities markets" by assuring equivalent disclosure of control data about listed companies.<sup>92</sup> Similar in scope and spirit to the Williams Act in the United States, the Transparency Directive applied to listed firms registered anywhere in the European Union. Basically, it required any natural person or legal entity to notify the issuer and the local governmental authority within seven calendar days after the person or entity's voting rights exceeded or fell below any of the following thresholds: ten percent, twenty percent, one-third, half, or two-thirds. Local law was permitted to vary these standards only slightly. In addition, the Transparency Directive recognized the reality of control groups by requiring the aggregation of voting rights within a business group or pursuant to a formal shareholders agreement or proxy arrangement. Informal groups were not, however, covered.<sup>93</sup>

How successfully has the Transparency Directive been implemented? Much depends on one's perspective, but the results have clearly been uneven. Prior to the directive, German corporate law required disclosure only when an individual's or entity's stake exceeded twenty-five percent. Thus, the Transparency Directive did mandate a significant change. But, revealingly, the effort to implement the Transparency Directive set off a pro-

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<sup>90</sup> The Acquired Rights Directive of 1977 has been implemented by legislation in many EU member states. In Britain, the Transfer of Undertakings (Protection of Employment) Act codifies its obligations. Essentially, on a transfer, the employee staff must be transferred on the same or better terms. For a brief summary, see *What the TUPA means for you*, GUARDIAN, Dec. 5, 1998, at 18.

<sup>91</sup> See Council Directive 88/627 of December 12, 1988 on the Information to be Published when a Major Holding in a Listed Company is Acquired or Disposed of, 1988 O.J. (L. 348) 62.

<sup>92</sup> See ECGN SURVEY, *supra* note 13, at 56-57.

<sup>93</sup> See *id.* at 87-90.

longed political battle in Germany. While the directive was supposed to have been adopted by local legislation by 1991 (and was in many other European countries), Germany did not adopt conforming legislation until 1994, in part because the very idea of transparency in ownership structure aroused controversy and disrupted long-held assumptions about the right to anonymity.<sup>94</sup>

This struggle has carried over into the compliance stage. A 1997 study of the implementation of the Transparency Directive by the European Corporate Governance Network criticized the implementation of the Transparency Directive across Europe<sup>95</sup> and concluded "that the Directive, at the moment, fails to achieve its objectives."<sup>96</sup> A variety of predictable problems were identified: the compliance efforts of some member states were not adequate; too little disclosure was provided concerning the blockholder's intent and plans; informal groups escaped coverage; and the data that was reported was often inaccessible to shareholders.<sup>97</sup>

Fairness requires the balancing observation that some progress has been made. Some states—most notably Italy and Belgium—have exceeded the Transparency Directive's minimum requirements. For example, ownership disclosure in Belgium is now required at the five percent level or three percent if the company so chooses. Such disclosure must be filed within forty-eight hours, is checked by a governmental agency, and is made publicly available in an on-line database accessible to investors that is run by the stock exchange.<sup>98</sup> Similarly, Italy now requires that equity holdings of more than two percent in listed companies must be reported to CONSOB within forty-eight hours, and the data is also made available to the public through an online computer system.<sup>99</sup>

Why has securities harmonization largely succeeded, while corporate law harmonization has been largely frustrated? A variety of reasons can be given: (1) disclosure harmonization sounds neutral and technocratic and does not on its face challenge long-established social policies; (2) securities harmonization is necessary for the development of a pan-European stock market and cross-listings, which are in the common interest of most issuers; and (3) securities harmonization can be largely accomplished at the administrative level and does not require national legislatures to act, thereby inviting political rivalries to enter the picture. Still, as the more controversial experience with the Transparency Directive shows, considerable resistance

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<sup>94</sup> See Marco Brecht & Ekkehart Bohmer, *Transparency of Ownership and Control in Germany*, in ECGN SURVEY, *supra* note 13, at 23 (noting "clash of cultures" over issue of transparency).

<sup>95</sup> See *id.* at 57.

<sup>96</sup> See *id.*

<sup>97</sup> *Id.* at 90-92.

<sup>98</sup> See Marco Becht, *Ownership and Control in Belgium*, in ECGN SURVEY, *supra* note 13, at 13-18.

<sup>99</sup> See Marcello Binachi et al., *Ownership Pyramidal Groups and Separation Between Ownership and Control in Italy*, in ECGN SURVEY, *supra* note 13, at 13-14.

has arisen when the law has sought to change the behavior of individuals—shareholders and families—or to change a long established cultural tradition—the desire for ownership anonymity. Thus, both sides in the debate over corporate convergence are correct, but at different levels.

### *C. The Appearance of Institutional Investors*

Although banks play a major role in some European securities markets (most notably Germany), other institutional investors, such as pension funds and mutual funds, have historically played no more than a minimal role on the European Continent. The absence of pension funds has been largely attributable to generous public pension systems across Europe. But this pattern has begun to change. In 1993, Italy passed its first legislation to regulate pension funds, a statute that was amended in 1995. A more liberal tax law was also passed to encourage their formation. Following the American model, Italian pension funds may not hold more than five percent of the voting shares of any listed company (ten percent in the case of non-listed companies) and may not acquire “direct control” of a company. Similarly, Italian law restricts open-end mutual funds to parallel five percent and ten percent ownership ceilings and also prohibits their acquisition of control. Whatever the wisdom of these provisions, they promise a new form of fragmented shareholding: small block holders. In turn, such shareholders are both exposed to exploitation and motivated to seek protections.

The development of pension funds in Europe still faces significant obstacles. In September 1998, fund management associations from six European countries united to seek relief through the European Community from investment restrictions placed on pension fund equity investments by local law, most notably in France and Germany.<sup>100</sup> Arguing that existing restrictions on equity investments “have a significant detrimental effect on the development of European-funded pensions [and] on the European economy,”<sup>101</sup> they called for the substitution of an American-style “prudent man principle” that would leave asset allocation decisions up to fund managers. A preliminary draft of a pension fund directive is expected to endorse this idea but to encounter opposition from the French and German governments.<sup>102</sup> Again, this confrontation not only parallels the American experience, it also frames another test case for the convergence hypothesis. Path dependency theorists and neoclassical economists would probably make different predictions about the eventual outcome of this battle, but it is already significant that a draft directive liberalizing investment restrictions is under serious consideration.

Given continued growth, these institutional shareholders may come to play an activist role similar to that played by their Anglo-American cousins.

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<sup>100</sup> See *Fund Managers Call for Relaxation of Restrictions*, FIN. TIMES, Sept. 11, 1988, at 2.

<sup>101</sup> *Id.*

<sup>102</sup> See *id.*



The key difference is that they will function for the foreseeable future in a concentrated ownership environment where small blockholders have less power. If they are unlikely to be powerful enough to change local law, they might still pressure their portfolio firms to secure foreign exchange listings and utilize the protections available to them under foreign law.

#### *D. The Harmonization of International Accounting Standards*

In July 1995, the International Accounting Standards Committee ("IASC"), a private international organization, and the International Organization of Securities Commissions ("IOSCO") reached an agreement to develop a core set of international accounting standards ("IAS") with the expectation that on completion of this project IOSCO would endorse these standards for use in cross-border financings and for listings in global stock markets.<sup>103</sup> A draft is now expected this year. Obviously a response to the globalization of the world's securities markets, this effort, if successful, would eliminate the need to reconcile an issuer's financial statements in its home jurisdiction's format with those of the jurisdiction(s) in which it wished to seek financing.

The IASC has already published some thirty standards dealing with a broad array of accounting topics, and the harmonization effort faces only modest obstacles on the European scene. But the willingness of the Securities and Exchange Commission ("SEC") to accept IAS standards for use in the United States remains a more problematic and unresolved issue. In April 1996, the SEC issued a statement that supported the IASC's efforts but that also specified rigorous criteria that would have to be satisfied before such standards could be used without reconciliation in the United States.<sup>104</sup>

The SEC's reservations appear to stem mainly from domestic concerns: if it permits foreign issuers to issue securities in the United States based on even marginally relaxed financial standards, can it long deny U.S. issuers the same ability?<sup>105</sup> Will it be seen as placing U.S. issuers at a competitive disadvantage by subjecting them to a more costly regulatory burden? As sensitive as this problem is for the SEC, it probably affects only *when* and not *whether* IAS standards will become usable without recon-

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<sup>103</sup> See David Mercado, *Evolving Accounting Standards in the International Markets*, in INTERNATIONAL SECURITIES MARKETS 1996, at 345, 346 (1996) (PLI No. B4-7166); see also Glenn Reiter, *International Securities Offerings: Recent Developments And Current Issues*, in 29TH ANNUAL INSTITUTE ON SECURITIES REGULATION (1997) (PLI B4-7206).

<sup>104</sup> See Mercado, *supra* note 103, at 419 (Exhibit C) (setting forth the SEC statement, which was not issued as a formal release).

<sup>105</sup> My colleague Louis Lowenstein has argued that the SEC will be under intense pressure to relax standards for domestic issuers if it lowers standards for foreign issuers. See Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1338 (1996). The counterargument is that institutional investors may force both foreign and domestic issuers to disclose more information than the SEC requires.

ciliation in the United States.<sup>106</sup> For the European issuer, even if the SEC accepts IAS standards, another unresolved question involves whether such an issuer can as a practical matter use this lesser standard of disclosure in the United States. Will securities analysts and institutional investors demand more?

In any event, the swift movement toward accounting harmonization in Europe again reveals that some forms of convergence do not encounter cultural obstacles or political resistance. Indeed, private lawmaking by standard-setting groups such as the IASC seems to largely sidestep obstacles that legislative efforts normally encounter.

### *E. Migration to Foreign Markets*

In principle, it is not strictly necessary to reform local law in order for functional convergence to occur. Instead, firms seeking any of a variety of goals—to raise equity capital, to increase share value, or to make acquisitions for stock—may decide to list on a foreign stock exchange and thereby opt into foreign governance standards.

The number of foreign listings on the principal U.S. exchanges reveals the extent of this international migration. As of the end of 1996, there were 416 foreign listings on NASDAQ, 305 on the New York Stock Exchange, and 63 on the American Stock Exchange, for a total of 784.<sup>107</sup> This number continues to grow rapidly. From 1992 to 1998, the foreign listings on the New York Stock Exchange more than tripled, from 119 to 361.<sup>108</sup> In addition, as of 1996, the London Stock Exchange had 533 foreign listings, although many of these were undoubtedly U.S. firms.<sup>109</sup> Of the thirteen thousand companies now registered with the SEC as “reporting” companies, it is estimated that more than one thousand are foreign.<sup>110</sup>

The accelerating pace of this migration may seem surprising when one realizes that foreign issuers incur extensive regulatory costs when they enter the U.S. markets and that most have never thereafter made securities offerings in the United States.<sup>111</sup> Why then do they list? Arguably, companies

<sup>106</sup> Some predict that the SEC will cross this bridge by no later than 2002. See Paul Pachter, *International Accounting Standards: The World's Standards By 2002*, 68 CPA J. 14, 15 (1998).

<sup>107</sup> See Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in A World Interacting Securities Markets*, 38 VA. J. INT'L. L. 563, 566 (1998).

<sup>108</sup> See Greg Ip & Gregory L. White, *Big Board Is Hoping Daimler Chrysler Drives In More Foreign Primary Shares*, WALL ST. J., Oct. 21, 1998, at C1; see also Gerard Achstatter, *Foreign Companies Flock to the U.S. But Their Stocks Carry Extra Risks*, INVESTOR'S BUS. DAILY, June 2, 1998 at A-7 (noting 50% rise in foreign listings from 1995 to 1998).

<sup>109</sup> See Licht, *supra* note 107, at 566.

<sup>110</sup> See Geiger, *supra* note 82, at 1786 (citing data from Office of International Corporate Finance of the SEC); see also Pachter, *supra* note 106.

<sup>111</sup> While foreign issuers list, they seldom make primary offerings in the United States. This may be attributable to a fear of the litigation remedies that they would face in the United States under the Securities Act of 1933 or to the additional accounting requirements of the SEC when a foreign issuer seeks

in smaller markets gain liquidity and possibly also some international recognition and prestige from a U.S. listing. But greater motivation probably lies in the finding, repeatedly observed by financial economists, that the announcement of a dual listing on a U.S. exchange by a foreign firm typically increases the firm's share value.<sup>112</sup> This may also seem surprising because entry into the U.S. securities markets may force the issuer to revise its previously reported earnings downward, as happened to Daimler-Benz.<sup>113</sup>

One explanation for the abnormal price movement on a U.S. listing is that such a listing represents a bonding mechanism: the foreign issuer is increasing the share value of its public shares by agreeing to comply with the generally higher disclosure standards that prevail in the United States.<sup>114</sup> Some evidence supports this interpretation, as opposed to the explanation that dual markets simply increase the demand for the stock, because other studies have found that when a U.S. issuer lists abroad on a foreign exchange, the opposite occurs: its shares exhibit negative abnormal returns.<sup>115</sup>

to register securities for sale (in which event the SEC requires not simply reconciliation to U.S. Generally Accepted Accounting Principles ("GAAP") but full compliance therewith).

<sup>112</sup> See Licht, *supra* note 107, at 634-35; see also, Gordon Alexander et al., *Asset Pricing and Dual Listing on Foreign Capital Markets: A Note*, 42 J. FIN. 151 (1987); Gregory Kedlec & John McConnell, *The Effect of Market Segmentation and Illiquidity on Asset Prices: Evidence from Exchange Listings*, 49 J. FIN. 611 (1994).

<sup>113</sup> When Daimler listed on the New York Stock Exchange in 1993, it was required to restate its 1992 annual earnings to comply with U.S. GAAP standards. It had reported a gain of DM 615 million to its shareholders, but was required to restate this as a loss of DM 1,839—or a swing of nearly DM 2,554. See Pachter, *supra* note 106, at 14. Obviously, this turnaround can both embarrass management and cause uncertainty for investors and thus represents a deterrent to a U.S. listing. Nonetheless, foreign firms continue to list at an increasing rate.

<sup>114</sup> Professor Edward Rock has studied the IPO process in Israel, which typically involves a "high-tech" start up company in Israel listing on NASDAQ as an integral part of the offering process. He concludes that an "unappreciated function of the U.S. mandatory disclosure regime is the extent to which it permits issuers to make a credible commitment to a level and permanence of disclosure." See Edward Rock, *Mandatory Disclosure As Credible Commitment: Going Public, Opting In, Opting Out and Globalization*, at 2 (Oct. 14, 1998) (unpublished manuscript). In essence, this is the same bonding thesis. See also Asher Blass et al., *Corporate Governance In An Emerging Market: The Case of Israel*, 10 J. APPLIED CORP. FIN. 79, 86-89 (1998) (finding that high quality Israeli IPOs listed on NASDAQ, while lower quality offerings listed on Tel Aviv Stock Exchange and that portfolio investors tended to invest in the former offerings, but not the Tel Aviv offerings). Such self-segregation again seems to support the bonding thesis.

<sup>115</sup> See Licht, *supra* note 107, at 634. One study even finds that foreign firms that had listed only their depositary receipts in the bulletin board market in the U.S. experience significant positive returns when they upgrade from this OTC market to the NASDAQ market and, as a consequence, become "reporting" companies subject to the SEC's mandatory disclosure system. See Darius Miller, *Why Do Foreign Firms List in the United States: An Empirical Analysis of the Depositary Receipt Market* (1996) (unpublished manuscript, on file with the author) (cited in Licht, *supra* note 107, at 634). The importance of this finding is that these issuers had already overcome market segmentation by establishing an ADR facility, but had not yet become subject to U.S. mandatory disclosure rules. See SEC Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2 (1998) (providing exemption for such foreign issuers upon filing of home country financial statements). Thus, the upgrade isolates the impact of the differential between SEC reporting requirements and home country requirements.

This negative movement may be because the market expects that the foreign listing will facilitate undetectable insider trading on the foreign exchange or other conduct impermissible in the United States.

The migration of foreign firms to the United States represents more than isolated decisions by individual firms. In some economies, resort to the U.S. capital markets appears to be a standard stage in a firm's economic development. The clearest example of this pattern has been the extraordinary phenomenon of Israeli firms effecting IPOs on NASDAQ. By some estimates, more than one hundred firms incorporated in Israel are now listed on the New York Stock Exchange, NASDAQ or the American Stock Exchange;<sup>116</sup> of these, more than seventy are high-tech companies.<sup>117</sup> In effect, in the words the NASD's chief executive officer, NASDAQ has become "a capital-raising engine for the Israeli economy."<sup>118</sup> Despite the small size of the Israeli economy, only Canada of all foreign countries has more listings on U.S. exchanges.<sup>119</sup> Interestingly, this process has occurred almost entirely in this decade. Nor is the Israeli experience entirely unique. From 1991 to 1997, international equity issuances in the United States have grown at a twenty-six percent annual rate.<sup>120</sup> Mexican firms and those of several other Latin American countries have also made IPOs in the United States.<sup>121</sup>

The Israeli pattern is particularly interesting because it shows reality behaving in exactly the opposite manner that the academic conventional wisdom had predicted. Academic commentators have generally predicted that competition among national securities disclosure regimes would invite "regulatory arbitrage" or, in more vivid terms, a "race to the bottom," as issuers played one system against another.<sup>122</sup> Yet the Israeli pattern shows that the interaction among different legal regimes can be complementary. Indeed, Israeli securities law in some important respects has been intentionally integrated with U.S. securities laws in order to facilitate joint U.S.-

<sup>116</sup> See Ira M. Greenstein and Lloyd Harnetz, *U.S.-Israel Transactions Present Unique Issue*, N.Y. L.J., Apr. 27, 1998, at S2.

<sup>117</sup> See Richard Rappaport, *Beating Their Swords Into IPO Shares*, FORBES ASAP, June 1, 1998, at 93.

<sup>118</sup> See *U.S. NASDAQ Wants Share of Israeli Privatization*, REUTER EUR. BUS. REP., Apr. 16, 1997, available in LEXIS, News Library, Cumws file (quoting Frank Zarb, chief executive officer of the NASD).

<sup>119</sup> See Rappaport, *supra* note 117, at 93. Some 12 Israeli IPOs were effected in 1996 in the United States, more than those of any other foreign country.

<sup>120</sup> See Pachter, *supra* note 106. In 1997, foreign registrants raised \$28 billion in U.S. capital markets—16 times the 1990 level. See *id.*

<sup>121</sup> For example, in 1997, TV Azteca effected a \$650 million IPO (as part of a privatization) through Bear Stearns. See Robinson, *Year End Review: Latin America Markets*, INVESTMENT DEALERS' DIG., Jan. 12, 1998, at 43.

<sup>122</sup> See Licht, *supra* note 107, at 635-36 (making this point that prior commentary had focused only on competition among different legal regimes and overlooked the possibility of complementary and mutually reinforcing interaction).

Israeli securities offerings. Market integration may itself represent an important form and measure of convergence.

The Israeli experience also underscores that some firms migrate to the U.S. markets because it is infeasible to effect an IPO in their own country. This difficulty may again reflect the lack of sufficient minority legal protections to attract equity investors in their country.<sup>123</sup> If the lack of minority legal protections did chill the ability of start-up firms to effect IPOs, it would follow that larger and older firms with established reputations could access the equity capital markets through IPOs. Interestingly, the available data seems to confirm this prediction. One recent study found that the average newly listed company is "much older and larger in Italy than in the United States." Specifically, this study concluded that "[t]he typical Italian IPO is 8 times as large and 6 times as old as the typical IPO in the United States."<sup>124</sup> Nor is the Italian experience unique. For Italy, from 1982 through 1993, the average age of companies that went public was thirty-three years.<sup>125</sup> In fact this was better than the overall average for European companies engaging in IPOs, which another study has computed at forty years.<sup>126</sup> Both figures contrast sharply with the U.S. experience, where venture capital-backed firms go public after an average period of five years.<sup>127</sup>

What explains this age differential between the United States and Europe? Given that the transaction costs of an IPO appear to be roughly comparable, the most obvious and logical explanation is that the relative absence of legal protections for minority shareholders makes it more difficult for young companies to win the trust and confidence of investors.<sup>128</sup> Older companies have higher reputational capital, which enables them to compensate for the shortfall in legal protections.

#### *F. The Need for Global Scale*

Besides the desire to increase their stock price, other, more powerful reasons may explain the interest of foreign corporations in listing on a U.S. securities exchange. The decision by Daimler-Benz, A.G. ("Daimler") to list on the New York Stock Exchange in 1993 and to comply with very different accounting requirements that greatly reduced its reported earnings

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<sup>123</sup> Controlling premiums in Israel appear to be the second highest in the Western world (second to only those in Italy), thereby suggesting that minority protections are limited. See Ronald Lease et al., *The Market Value of Control in Publicly-Traded Corporations*, 11 J. FIN. ECON. 439 (1982); Macey, *supra* note 53, at 684.

<sup>124</sup> See Pagano et al., *supra* note 57, at 61.

<sup>125</sup> See *id.* at 36. In the U.S., venture capital backed firms go public after an average period of five years. See *id.*

<sup>126</sup> See Kristian Rydqvist & Kenneth Hogholm, *Going Public in the 1980's: Evidence from Sweden*, 1 EUR. FIN. MGMT. 287, 309 (1995).

<sup>127</sup> See Pagano et al., *supra* note 57, at 36.

<sup>128</sup> For just this explanation, see Pagano et al., *supra* note 57, at 29.

now comes into focus as a prelude to Daimler's 1998 acquisition of Chrysler Corporation in what was essentially a stock for stock exchange. Had Daimler been traded only in Germany in a much less liquid market and subject to less transparent disclosure requirements, the acquisition of Chrysler for Daimler stock would have likely been unattractive to Chrysler shareholders, and it is likely that the acquisition would have been infeasible as a cash transaction.

Yet the Chrysler transaction (or some alternative) may have been critical to Daimler if it believed that it needed to increase its scale in order to compete globally in the future. Interestingly, Daimler has already announced plans to enter into some form of affiliation with Japan's Nissan Diesel Motor Company, the fourth largest truck maker in Japan, which development does indeed suggest that it plans to increase its scale of operations significantly. Even more revealing has been the behavior of other large German firms. Although other German firms initially disapproved of Daimler's decision to list on the NYSE, a growing number have followed its lead.<sup>129</sup>

In a world of global competition, the fear of small and mid-sized firms (or at least their managements) is that they must "eat or be eaten"—that is, grow in size into one of the largest firms in their industry or expect to become acquisition targets. By 1999, industry observers have seen this motivation underlying British Petroleum's \$48 billion merger with Amoco, Ford's acquisition of Volvo, and Mobil's proposed merger with Exxon. At the level of small firms, the problem is even more pressing. Students of Italian corporate governance have predicted that its characteristic firm—small and family-held with virtually no outside investors—is uniquely threatened by increased competition within the European Union because the small Italian firm has survived largely based on its established satellite relationship with a larger and inefficient state-controlled firm.<sup>130</sup> With active cross-border competition, this equilibrium is unlikely to continue, and the smaller family firm is no longer viable. Thus, whether for managerialist motives or to pursue true economics of scale and scope, European firms increasingly perceive themselves under a need to grow in order to survive in a truly global economy.

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<sup>129</sup> In August 1998, SAP, the fourth largest German company in terms of market capitalization, listed on the New York Stock Exchange. See *Corporate Germany Reaping the Rewards of Risk Taking*, FIN. TIMES, Aug., 11, 1998, at 20. Hoechst, the German chemical and pharmaceutical giant, has also recently listed. See *Survey-German Banking and Finance 1998: A Unique Perspective*, FIN. TIMES, June 24, 1998, at 7. Finally, Siemens AG, the largest German industrial corporation next to Daimler, has indicated its intent to shift to U.S. GAAP by 2000 and list on the New York Stock Exchange by 2001. See Nicholas Bray, *International Accounting Rules Catch On*, WALL ST. J., Oct. 21, 1998, at B19D.

<sup>130</sup> See Macey, *supra* note 53, at 692 (small Italian firms "unlikely to survive European unification").

This perceived need to grow globally is most easily satisfied through cross-border equity mergers, of which both the Daimler-Chrysler and B.P.-Amoco transactions represent recent examples. This can present difficult legal challenges, particularly when the legal regimes of the two participants have seemingly incompatible legal rules. Although U.S. lawyers and scholars are used to relatively free corporate mobility between state jurisdictions, the rules are quite different on the international level, at least for some important jurisdictions. At present, there is considerable legal uncertainty in Germany as to whether a domestic German corporation can merge with a foreign corporation.<sup>131</sup> Although a cumbersome share exchange procedure was devised in the Daimler-Chrysler transaction that produced the functional equivalent of a merger, the current reality is that triangular mergers are disfavored by German law and any attempt to merge Daimler into Chrysler in a direct or triangular merger would probably not have worked.<sup>132</sup> Moreover, it was even clearer that Germany's codetermination laws required any company doing business within Germany that employs more than certain specified numbers of employees to comply with its mandates.<sup>133</sup> Thus, if global scale is necessary, some potential acquirors may be hobbled by their inability to escape domestic social policies, such as codetermination, that elsewhere seem outmoded.

Important as these constraints on free corporate mobility are, another feature of the Daimler-Chrysler union may merit even greater emphasis: Chrysler shareholders agreed to accept shares in a German corporation in a zero premium "merger of equals," which transaction resulted in their enjoying far fewer protections as minority shareholders. Why should U.S. shareholders accept fewer legal protections without a takeover premium? The most logical answer is that U.S. shareholders and Chrysler executives placed heavy reliance on Daimler's listing on the New York Stock Ex-

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<sup>131</sup> See Theodor Baums, *Corporate Contracting around Defective Regulations: The Daimler-Chrysler Case* (Arbeitspapier No. 68, Universität Osnabrück, 1998) (noting that some commercial registers in Germany will not register transnational mergers and others will). Or, as one of Chrysler's senior corporate attorneys observed (seemingly ruefully): "There's no such thing in German law as a merger between a German company and a non-German company." *Bar Talk: The Gamma Project: The Marriage of Chrysler and Daimler*, AM. LAW., June, 1998, at 13 (quoting Meredith Brown of Debevoise & Plimpton).

<sup>132</sup> See Baums, *supra* note 131, at 6-8. Indeed, mergers appear to be rarely used as an acquisition method in Germany. See DIETER BEINERT, *CORPORATE ACQUISITIONS & MERGERS IN GERMANY* 48 (1991). Instead, acquisitions are chiefly accomplished through share or asset purchases. See *id.* at 45.

<sup>133</sup> Under the Co-Determination Act (*Mitbestimmungsgesetz*) of 1976, the supervisory board of a German corporation (including both AGs and GmbHs) that employs more than two thousand employees must consist of an equal number of shareholders' representatives and labor representatives. See BEINERT, *supra* note 132, at 87-88. Other co-determination statutes apply to certain smaller companies having more than five hundred employees. See *id.* Where a controlling foreign parent holds the stock of the German company, the same basic rules apply and codetermination is required if the subsidiary employs over two thousand workers. See THE GERMAN CO-DETERMINATION ACT 23 (Hannes Schneider & David Kingman eds., 1976).

change. To be sure, Daimler may also have enjoyed sufficient reputational capital so that Chrysler shareholders were willing to accept their potential legal vulnerability. Still, this possibility that reputational capital can substitute for legal protections affects only a limited number of corporations: namely, those with "brand name" reputations (as Daimler certainly has), or, at the least, with substantial business histories.<sup>134</sup> Otherwise, the U.S. or U.K. firm will be the preferred acquiror if the transaction involves an equity component.<sup>135</sup>

The implication, then, is that if a wave of global mergers occurs, the acquirors will tend to be either firms with high stock values—because their legal regimes protect minority rights—or firms with high reputational capital. Either way, the family-held firm is likely to be left in the wake, becoming either a target or a bystander.

### III. SCENARIOS FOR THE FUTURE

To this point, this Article has examined in succession the barriers to convergence in corporate governance and then the forces impelling convergence—and found both powerful. This Part will turn to the actual interaction of these contending forces and make several predictions.

#### *A. Functional Convergence Should Dominate Formal Convergence*

An implicit but overly facile assumption of the political theorists who believe that convergence will be blocked by legislative inertia and special interests is that convergence can only arrive through legislative amendment of corporate codes. Yet formal structural changes may not be necessary if functional changes, implemented by other means, can bring the relative efficiency of competing governance systems into relative parity. Essentially, Professor Gilson has made this point, arguing that we should anticipate functional convergence in corporate governance systems, but not necessarily major legislative or structural changes in formal rules or institutions.<sup>136</sup> Gilson's analysis relies heavily upon the research of Steven Kaplan and others, who have found that, across very different governance regimes and institutional settings, senior managements appear to be replaced and/or disciplined at about the same rate in response to poor economic performance

<sup>134</sup> For the finding that Italian corporations needed a substantial business history (on average 33 years) before they could effect a successful IPO, see Pagano et al., *supra* note 57.

<sup>135</sup> Ford's acquisition of Volvo's automobile assets is another case in point. Volvo's shareholders were adamant that they preferred Ford to Fiat or Renault, the two other most likely merger candidates. See Edmund Andrews, 'Ford-Volvo': A Deal For All Sweden, N.Y. TIMES, Jan. 30, 1999, at C5. Renault shares were particularly resisted by Swedish shareholders, because it was viewed as a state-controlled company, which was unlikely to maximize the share value of Volvo or provide Swedish stockholders with a liquid investment vehicle. See *id.* at C5.

<sup>136</sup> See Gilson, *supra* note 27.



by their firms.<sup>137</sup> Such evidence suggests that very different structural systems of governance have reached relatively similar levels of efficiency.

Still, a difficulty remains in using this data to conclude that functional convergence is approaching: namely, this evidence is equally consistent with future stasis as with future change. If managers in Germany, Japan, and the United States will get the proverbial ax for about the same level of substandard performance, and thus all face roughly the same margin for error, the logical inference to be drawn from this finding is that a measure of functional convergence has already arrived. Further convergence cannot necessarily be inferred, as the systems may be at a competitive equilibrium. Rather, change would become predictable on this basis only if one of these competing governance systems further tightened its own standards and thereby destabilized the current equilibrium.

Put differently, given the institutional barriers to convergence, functional convergence is predictable only to the extent that one governance system begins to outperform another. Then, and only then, does a competitive response become necessary. Assume, for example, that the legal governance rules in each competing system are, hypothetically, twenty percent inefficient in the aggregate. As a result, each system can tolerate its own national idiosyncrasy (for example, codetermination in Germany) and need not respond to the fact that, in a given area, the rules of a competing system are more efficient.

Still, such a tacit collusion in inefficiency can continue only so long as the equilibrium is not disturbed by destabilizing changes. The Asian and Russian financial crises may have had a destabilizing impact on much of the world. A need to reform corporate governance in light of these crises has been widely perceived, and financial assistance from the World Bank and the International Monetary Fund has been conditioned on efforts to end the former system of "crony capitalism." New functional adaptations then seem most predictable within those systems that have been most disrupted by the recent financial crisis.

### *B. The Motor Forces for Functional Convergence*

Even if the overall efficiency of national governance systems were more or less comparable, individual firms might still find it necessary to revise their own governance structure as the result of competitive pressures. One such pressure is the perception, shared by many large firms operating in international markets, that they must grow in scale to survive as viable independent firms. In common, the otherwise dissimilar mergers between

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<sup>137</sup> See Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S.*, 102 J. POL. ECON. 510 (1994); Steven N. Kaplan, *Top Executive Turnover and Firm Performance in Germany*, 10 J.L. ECON. & ORG. 142 (1994); Steven N. Kaplan & Bernadette A. Minton, *Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers*, 36 J. FIN. ECON. 224 (1994).

Daimler and Chrysler, Deutsche Bank and Bankers Trust, British Petroleum and Amoco, Ford and Volvo, and Exxon and Mobil exemplify this pattern. To the extent that acquiring firms are incorporated in jurisdictions that protect minority shareholders, that is, the United States or the United Kingdom, the acquiring firm has the option of using its own shares as the consideration for such a merger. Two consequences follow from this option: (1) such firms may be able to economize on the costs of achieving the desired global scale,<sup>138</sup> and (2) in a cross-border merger, the firm incorporated in the minority-protecting legal regime is more likely to be the surviving entity.<sup>139</sup>

At first glance, the Daimler-Chrysler transaction seemingly stands as an obvious counterexample: in that case, Daimler, the firm with fewer protections for its minority shareholders, emerged as the surviving company and used its shares as the medium of exchange. But to effect this acquisition, Daimler found it necessary to revise its governance structure in advance of the merger, beginning with its 1993 decision to list on the New York Stock Exchange. Such a listing, which entails new governance and disclosure standards, is a paradigmatic example of functional convergence.

Ultimately, the important lesson of the Daimler-Chrysler merger is that Chrysler executives were willing to exchange their shares and options for a German company's shares—at least when the latter's shares were listed on the New York Stock Exchange. This willingness may have been significantly predicated upon the assurance of full disclosure that an NYSE listing conveys. In addition, because the Daimler-Chrysler merger significantly diluted the position of Deutsche Bank,<sup>140</sup> the long-time controlling shareholder of Daimler, Chrysler shareholders had less reason to fear the misuse of the broad powers given a controlling shareholder under German law.<sup>141</sup>

Under this scenario, the prediction is not that Anglo-American firms will acquire European firms until the latter become scarce. Family-controlled firms may well resist any overtures, because, as earlier explained, the value of their controlling shares can exceed the per-share price that the acquiring firm will pay for the firm as a whole.<sup>142</sup> But to the extent

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<sup>138</sup> Of the recent cross-border mergers, only Deutsche Bank's bid for Bankers Trust has been for cash, and revealingly Deutsche Bank is not listed on the New York Stock Exchange. Also, its acquisition of Bankers Trust is for approximately \$9 billion and thus within its financial limits. Larger takeovers in the range of the Amoco-B.P., Exxon-Mobil or Daimler-Chrysler transactions would be extremely difficult to finance for cash.

<sup>139</sup> This is because it can issue listed shares that will be the functional equivalent of cash.

<sup>140</sup> It is estimated that former Chrysler shareholders will receive 44% of the stock in the merged entity. See John Tagliabue, *Germans Reject Challenge to Daimler Stock Options*, N.Y. TIMES, Aug. 13, 1998, at D4. In addition, American institutional investors may have already held significant stakes in Daimler, thus raising at least the possibility that American shareholders may own a majority of the merged entity.

<sup>141</sup> It is also possible that this feature was a major attraction of the merger to Daimler management because it freed them from the supervision of their controlling shareholder.

<sup>142</sup> See *supra* notes 44-46 and accompanying text.

that a need for global scale is perceived to exist, large but threatened firms in major international industries will seek merger partners. The recent spate of cross-border mergers evidences this and suggests that more such transactions are likely. In this mating dance, those firms able to issue higher-valued shares with minority protections have a significant advantage.

The desire to effect an equity merger is by no means the only reason to seek a U.S. listing. The firm's management may have a variety of other motives. First, by expanding the firm's shareholder base, it may enable management to dilute a controlling shareholder whose iron hand the issuer's managers want to see relaxed.<sup>143</sup> Second, a U.S. listing will predictably increase the company's stock price and thereby placate shareholders.<sup>144</sup> Third, a U.S. listing may enable the firm's managers to institute U.S.-style stock option plans, which U.S. institutional investors can be expected to accept but at which European investors may frown. From a managerialist perspective, the difference in pay scales (particularly as a result of stock options) is striking between U.S. and European firms. One statistic from the Daimler-Chrysler merger is truly startling: the entire ten members of the Daimler managing board received in the aggregate less compensation—around \$12.3 million—in the year before the merger than did Chrysler's second-ranking officer, who received slightly more than \$13 million.<sup>145</sup> Chrysler's chief executive officer ("CEO") alone stands to receive more than \$69 million in stock and cash in the merger in respect of outstanding Chrysler stock options and bonuses that he had previously been issued.<sup>146</sup> Given that German CEOs typically receive much less,<sup>147</sup> this disparity creates an incentive to internationalize one's shareholder base, both by listing on U.S. stock exchanges and by effecting cross-border acquisitions that will bring in U.S. shareholders. Already there are signs that the prior hostility of German law to U.S.-style executive compensation is being relaxed.<sup>148</sup>

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<sup>143</sup> While Deutsche Bank's supervision of Daimler hardly amounted to an "iron hand" rule, the Daimler-Chrysler merger did dilute its stake to 15%, which seems below the level sufficient to confer control.

<sup>144</sup> See *supra* notes 112-15 and accompanying text.

<sup>145</sup> See Tagliabue, *supra* note 140.

<sup>146</sup> See *id.*

<sup>147</sup> Daimler's own CEO was estimated to have been paid between \$1.1 and \$1.5 million during this same year. See *id.*

<sup>148</sup> See David Johnston, *American-Style Pay Moves Abroad; Importance of Stock Options Expands in a Global Economy*, N.Y. TIMES, Sept. 3, 1998, at C1. It can be debated whether the new German system for stock options through the conversion of debentures that are sold only to management represents an example of "functional convergence" or "formal convergence," but either way German courts have upheld the practice.

### C. The Regulatory Costs of a U.S. Listing: A Survey

Whatever the motives for seeking a U.S. listing, the foreign issuer must balance the projected benefits from listing in the U.S. against a very real increase both in regulatory costs and the potential for litigation. Once an issuer lists either on a U.S. exchange or NASDAQ, the U.S. securities laws become broadly applicable to it.<sup>149</sup> This is critically important, because the U.S. securities laws do not simply require heightened disclosure and more rigorous financial reporting; rather, they also seek to reduce agency costs in ways that particularly inhibit controlling shareholders and that are not closely paralleled by European law.

Historically, the federal securities laws were originally focused on compelling disclosures by promoters and other controlling persons.<sup>150</sup> That is, the primary goal of both the British Parliament and the U.S. Congress was less to mandate disclosure of all material information relating to firm value than to focus on the special (and well-recognized) abuses by which promoters overreached shareholders, in particular by using the proceeds of the stock flotation to buy property from the promoters at inflated prices.<sup>151</sup> Although the goals of the federal securities laws have broadened, this focus on reducing agency costs has persisted. According to one scholar, "the most substantial innovation" of the United States' mandatory disclosure system "was the use of disclosure after the promotional stage to combat manager/shareholder agency problems."<sup>152</sup> In short, both as they were originally adopted and as they have evolved, the federal securities laws have focused on monitoring the relationship between controlling shareholders or managers and their firm.

The following provisions of the federal securities laws are likely to surprise the foreign issuer, because they go well beyond requiring material

<sup>149</sup> Essentially, foreign issuers that have more than 300 shareholders of record in the United States are in theory required to register under § 12(g) of the Securities Exchange Act of 1934. However, an exemptive rule affords them an easy escape from the U.S. periodic disclosure system so long as they agree to provide the SEC with the same documents and information that they file in their home countries or give their shareholders. See Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2 (1998). This exemption is ended, however, once the foreign issuer lists on NASDAQ. See Rule 12g3-2(d), 17 C.F.R. § 240.12g3-2 (1998). Listing on an exchange requires the foreign issuer to register under §12(b) of the Securities Exchange Act of 1934, and Rule 12g3-2 thereby becomes inapplicable. See also *infra* notes 178-79 and accompanying text.

<sup>150</sup> A historical consensus exists that the Securities Act of 1933 was largely modeled after a British statute. Professor Mahoney has argued that the original intent of both the British Parliament and the American Congress was to force promoters to disclose self-dealing relationships with the firm. See Mahoney, *supra* note 36, at 1048-1100. Professor Mahoney argues that the federal mandatory disclosure system was "an incremental change from a longstanding set of judicial doctrines that were designed to combat a specific agency problem—the promoter problem." *Id.* at 1111. Related agency problems arise whenever there is a controlling shareholder, as there typically is in legal regimes characterized by concentrated ownership.

<sup>151</sup> See *id.* at 1049, 1111.

<sup>152</sup> *Id.* at 1111.

disclosures by the issuer and seek in effect to impose substantive obligations on managers and controlling persons, essentially in order to minimize agency costs. Because prior commentary has largely ignored this focus of the federal securities law, an extended examination is necessary.

*1. Section 13(d) of the Exchange Act.*—This critical provision requires any person or group owning beneficially more than five percent of any class of equity security registered pursuant to section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") to file a report (known as a Schedule 13D) within ten days after the five percent threshold is crossed.<sup>153</sup> The differences between this provision and the European Community's Transparency Directive are notable: (1) the trigger level is five percent, not ten percent;<sup>154</sup> (2) the broad definition of beneficial ownership in section 13(d) deems a person to be an owner if the person has or shares the power to vote or to buy or sell the security, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise;<sup>155</sup> (3) section 13(d) also requires disclosure of the identity of persons who agree to act in concert with respect to more than five percent of any class of voting equity security "for the purpose of acquiring, holding, voting, or disposing of equity securities"<sup>156</sup>—thereby sweeping many informal coalitions within section 13(d)'s coverage; (4) the Schedule 13D filing must be amended promptly following any material increase or reduction in the filing person's holdings or in the composition of the group;<sup>157</sup> (5) Schedule 13D requires much fuller disclosure than does the Transparency Directive, covering not only the identity of the acquiring person or group, but also the source and amount of funds used to acquire the securities, the purpose of the acquisition, and the nature of any arrangements to which the acquiror is a party

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<sup>153</sup> The statutory command to make a disclosure filing in § 13(d) is fleshed out by Rule 13d-1(a). Rule 13d-1(b)(1) then permits institutional investors under certain conditions to file a shorter, less burdensome document, known as a Schedule 13G, within 45 days after the conclusion of the calendar year. Sections 13(d) and 13(g) of the Exchange Act do not apply to equity securities of issuers that must file periodic reports only by reason of § 15(d) of the Exchange Act because the issuer made a public offering in the United States. This exemption, however, will not benefit issuers traded in any public market (other than a very small bulletin board market), as § 12(g) will require registration if there are as few as three hundred shareholders resident in the United States.

<sup>154</sup> See *supra* notes 92-93 and accompanying text for the 10% threshold under the Transparency Directive.

<sup>155</sup> See SEC Rule 13d-3, 17 C.F.R. § 240.13d-3 (1998).

<sup>156</sup> See SEC Rule 13d-5(b)(i), 17 C.F.R. § 240.13d-5 (1998); see also *Wellman v. Dickinson*, 682 F.2d 355, 362-63 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983). No formal or written agreement is necessary to give rise to a § 13(d) group. See *SEC v. Savoy Industries Inc.*, 587 F.2d 1149, 1162-63 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979); *GAF Corp. v. Milstein*, 453 F.2d 709, 715-16 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).

<sup>157</sup> See Rule 13d-2, 17 C.F.R. § 240.13d-2 (1998). For a discussion of this "promptness" requirement, see SEC Litigation Release No. 12835 (April 11, 1991), *SEC v. Edelman*, 48 SEC Docket No. 12, at 952, 953 (April 23, 1991).

relating to the target company's securities.<sup>158</sup> These disclosures can, and often do, become the subject of litigation in the U.S. courts as either the target company, the SEC, or others seek to use section 13(d) as a window by which to peer into the acquiring group and learn its plans. In turn, this means that the process of preparing a Schedule 13D is complicated and costly and will almost certainly involve the retention of U.S. counsel.

Most importantly, the beneficial ownership reporting requirements of section 13(d) apply to both U.S. and foreign persons who hold the requisite amount of voting securities in a firm that is registered under section 12 of the Exchange Act.<sup>159</sup> Thus, if a French citizen buys more than five percent of the voting stock in an Italian corporation that is listed on NASDAQ, the reporting requirements of section 13 are triggered, even if the stock is purchased on an Italian exchange and no jurisdictional means within the United States are employed. This same conclusion also holds if the Italian company only listed American Depositary Receipts (or "ADRs") on the U.S. exchange, as the SEC looks through the ADRs and requires the underlying security to be registered under section 12.<sup>160</sup>

Suppose then that the Italian corporation lists on NASDAQ in 1999 and registers under section 12(g) of the Exchange Act. Must all its existing five-percent-or-greater blockholders file a Schedule 13D within ten days? Here the SEC has made a small concession and permits the filing to be made on a delayed basis. Because these securities were acquired prior to the section 12(g) registration, the SEC deems the requisite filing to be under section 13(g) of the Exchange Act, which must be made within forty-five days after the close of the calendar year covered by the registration statement.<sup>161</sup> Still, this new obligation could be an abrupt surprise for many large blockholders.

The fact that U.S. law imposes this obligation does not mean that it can necessarily enforce it. A high rate of noncompliance is probable, particularly with regard to informal groups. But because of the Transparency Directive, persons owning ten percent of a European-listed company should already be disclosing their identity and thus could become conspicuous targets if the SEC or others wished to cross-check. Having thus found at least

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<sup>158</sup> See Securities Exchange Act of 1934 § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1994); see also Schedule 13D, Items 2-6, 17 C.F.R. § 240.13d-101 (1998).

<sup>159</sup> For a good overview of the application of the Exchange Act to foreign persons and entities, see Edward F. Greene et al., *U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS* § 7.02 (4th ed. 1998).

<sup>160</sup> See American Depositary Receipts Securities Act Release No. 6894, 56 Fed. Reg. 24,420 (1991) (the "ADR Concept Release"); see also Greene et al., *supra* note 159, § 7.02, at 7-4.

<sup>161</sup> See SEC Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d-1(b)(2) (1998). Although technically the Schedule 13G is only available to U.S. institutional investors (and only under certain conditions), a series of no-action letters have permitted foreign institutional investors to use this simplified form. See Greene et al., *supra* note 159, § 7.02, at 7-5 n.8.

some persons required to file under section 13(d), the SEC could demand far more disclosure under its rules.

2. *Tender Offers.*—Under section 14(d) of the Exchange Act, if any person, including a European corporation, makes a tender or exchange offer for more than five percent of any class of equity securities of a target corporation, including another European corporation, that is registered under section 12 of the Exchange Act, that offer must comply with the disclosure and procedural requirements of section 14(d). Even if the target is not so registered, the antifraud rules of section 14(e) of the Exchange Act will still apply if the offer is made to U.S. residents. Thus, U.S. tender offer disclosure rules could apply to a tender offer by a foreign bidder for a foreign target corporation that had one percent or less of its stock held by U.S. residents.<sup>162</sup>

Not only does U.S. law thus potentially apply, but its substantive provisions, particularly regarding timing, withdrawal, and proration rights, are significantly different from those of many other countries. For example, U.S. law gives each shareholder of the same class the opportunity to participate in the offer on a proportional basis and to receive the "best price" paid to any other shareholder pursuant to the tender offer.<sup>163</sup> Moreover, although the term "tender offer" is not defined by the Williams Act, the SEC has long taken the position that negotiated purchases can under certain circumstances amount to de facto tender offers,<sup>164</sup> which conclusion will almost invariably mean that U.S. law has been violated.

Because of the extraterritorial reach of the U.S. securities laws, the potential exists that U.S. law could directly conflict with the tender offer rules of another country, most likely those of the jurisdiction of the target company's incorporation. The SEC has recognized the need to minimize such regulatory conflicts and has granted a number of exemptions on a

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<sup>162</sup> In a 1990 Concept Release, the SEC proposed exempting foreign bidders from the procedural and disclosure provisions of the Williams Act where (1) the target was a foreign corporation, and (2) 10% or less of the target's outstanding shares were held of record by U.S. shareholders (other than U.S. citizens who were 10% or greater shareholders). See Concept Release on Multinational Tender and Exchange Offers, Securities Act Release No. 33-6866, 55 Fed. Reg. 23, 75 (1990). The SEC also indicated that the civil liability provisions in § 14(e) of the Exchange Act would continue to apply. The SEC has recently moved to implement this proposal. See Cross-Border Tender Offers Business Combinations and Rights Offerings, Securities Act Release No. 7611, 63 Fed. Reg. 69,136 (1998). Even if it were adopted, the proposed 10% threshold would leave most large multinational firms listed on the NYSE fully subject to U.S. tender offer law, because U.S. ownership would exceed 10%.

<sup>163</sup> See SEC Equal Treatment of Security Holders, 17 C.F.R. § 240.14d-10 (1998).

<sup>164</sup> The SEC has long used an eight-factor test to determine whether closely-linked purchases amount to a tender offer. See *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945, 949-52 (9th Cir. 1985); *Wellman v. Dickinson*, 475 F. Supp. 783, 823-26 (S.D.N.Y. 1979). Under this test, efforts by a controlling shareholder to buy shares from insiders at a common price could give rise to a tender offer with a concomitant obligation under Rule 14d-10 to open the offer to all shareholders.

case-by-case basis to accommodate concurrent foreign and domestic bids for foreign target corporations.<sup>165</sup>

Bidders have also sought to avoid the application of U.S. tender offer law by making tender offer bids open only to persons resident outside the United States.<sup>166</sup> It remains an open and unresolved question, however, whether the SEC or private parties could successfully challenge a tender offer for a company registered under section 12 that excluded U.S. residents.<sup>167</sup> In any event, many bidders will not want to leave a significant percentage of minority shareholders outstanding in the United States after their offer and so are compelled to negotiate with the SEC over the terms of a partial exemption from U.S. tender offer rules.

**3. Corporate Governance.**—Although listing on a U.S. exchange or NASDAQ does not subject an issuer to U.S. corporate law, it is necessary for any issuer (foreign or domestic) to enter into a listing agreement with the New York Stock Exchange, the American Stock Exchange ("AMEX"), or NASDAQ in order to have its securities traded on such market. These listing agreements all contain corporate governance provisions, although those required by NASDAQ and AMEX are somewhat less demanding.<sup>168</sup> For example, the standard NYSE requirements specify that a listed company must (a) have at least two outside directors on its board, (b) establish and maintain an audit committee composed of independent directors, and (c) set an appropriate quorum requirement for shareholder meetings.<sup>169</sup> Other NYSE corporate governance policies, including its voting rights policy, which precludes certain deviations from a "one-share, one-vote" standard,<sup>170</sup> do not apply to foreign issuers or are subject to waiver if counsel opines to the NYSE that local law precludes such a policy.<sup>171</sup> Still, the NYSE does insist on some minimum governance standards for all issuers, including (i) an audit committee or similar body to monitor transactions

<sup>165</sup> For a review of SEC policy toward concurrent foreign and domestic tender offers, see Greene et al., *supra* note 159, § 7.03(3); see also SEC Release No. 34-27671 (Feb. 2, 1990).

<sup>166</sup> See Greene et al., *supra* note 159, § 7.03[4].

<sup>167</sup> Some informed commentators have opined that the SEC would today likely take the view that the bidder cannot avoid compliance with the Williams Act by excluding U.S. residents from the offer, at least in the case of an issuer whose equity securities were registered under § 12 of the Exchange Act. See *id.* § 7.03[4][b], at 7-25.

<sup>168</sup> For an overview of these requirements, see *id.* § 2.03[2][b].

<sup>169</sup> See NYSE LISTED COMPANY MANUAL §§ 303.00, 310.00(A).

<sup>170</sup> The NYSE, AMEX and NASDAQ have a common voting rights policy that precludes actions that disenfranchise shareholders of stock traded in their markets or dilutes their voting strength. This policy specifically prohibits any disparate reduction of voting rights through any corporate action or issuance of stock, including plans that cap voting rights for any shareholder or that require a holding period before voting rights become fully exercisable. See Order Granting Approval to Rule Changes Relating to Exchanges' and Associations' Rules Regarding Shareholder Voting Rights, SEC Release No. 34-35121, 59 Fed. Reg. 66,570 (1994).

<sup>171</sup> See Greene et al., *supra* note 159, § 2.03[2][b], at 2-21 to 2-23.



between the company and its insiders, (ii) an annual shareholders' meeting, and (iii) a requirement that any tender offer made by the company for its own shares or for those of another listed company give all holders of the target an equal opportunity to participate.<sup>172</sup> Both the AMEX and NASDAQ follow substantially similar policies.<sup>173</sup>

4. *The SEC's "Going Private" Rules.*—Under section 13(e) of the Exchange Act, the SEC is granted authority to regulate purchases by an issuer registered under section 12 of its own shares to the extent that such rules are "reasonably designed" to prevent "fraudulent, deceptive or manipulative" acts. This authority also extends to purchases by a controlling person or affiliate of the issuer. Pursuant to this authority, the SEC has adopted Rule 13e-3 to regulate "going private" transactions, and its reach goes well beyond that of other SEC antifraud rules.<sup>174</sup> Under Rule 13e-3, the triggering test is whether the proposed transaction would result in the issuer losing its listing on a U.S. exchange or NASDAQ or no longer being held of record by more than three hundred persons. In short, if the controlling shareholder threatens its public shareholders with a loss of liquidity, Rule 13e-3 applies and requires elaborate disclosures pursuant to which the SEC gains the ability as a practical matter to assess the fairness of the transaction.<sup>175</sup>

Although Rule 13e-3 could certainly slow a European blockholder that was intent on squeezing out minority shareholders at an unfairly low price, the ultimate impact of Rule 13e-3 may seem open to doubt because it is simply a disclosure rule, and the federal securities laws do not provide any remedy for a fully disclosed breach of fiduciary duty.<sup>176</sup> Experience has

<sup>172</sup> See *id.* § 2.03[2][b], at 2-23 to 2-24 (discussing nonwaivable provisions of NYSE corporate governance policies).

<sup>173</sup> See *id.* § 2.03 [2][c], [d].

<sup>174</sup> Rule 13e-3 requires a detailed evaluation of the fairness of the proposed transaction, including a detailed assessment of the material factors upon which the issuer's claim that the transaction is fair is based. See Schedule 13E-3, Item 8(b), 17 C.F.R. § 240.13e-100 (1998). Failing this mandatory disclosure, the transaction can be enjoined or damages sought. There is thus no need to prove a material omission if the specific justifications and evaluation strikes the court as inadequate. See *Howing Co. v. Nationwide Corp.*, 826 F.2d 1470, 1478-79 (6th Cir. 1987).

<sup>175</sup> Among other things, the issuer is required to focus on fairness by describing the purpose of the transaction, the alternatives considered, and the effect of the transaction, including the benefits and detriments to the issuer and affected securities holders. See Schedule 13E-3, Item 7, 17 C.F.R. § 240.13e-100 (1998). If an outside report or valuation is utilized, there must be a summary of the report and information about how the outside party was selected and how the compensation of such party was to be determined. See Schedule 13E-3, Item 9, 17 C.F.R. § 240.13e-100 (1998). Most importantly, Item 8 of Schedule 13E-3 requires the issuer (or the affiliate filing the Schedule 13E-3) to state that it "reasonably believes that the Rule 13e-3 transaction is fair or unfair to the unaffiliated security holders" and then requires the issuer or affiliate to "discuss in reasonable detail the material factors upon which the belief . . . is based." Schedule 13e-3, Item 8, 17 C.F.R. § 240.13e-100 (1998).

<sup>176</sup> See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1997).

shown, however, that relatively few fiduciary breaches are ever fully disclosed, at least in the SEC's eyes. Thus, the rigorous disclosure standards in Rule 13e-3 function in practical effect as an effective substitute for rules requiring substantive fairness. In addition, a private cause of action has been recognized under Rule 13e-3, with the result that a class action can be maintained for its violation.<sup>177</sup>

Because foreign issuers are generally subject to Rule 13e-3 (if the foreign issuer is listed on a U.S. exchange or NASDAQ<sup>178</sup> or if it has issued securities for a U.S. reporting company<sup>179</sup>), listing on a U.S. exchange carries with it the obligation to justify in great detail the fairness of any squeeze-out transaction. The net impact might be to substantially neutralize the traditional and formidable powers of a controlling shareholder under German law—if the foreign issuer has listed its stock on a U.S. exchange or NASDAQ or entered into a merger with a U.S. company.

*5. Foreign Corrupt Practices Act.*—All issuers—foreign or domestic—who become subject to section 12 of the Exchange Act acquire a legal obligation to “make and keep books, and records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer,”<sup>180</sup> and to “devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that” certain specified standards will be satisfied.<sup>181</sup> Both these statutory obligations share a common purpose: to preclude the use of corporate funds to make bribes or other “questionable payments” and to discourage the creation of “off-books” accounts that can be used for such purposes. SEC rules also prohibit any corporate officer or other person from directly or indirectly falsifying or causing to be falsified “any book, record or account” subject to these rules.<sup>182</sup> Hence, at least as a formal legal obligation, listing in the United States disables a foreign corporation from engaging in bribery or similar practices to obtain contracts or regulatory approvals or otherwise market its services.

Although an international consensus has been reached, at least among the major industrial nations, that bribery to obtain business contracts either domestically or abroad should be unlawful,<sup>183</sup> U.S. securities and criminal law today enforces this norm alone.

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<sup>177</sup> See, e.g., *Howing*, 826 F.2d at 1474 (upholding private cause of action under Rule 13e-3), *aff'd*, 927 F.2d 263 (6th Cir. 1991).

<sup>178</sup> See SEC Rule 12g3-2(d)(3), 17 C.F.R. § 240.12g3-2(d)(3) (1998).

<sup>179</sup> See SEC Rule 12g3-2(d)(2), 17 C.F.R. § 240.12g3-2(d)(2) (1998).

<sup>180</sup> See Securities Exchange Act of 1934, § 13(b)(2)(A), 15 U.S.C. § 78m(b)(2)(A) (1994).

<sup>181</sup> See Securities Exchange Act of 1934, § 13(b)(2)(B), 15 U.S.C. § 78m(b)(2)(B) (1994).

<sup>182</sup> See SEC Rule 13b2-1, 17 C.F.R. § 240.13b2-1 (1998).

<sup>183</sup> In 1998, Congress approved an international convention sponsored by the Organization for Economic Cooperation and Development (OECD) that committed each OECD nation to criminalize such

6. *The Extraterritorial Reach of Rule 10b-5.*—Under the dual “conduct” and “effect” tests used by the U.S. courts to determine the extraterritorial reach of Rule 10b-5, a U.S. court has subject matter jurisdiction if either (a) the foreign defendant’s activities in the United States went beyond a “merely preparatory” level and involved actions or culpable failures to act that “directly caused” the claimed losses,<sup>184</sup> or (b) a predominantly foreign transaction has “substantial effects” in the United States.<sup>185</sup> In its most important recent decision on the subject, the Second Circuit has upheld subject matter jurisdiction based on Rule 10b-5 in a case involving at bottom only a substantial purchase of stock in a U.K. company by a Channel Islands subsidiary of a Bermuda holding company.<sup>186</sup> The decisive factor for the Second Circuit appears to have been that ten percent of the U.K. target company’s stock was traded on NASDAQ in the form of ADRs. Given this broad reach, a foreign issuer listed on a U.S. exchange must realistically assume that it can be sued in the United States for any allegedly false statements made anywhere in the world if the statements would foreseeably impact a U.S. securities market. Although some commentators have viewed the broad extraterritorial reach of U.S. securities law as “dangerous,”<sup>187</sup> and various compromises have been proposed to curb its reach,<sup>188</sup> the current reality is that a U.S. listing entails a substantial litigation risk.

As incomplete as this selective tour of the impact of the federal securities laws on foreign issuers has been, it suffices to support the following generalization: the U.S. securities laws have a special constraining impact on controlling persons. Much of the discretion and potential for opportunistic actions that controlling shareholders can take under other legal regimes is sharply limited by these laws. Specifically, U.S. law regulates controlling shareholders at the following critical junctures:

- (1) its ownership disclosure rules deny them the veil of anonymity by requiring a transparent ownership structure pursuant to section 13(d) of the Exchange Act;

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bribery. See *Congress Passes Bill to Curb International Business Bribery*, N.Y. TIMES, Oct. 22, 1998, at A5.

<sup>184</sup> See *Leasco Data Processing Equip. v. Maxwell*, 468 F.2d 1326, 1335-37 (2d Cir. 1972).

<sup>185</sup> See *Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252, 263-63 (2d Cir. 1989), cert. denied 492 U.S. 939 (1989); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 988-90 (2d Cir. 1975), cert. denied, 423 U.S. 1018 (1975).

<sup>186</sup> See *Itoba Ltd. v. Lep Group Plc*, 54 F.3d 118 (2d Cir. 1996), cert. denied, 516 U.S. 1044 (1996).

<sup>187</sup> See generally Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT’L L. & BUS. 207 (1996).

<sup>188</sup> See Donald C. Langevoort, *Schoenbaum Revisited: Limiting the Scope of Antifraud Protection in an Internationalized Securities Marketplace*, 55 LAW & CONTEMP. PROBS. 241, 255-60 (1992).

- (2) its insider trading rules restrict (with criminal penalties) their ability to purchase or sell based on material, nonpublic information;<sup>189</sup>
- (3) its tender offer rules assure all shareholders an equal opportunity to participate in any tender offer for their shares;
- (4) its continuous disclosure system generally requires timely disclosure of material developments by the issuer or controlling shareholders; and
- (5) its "going private" rules deny controlling shareholders the practical ability to squeeze out the minority at an unfairly low price.

The more pervasive and inhibiting these restrictions on controlling shareholders appear to be, the more the apparent mystery deepens as to why foreign issuers seem to be migrating in record numbers to U.S. exchanges.<sup>190</sup> Correspondingly, this pattern also raises a normative policy question that is next addressed: Should U.S. law attempt to impose quasi-substantive restrictions on the foreign issuer who wishes to enter the United States markets?

#### *D. The Case for Mandatory Rules*

Three different arguments will be advanced in this section, but they have a common theme: dispersed ownership requires special legal rules if it is to persist. Firms listed in the same market have a greater interdependency than is generally appreciated, because of what this Article will call "network externalities." As a result, it becomes appropriate for U.S. law not simply to protect U.S. investors, but also to protect its capital markets.

*1. Listing as a Bonding Mechanism.*—The simplest explanation for the migration of foreign issuers to U.S. exchanges and NASDAQ is that such a listing is a form of bonding—a credible and binding commitment by the issuer not to exploit whatever discretion it enjoys under foreign law to overreach the minority investor.<sup>191</sup> That is, the issuer ties its own hands by subjecting itself to the mandatory requirements of U.S. law in order to induce minority shareholders to invest in it.

<sup>189</sup> See *United States v. O'Hagan*, 117 S.Ct. 2199, 2206-07 (1997).

<sup>190</sup> As noted earlier, foreign listings on the New York Stock Exchange have recently tripled, over one thousand foreign issuers now trade in U.S. markets, and the trend seems to be increasing. See *supra* notes 107-10 and accompanying text.

<sup>191</sup> "Bonding" is, of course, a term of art in the standard "agency cost" literature. Essentially, the principal can either "monitor" the agent to reduce inappropriate conduct by the agent, or the agent can "bond" its own conduct, for example, by posting a surety bond or otherwise subjecting itself to penalties. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

The problem with this explanation, however, is that the issuer may simply have decided to list for other reasons: to expand its shareholder base, to gain the advantages of increased liquidity, or to overcome market segmentation.<sup>192</sup> How then can one distinguish true efforts at bonding from simply an attempt to gain a broader shareholder base? The answer probably lies in the motivation for the listing transaction. If the issuer has already listed elsewhere, enjoys a liquid market, and does not use its U.S. listing to make a primary offering into the United States, then its entry into the U.S. markets does not look like a pursuit of greater liquidity, but may be an effort to increase its stock price through bonding. Even more clearly, when the U.S. listing is incident to an IPO, which has often been the case with Israeli high-tech companies, or where the issuer is contemplating a prospective equity merger, then there is even more reason to view bonding as the appropriate description. As noted earlier, European firms on average have been unable to effect an IPO until they were decades older and much larger than the typical American firm doing an IPO.<sup>193</sup> By entering the U.S. markets, a foreign issuer may thus be able to make an equity offering that could not be made in its home market. But the reason that it cannot sell equity in its home market may be the fear that its controlling shareholders will appropriate much of the minority's investment. Migration to the United States and its greater legal protections thus may constitute a bonding strategy to solve this problem.

In general, the higher the regulatory costs of entry into the U.S. securities markets are perceived to be, the more this hypothesis becomes the most satisfactory explanation for a U.S. listing, because if increased liquidity were instead the primary goal, it could be obtained in other international securities markets, such as London.

2. *Network Externalities as a Justification for Mandatory Rules.*—If bonding explains part, but not all, of the phenomenon of foreign firms migrating to U.S. securities markets, it still does not necessarily justify subjecting the foreign issuer to U.S. law. Arguably, this bonding hypothesis points toward a different policy: namely, permitting, but not requiring, foreign issuers to subject themselves to U.S. securities law. Then, those firms that wished to assure minority investors that they would comply with the higher U.S. standards could voluntarily elect to opt into the U.S. system, while other firms could list while agreeing only to meet their home juris-

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<sup>192</sup> While market segmentation; that is, the existence of barriers to cross-border capital flows, supplies an alternative explanation for multiple and global stock listings, financial economists have recently preferred the bonding explanation. See Oren Furst, *A Theoretical Analysis of The Investor Protection Regulations Argument for Global Listing of Stocks* (Sept. 10, 1998) (working paper, International Center for Finance at Yale University, on file with the author); see also Blass et al., *supra* note 114, at 86-87 (noting that high quality Israeli IPOs have preferred to list in the United States on NASDAQ, whereas lower quality IPOs have listed on the Tel Aviv Stock Exchange).

<sup>193</sup> See *supra* notes 124-27 and accompanying text.

diction's standards.<sup>194</sup> Given such a choice, the two populations arguably would segregate, and potentially the shares of firms agreeing only to meet their home country standards would trade at a price discount. On this basis, some commentators have urged the abandonment of mandatory U.S. disclosure rules and the adoption of essentially such a system.<sup>195</sup>

The common premise of these proposals is that the "United States has only a weak interest in the disclosure behavior of foreign issuers, even those whose shares are predominantly owned by U.S. investors."<sup>196</sup> Among these critics, some doubt the benefit of any mandatory disclosure standards, while others believe the use of U.S. standards for U.S. issuers benefits allocative efficiency within the U.S. economy, but they still oppose their broader application to foreign issuers (even if principally owned by U.S. investors).<sup>197</sup>

What then is the U.S. interest in requiring foreign issuers to comply with U.S. disclosure standards once they enter the U.S. market, even though only a minority of the affected shareholders are U.S. citizens? Perhaps the strongest argument for mandatory standards is that the United States should protect the "network externalities" associated with its securities markets. Network externalities are a familiar economic concept and are defined as the increasing returns to users of a product as its total number of users grow.<sup>198</sup> The classic example is the telephone: if the telephone is used only by one thousand citizens, it is a novelty; if it is used by 100 million, it is a necessity. As the number of users grows and each user can reach more persons by means of the telephone, the telephone has a higher value for all users. Similarly, as more people came to use the automobile earlier in this century, a supporting infrastructure developed around it: gas stations became plentiful and roads were upgraded, making the automobile a more valuable means of transportation.

That there are network externalities associated with securities markets seems self-evident. As more users come to a market, the market gains liquidity and, predictably, price spreads narrow, as dealers can quote narrower bid-asked spreads as trading volume increases.<sup>199</sup> Clearly, a listing

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<sup>194</sup> The election to comply with "higher" U.S. standards would, however, have to be irrevocable; otherwise, having sold shares to U.S. investors, foreign issuers might reconsider their election and return to a "lower" disclosure standard.

<sup>195</sup> See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 941-45 (1998); Merritt Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?*, 95 MICH. L. REV. 2498 (1997).

<sup>196</sup> See Fox, *supra* note 195, at 2618.

<sup>197</sup> This is Professor Fox's position—he doubts the case for investor protection, but believes mandatory disclosure does improve efficient pricing and allocative efficiency. See *id.*

<sup>198</sup> For a recent discussion of "network externalities" as applied to corporate law, see generally Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

<sup>199</sup> It is well recognized that a security's "spread" (*i.e.*, the distance between its bid and asked price) tends to narrow as trading volume increases. Greater liquidity allows the market-maker to reduce the price it charges for functioning as a financial intermediary.

becomes more valuable as more investors come to the market. In this light, an initial "network externality" is the advantage of complementarity. As issuers conform to common disclosure, accounting, and listing standards, investors gain the ability to compare securities in a common language and scoring system. Inherently, investors need to compare security A against security B, and this task becomes quicker and easier as more issuers converge to comply with the dominant market's accounting and disclosure standards. In short, as any number of commentators have noted,<sup>200</sup> harmonization of disclosure standards results in reduced effort and transaction costs for the investor.<sup>201</sup>

Complementarity is, however, only an initial example. While complementarity chiefly reduces costs for investors, the more important network externalities that surround a securities market may be those that primarily enhance the issuer's ability to obtain the highest price for its securities. Obviously, the existing listed firms in a market share a common interest that newcomers not injure or erode the reputational capital surrounding the market that they may have created. For example, if a foreign issuer's management could engage in insider trading, which would be possible if U.S. law were superseded by home country law, as proponents of curbing the extraterritorial reach of the U.S. securities laws have urged, then the existing domestic firms in the same market might be disadvantaged. Similarly, lax accounting standards abroad might make the incoming foreign firm appear more successful than the domestic firm because of the absence of a common disclosure standard; in short, domestic firms might be injured by the uncertainty and reputational stigma that insider trading and other predatory conduct arguably create. Nor is the injury merely reputational: if insider trading becomes possible, dealers in the market will realize that they are trading at a disadvantage with informed traders and will predictably increase their bid-asked spreads to protect themselves from better-informed traders.<sup>202</sup> This point is not limited to insider trading; rather, in-

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<sup>200</sup> For a good review of these arguments, see Uri Geiger, *The Case for the Harmonization of Securities Disclosure Rules in the Global Market*, 1997 COLUM. BUS. L. REV. 241; see also Lawrence J. White, *Competition versus Harmonization—An Overview of International Regulation of Financial Services*, in INTERNATIONAL FINANCIAL MARKETS: HARMONIZATION VERSUS COMPETITION 5, 39 (Claude Barfield ed., 1996).

<sup>201</sup> The counterargument will predictably be made that an efficient market can discount the legal risks associated with foreign stocks. Although this is highly debatable, it misses the key point about the social waste involved. The available empirical evidence suggests that accounting differences do significantly affect the decisions of participants in the capital markets. See FREDERICK D. S. CHOI AND RICHARD M. LEVICH, *THE CAPITAL MARKET EFFECTS OF INTERNATIONAL ACCOUNTING DIVERSITY* 90-98 (1990) (emphasizing costs and social waste involved in attempts to compare issues using different accounting systems). In short, even if the approximate adjustments can be made to share price, the effort is costly and wasteful.

<sup>202</sup> For a fuller discussion of the likelihood that specialists and market makers would react to the possibility of informed trading by insiders, by widening their spreads, see Lawrence R. Glosten, *Insider Trading, Liquidity, and the Role of the Monopolist Specialist*, 62 J. BUS. 211 (1989). It is, of course,

sider trading is but one example of conduct that increases agency costs. To the extent that agency costs are greater under foreign law regimes, U.S. investors are faced with an increased prospect of self-interested action by management and other insiders, as foreign firms not subject to U.S. legal standards increasingly enter the market.

Another subcategory of network externalities involves the assurances that issuers in the U.S. market receive about the conduct of their fellow issuers. For example, a firm that today enters the U.S. market becomes subject to the Foreign Corrupt Practices Act, which precludes not only bribes and "questionable payments," but all forms of off-books accounts and falsification of accounting records. Thus, a foreign issuer entering the U.S. market effectively agrees not to compete against its U.S. rivals using such means. Even if this prohibition cannot be fully enforced, there is at the margin some reduction in the risk that U.S. issuers face that they will be subject to illicit competition from foreign rivals. This is another example of a network externality, because as the number of listed foreign issuers grows, the earlier firms gain increased value from the listing of subsequent firms.

Closely related to this benefit is the benefit to earlier-listed firms that they not suffer competitive injury because of their mandatory disclosure of proprietary information, which their competitors can then exploit. Some commentators have argued that mandatory disclosure, as practiced in the United States, frequently results in competitive injuries to U.S. firms.<sup>203</sup> But, if so, requiring foreign firms to comply with a similar standard at least levels the playing field—whereas permitting foreign firms to continue to disclose under a less-demanding standard would perpetuate this disparity. Once again, as foreign firms list, the earlier-listed domestic firms benefit, but only to the extent that a common disclosure standard prevails. To be sure, this protection does not attract the foreign issuer to the U.S. market, but it is a regulatory cost that it must bear, and from which U.S. issuers benefit, so long as U.S. legal standards are mandatory for all listed companies.

These observations need to be generalized in terms of this Article's earlier analysis of concentrated versus dispersed ownership patterns. Fundamentally, blockholder systems of concentrated ownership and the Anglo-American system of dispersed ownership represent highly inconsistent ap-

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arguable that only foreign issuers will be subject to such wider spreads, as both dealers and investors discount only these stocks. But this exclusive focus on stock price ignores the impact of tolerating insider trading in some cases on the behavior of potential future inside traders. Once it becomes possible to trade some U.S. listed stocks based on nonpublic, "inside" information, the temptation grows to use such information in the case of domestic issuers as well. In effect, the prohibition loses its moral force, and an increased rate of violations becomes predictable.

<sup>203</sup> See Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 *BROOK. L. REV.* 763 (1995) (stressing that disclosure to the market also implies disclosure of proprietary plans to competitors).



proaches to corporate governance, even if it is arguable that they are equally efficient. Blockholder systems attempt to subsidize the cost of effective monitoring of management by offering the blockholder the practical ability to engage in forms of self-dealing and insider trading that are anathema to market-centered systems of dispersed ownership.<sup>204</sup> Whatever the wisdom of this approach, the listing of the minority shares of such blockholder-dominated companies on U.S. exchanges essentially introduces firms that tolerate opportunism by the blockholder into a population of firms that have traditionally closely policed this same controlling shareholder relationship. The result is to marry the square peg with the round hole—unless the market-centered system's policy of protecting minority rights is extended to apply to blockholder-dominated companies. In this light, the most important network externality associated with the U.S. and U.K. systems of market-centered dispersed ownership is the sense of trust and confidence that investors have developed over decades of experience and with thousands of listed securities. In principle, trust grows as the number of listings on the exchange increase because this deepens the investors' experiential base, but it is subject to injury if new listings will disrupt and contradict that prior experience. In short, "high-trust" markets are injured by the introduction of "low-trust" firms.

In truth, the forces that encourage the development of trust and cooperation may transcend purely legal forces,<sup>205</sup> but the existence of strong legal protections seems an excellent proxy for these forces. Indeed, where legal forces exist to protect the minority shareholder, an institutional and cultural infrastructure—composed of such important actors as security analysts, rating agencies, and business journalists—soon follows. Ultimately, trust is a learned behavior for investors, and their common experience, which teaches them that trust in management is efficient, may be based on a composite of legal and social forces. But for precisely this reason, a market cannot simultaneously trade high-trust U.S. and U.K. firms and low-trust European and Asian firms without the investors' unsatisfactory experience with the latter creating skepticism of the former. In short, some spillover is inevitable.<sup>206</sup>

A final, related consideration involves the political economy underlying securities markets—and, more specifically, how the existing political consensus that supports trust could quickly unravel if foreign and domestic issuers were subject to markedly different disclosure standards. Clearly, compliance with higher U.S. disclosure standards imposes real costs on

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<sup>204</sup> See *supra* notes 51-56 and accompanying text.

<sup>205</sup> For a fuller discussion of the role of trust in firms, markets, and organizations, see Rafael La Porta et al., *Trust in Large Organizations*, 87 AM. ECON. REV. 333 (1997).

<sup>206</sup> Thus, even a foreign, blockholder-dominated firm whose minority shares trade at a greatly discounted price erodes trust when it enters into a deal or transaction that subsidizes its blockholders at the expense of public shareholders.

U.S. issuers and may also at times compel them to disclose proprietary information that they would prefer not to reveal to their business competitors.<sup>207</sup> Against this backdrop, assume that the SEC were to permit foreign issuers to list in the United States without complying with U.S. standards. At this point, the political reaction of domestic issuers seems obvious: why, they would ask, should they be subject to higher costs and greater competitive injury when their international competitors were permitted to sell securities in the United States based on a less demanding standard? In effect, permitting foreign issuers to abide only by foreign standards concedes that investor protection concerns do not require more. Once the SEC makes such a concession, its negotiating position vis-à-vis domestic issuers would be seriously compromised. Hence, accepting any significant disparity in disclosure standards for one market creates an unstable environment in which political pressures are likely to produce regulatory arbitrage—and the proverbial “race to the bottom.”

3. *Strong Managers and Dispersed Ownership.*—As earlier noted, the “political” theory of corporate finance explains dispersed ownership as largely the result of legal constraints that (in the U.S. context) impeded the natural development of financial intermediaries; in contrast, the newer “legal” hypothesis views dispersed ownership as the consequence of Anglo-American law’s success in protecting minority shareholder. But the legal hypothesis is relatively vague about just what the specific legal differences are that protect minority investors in the Anglo-American context.

The recent history of privatization in the transitional economies of Eastern Europe provides, however, a natural experiment that shows the instability of dispersed ownership in a legal regime that does little to protect minority investors. In several of these countries, shares in the newly privatized firms were broadly distributed through a technique known as “voucher privatization” that essentially distributed the shares gratuitously among all adult citizens.<sup>208</sup> In the Czech Republic, where minority protections were the weakest, dispersed ownership proved short-lived; controlling blocks were quickly assembled, the minority shares lost much of their value, and the trading market for such shares largely vanished.<sup>209</sup> This ex-

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<sup>207</sup> This point that disclosure to the market also means disclosure to one’s competitors and can result in competitive injuries has been stressed by Professor Edmund Kitch. See Kitch, *supra* note 203.

<sup>208</sup> For a review of the very different Czech and Polish experiences with voucher privatization, see John C. Coffee, Jr., *Inventing a Corporate Monitor for Transitional Economics: The Uncertain Lessons from the Czech and Polish Experiences*, in *COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH* 68-138 (Klaus Hopt et al. eds., 1998).

<sup>209</sup> See *id.* at 111-38. In 1995, the Prague Stock Exchange had 1,716 listings; by early 1999, this number had fallen by more than 80% to 301 listings, and it was estimated that fewer than a dozen of these enjoyed any liquidity. See Peter S. Green, *Prague Exchange’s Failed Reform Efforts Leaves Some Predicting Its Demise*, *INT’L HERALD TRIB.*, Mar. 17, 1999, at 16. Correspondingly, over the same period, the value of an investment in an index of the leading 50 stocks on the Prague Stock Exchange

perience supports a simple generalization: the greatest danger facing a dispersed shareholder is the "theft" of their share value incident to a rapid assembly of a controlling block. In a nontransparent market, the dispersed shareholder is inherently vulnerable and does not know whether to sell at the first sign of a potential control acquisition or to hold out for a higher price.

In contrast, in the classic Berle-Means corporation, with its separation of ownership and control, strong managers are in a position to "protect" the dispersed shareholders from any creeping acquisition of control that does not afford all shareholders a roughly equal opportunity to share in the control premium. In addition, legal rules in both the United States and the United Kingdom protect the dispersed shareholder from the "creeping" acquisition of control without the payment of a control premium. Perhaps more importantly, managers themselves have only weak incentives to buy control because they are already undiversified and hence should rationally be risk-averse about further investments in their firm. In addition, U.S. law closely regulates "going private" transactions. But if management does not want to buy the firm, they also do not want outsiders to assemble a controlling block. To be sure, such "protection" may well result in managerial entrenchment, as self-interested managers resist all third party offers. Still, the ultimate tradeoff is uncertain: "strong managers" may protect dispersed shareholders from non-pro rata attempts to "steal" the firm's control premium, but they also may entrench themselves, resisting even generous tender offers for all the firm's stock. This explanation can also provide a further reason for migration to U.S. securities markets: firms facing the gradual dissipation of a control block, including a control holder who wishes to sell, may prefer the U.S. market where managers can better hope to resist the sudden formation of a new control block.

In general, a management that does not hold a controlling equity position may be the dispersed shareholders' principal protection against theft of the control premium. To be sure, this protection comes at a price, but it also explains why dispersed ownership is a stable, persistent phenomenon in the Anglo-American context, while dispersed share ownership has proved to be only a temporary stage in transitional economies. By insisting upon the manager's fiduciary duty to the firm, a concept unknown to civil law, Anglo-American law restricts the ability of the firm's management to acquire control of the firm at a price below fair value. In so doing, common law legal regimes also give management a strong incentive to resist outsiders who would similarly assemble a control block. The net result is a system of checks and balances that permits dispersed ownership to persist. In this light, the key difference between "common law" and "civil law" legal re-

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would have fallen by over 60%. *See id.* (noting decline of PX-50 index from 1,000 to 371). In contrast, the Polish experience appears to have been different and dispersed ownership has been more stable, in part because it was far more difficult to assemble a controlling block under its legal rules.

gimes may be less the statutory protections than the ability given to a "strong" management to fend off outside control seekers.

### *E. The Centrality of Securities Regulation*

This Article has said little about state corporate law, because it believes that the critical restraints that most limit agency costs are today contained in the federal securities laws.<sup>210</sup> To be sure, the constraints in federal and state law may redundantly overlap, but as a result the federal securities laws so overshadow state corporate law as to make the distinctions among state laws relatively unimportant in the case of the publicly held corporation, at least with regard to the goal of limiting agency costs.<sup>211</sup> Interestingly, this is basically what Canadian scholars have reported about corporate charter competition in Canada.<sup>212</sup>

The immediate significance of this assessment that federal law has overshadowed state law variations lies principally in its implications for foreign issuers. Even if some foreign jurisdictions do grant controlling shareholders the discretionary power to take self-interested actions, this discretion may be significantly constrained by federal securities regulation. In short, the much discussed differences between the protections given by Anglo-American law versus Continental European law may be overshadowed by the legal protections implicit either in the U.S. securities law or in a "harmonized" international system of securities regulation. Although these disparities in the scope of securities regulations would be more significant than the variations among state law on corporate duties within the United States, these disparities may also be reduced or neutralized by the threat of both SEC and private enforcement in U.S. courts.

Is such a Pax Americana truly possible? Concededly, it is probably premature to predict that U.S. courts will fully enforce the provisions of U.S. securities law against foreign controlling persons of a foreign corpora-

<sup>210</sup> Of course, state law regulates the simplest forms of fiduciary abuse: unfair self-dealing, excess compensation, usurpation of corporate opportunities. But these forms of misconduct rarely have a material impact on share price. In contrast, federal law more directly regulates corporate control transactions that could more severely injure minority shareholders.

<sup>211</sup> No other commentator to my knowledge has made this argument, but there is recognition that state corporate law has become virtually uniform across the states. See Carney, *supra* note 37, at 717. Where variations among states may have greater significance is in reducing transaction costs; this is both outside the fiduciary duty context and largely unaffected by the federal securities laws. Although novel, my thesis has a historical foundation. Professor Mahoney has argued that the original purpose of both the U.S. and U.K. securities laws was to reduce the capacity of promoters and insiders to overreach public shareholders. See Mahoney, *supra* note 36. In that light, this Article's claim is simply that the SEC has substantially succeeded. For earlier assessments of the requirements of federal securities law that implicitly find them as important as state fiduciary duties in preventing misconduct by controlling persons, see Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1483-85 (1989); Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1 (1993).

<sup>212</sup> See Daniels, *supra* note 33, at 182-84 (because Canadian securities administrators could in effect countermand provincial law, charter competition among the provinces has not developed).

tion. The strain on the enforcement capacity of the SEC would be considerable in the case of some norms, but not others.<sup>213</sup> Perhaps U.S. law will never be zealously enforced in the case of companies that simply allow some small percentage of their stock to drift into the hands of shareholders in the United States. Still, for the truly large firm that enters the U.S. securities markets in a major way, this entry is probably irreversible as a practical matter, as U.S. shareholders cannot easily be expelled or squeezed out at low cost. With such entry will predictably come a substantial degree of functional convergence.

*F. Markets Versus States: Does the Experience with State Charter Competition Have Relevance to the Prospect for Convergence?*

Few topics have been as extensively debated in the area of corporate law as the claim that corporate chartering competition results in a more efficient body of corporate law.<sup>214</sup> Proponents of the view that charter competition produces a "race to the top" have recently argued that a competitive market for securities law should be similarly encouraged by permitting issuers to choose the applicable jurisdiction whose securities laws would apply to their activities.<sup>215</sup> But are the two contexts truly analogous?

This Article has suggested that convergence at the level of securities regulation will outpace convergence at the level of corporate law. In essence, this is a prediction that international events will follow the *de facto* outcome of the U.S. charter competition experience. One reason for this prediction is that the forces that have produced a dominant supplier of corporate law at the state level, Delaware, have even greater impact in the international arena of securities regulation and thus make it even more likely that U.S. securities markets will become the dominant supplier of law for large publicly held corporations.

To understand this contention, it is useful to start with an obvious point that most commentators have largely ignored, namely, that virtually all publicly held corporations are regulated at two distinct levels: (1) their jurisdiction of incorporation, and (2) the various jurisdictions where their securities trade. This system of dual regulation applies not only to Delaware corporations trading on the New York Stock Exchange, but equally to Japanese corporations trading on the London Stock Exchange.<sup>216</sup>

<sup>213</sup> For example, it may be very costly to enforce Section 13(d)'s notion of a voting group against European individuals and firms that form voting alliances without disclosure. See *supra* notes 155-61 and accompanying text. Still, more visible transactions (such as "going private" transactions or voting rights recapitalizations) could be more easily monitored.

<sup>214</sup> For the principal contending positions, see *supra* note 32.

<sup>215</sup> See Choi & Guzman, *supra* note 195, at 930-34; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

<sup>216</sup> Adding further complexity is the fact that there is a third potential source of regulation: the rules of the securities exchange(s) on which the issuer's stock trades. For the moment, this complexity can be deferred.

The nature of the competition at these various levels differs, however, dramatically. Proponents of a market for corporate charters have modeled charter competition as simply a contest among different jurisdictions offering their laws as a product that the issuer, as consumer, chooses from among many in a competitive marketplace.<sup>217</sup> Delaware, a small state, can thus outcompete New York or California, much larger states, if it offers a superior product. Indeed, as a small state, Delaware can make a more credible commitment that it will not change its law in the future adversely to the firms incorporating in Delaware, because the corporate franchise tax revenue it would thereby risk means more to it proportionately than it would to a larger state.<sup>218</sup> But at the level of securities regulation, the competing jurisdictions are not simply marketing a product, legal rules; rather, they are also offering the issuer access to markets of varying size, which access is tied to acceptance of the jurisdiction's legal rules. Thus, a small jurisdiction, such as Switzerland or Delaware, cannot as easily compete on equal terms with larger jurisdictions, such as the United States or New York, if the legal rules so offered do not carry with them access to securities markets. In short, Delaware or Switzerland could not become the predominant supplier of legal rules in the securities regulation context—unless the larger jurisdictions decided to relinquish their control by allowing access to their markets based simply on issuers complying with the law of some other jurisdiction.

Put differently, regulatory arbitrage works only to the extent that the party regulated can freely choose the law applicable to it, typically, by reincorporating in a less regulated jurisdiction. But, in securities regulation, it is not an attractive option for the issuer to flee a regulated jurisdiction if the issuer thereby also flees the principal market for its securities. For example, few issuers would willingly move from the New York Stock Exchange to the Milan Stock Exchange in the same manner that they might switch their jurisdiction of incorporation from New York to Delaware.

Of course, in theory, U.S. law could provide that any foreign issuer that complied with the disclosure rules of its home jurisdiction could sell its securities in the United States. Such a reciprocal system is in fact close to what the harmonization process has essentially wrought in Europe.<sup>219</sup> Still, little reason exists for the United States effectively to surrender control over domestic trading within its borders in such a fashion. In Europe, harmonization was a necessary step to the creation of pan-European trading and

<sup>217</sup> See generally Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985).

<sup>218</sup> For Delaware, corporate franchise tax revenue has consistently averaged 16.7% of Delaware's total tax revenues. See Romano, *supra* note 215, at 2389. The potential tax revenues to the United States (or the SEC) from attracting foreign issuers to list in U.S. markets are trivial by comparison.

<sup>219</sup> See *supra* notes 82-86 and accompanying text. Of course, under the EC model, each jurisdiction must have disclosure standards meeting some minimum level. Hence, the system is not simply a reciprocal one.

stock markets having sufficient size and scale to be efficient. Not only is this not so in the United States, but the United States also lacks the economic motive that animates Delaware to seek to attract foreign corporations: namely, the prospect of increased corporate franchise revenues and hence reduced state taxes on its citizens. Because U.S. tax revenues are not meaningfully affected by foreign listings, U.S. regulators have less reason to engage in regulatory competition.

In any event, from a bureaucratic perspective, the occasions are rare on which a regulatory agency has voluntarily ceded control without some compelling need that required such a surrender. The usual assumptions of political science are that public agencies act to maximize their powers, just as private firms seek to maximize revenues or profits. Indeed, for the last decade, the SEC has steadfastly resisted any reciprocal prospectus system under which foreign issuers could issue securities in the United States based on their home country's disclosure standards and has instead insisted on a harmonization that would largely replicate U.S. standards.<sup>220</sup>

Assuming then that the United States will not lightly open its markets to foreign issuers who do not comply with U.S. disclosure standards (either current standards or some future harmonized standards), what does this conclusion imply for the likely course of international convergence at the securities regulation level? Here, the data from the U.S. experience with charter competition becomes very relevant and supports three basic generalizations.

First, the best documented finding in the empirical literature on the U.S. corporate chartering competition is that a high degree of uniformity has emerged in American corporate laws. One recent careful study concludes that "American corporate law is relatively uniform across the states."<sup>221</sup> In essence, this is a conclusion that competition works and that, at least among U.S. jurisdictions, path dependent forces have not impeded that competition materially. Much the same could happen on the securities regulation level. Even if a German corporation cannot reincorporate outside Germany, it can certainly sell its securities outside of Germany. Thus, competition among jurisdictions and markets can develop at the securities regulation level, and by analogy it should similarly produce a high level of uniformity.

Second, recent commentators have argued that the U.S. market for corporate law is imperfectly competitive, with Delaware possessing market power and competitive advantages that other jurisdictions cannot replicate.<sup>222</sup> When the advantages that give Delaware market power and a dominant position are closely examined, however, they prove to be even

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<sup>220</sup> For a review of this debate, see Geiger, *supra* note 82; Lowenstein, *supra* note 105.

<sup>221</sup> See Carney, *supra* note 37, at 717.

<sup>222</sup> See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998).

more present in the case of the U.S. capital markets. For example, some argue that the key advantage possessed by Delaware in the competition for corporate charters is that of network externalities,<sup>223</sup> and, as earlier argued, this is also a key advantage of the U.S. securities markets.

Another factor that could confer dominance on the largest and most popular exchange is "herding."<sup>224</sup> Corporations may prefer to locate in a popular jurisdiction of incorporation for reasons that are simply based on its popularity, not the inherent superiority of its law. Such a "safe" decision protects the corporation's advisers from criticism, pleases uninformed shareholders who assume it is correct, and produces no adverse reaction from a marketplace that cannot easily evaluate legal differences and so prefers the consensus choice.<sup>225</sup> But again, this point applies at least equally to long-established capital markets that already possess substantial reputational capital. Listing on such a market is a safe decision that will not invite criticism. Hence, migration of the largest firms to the largest marketplace seems logical, both because of network externalities and because of the phenomenon of low-risk herding. Other markets cannot easily compete away the "first mover" advantages enjoyed the U.S. markets. Although other markets may be less regulated, lesser regulation may scare potential investors to the same degree that it attracts potential issuers. The tradeoff is indeterminate.

Finally, the U.S. experience with charter competition suggests one last implication: once one jurisdiction becomes dominant, other jurisdictions may not seek to compete with it on a head-to-head basis but may instead seek to specialize and differentiate themselves by marketing different legal products. Thus, some commentators have suggested that, once Delaware became the dominant jurisdiction of incorporation, other states began to specialize and focus their corporate laws on smaller, privately held firms that lacked dispersed ownership in order to retain these smaller firms or attract similar firms to their jurisdiction.<sup>226</sup> Such specialization could similarly characterize the international competition among securities markets, as firms with concentrated ownership might seek to list only on non-U.S. markets. Some foreign markets would specialize in serving such controlled firms, while the U.S. markets might offer their services principally to firms with dispersed ownership. If so, the market power of the U.S. exchange would not be seriously challenged.

These conclusions lead to a more general hypothesis: the greater the likelihood that the predominance of U.S. capital markets will persist be-

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<sup>223</sup> See *id.* at 1923-27; see also Klausner, *supra* note 198, at 842-47.

<sup>224</sup> For a general discussion of herding, see David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465 (1990).

<sup>225</sup> See Kamar, *supra* note 222, at 1923-27.

<sup>226</sup> See Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985); see also Daniels, *supra* note 33, at 138-40.



cause of the foregoing "first mover" advantages, the less that U.S. regulators need to fear regulatory arbitrage. Foreign issuers will pay some price in increased regulation in order to obtain the advantages of the dominant market. Commentators have suggested that Delaware extracts exactly this advantage from its position as the dominant jurisdiction in order to benefit local interest groups.<sup>227</sup> At the securities regulation level, the SEC could correspondingly exploit the dominance of U.S. markets to protect the dispersed shareholder—who is after all the key constituent that the SEC has long sought to benefit.

Predictably, those who favor regulatory arbitrage and interjurisdictional competition will reply that this position makes the SEC a "monopolist" able to impose its rules and regulations on foreign issuers.<sup>228</sup> At least at the level of international securities regulation, this is demonstrably false: other strong international competitors exist and more may soon arise. The London Stock Exchange is the most obvious example,<sup>229</sup> but the prospect of a pan-European securities exchange now seems increasingly likely. Still, even in the face of significant competition from the London Stock Exchange, foreign listings on the New York Stock Exchange have tripled during this decade.<sup>230</sup> Given the evident choice and the resulting migration to U.S. exchanges, the need to lower U.S. standards to "meet the competition" seems nonexistent.

#### IV. CONCLUSION AND RECOMMENDATIONS

Paradigms shift and often quickly. At the beginning of this decade, scholars fashioned a "political" theory of corporate finance, largely to account for the restrictions placed by U.S. law on institutional activism. With the increasing evidence that newly privatized economies have been unable to establish viable securities markets, another, more recent group of scholars has focused on the dichotomy between dispersed and concentrated ownership and concluded that legal protections for minority shareholders are the critical variable that underlies the growth of viable securities markets. This Article has suggested that, within the U.S. context, the critical protections for the dispersed shareholder are principally found in the federal securities laws, particularly those provisions regulating corporate control transactions.<sup>231</sup>

<sup>227</sup> See Macey & Miller, *supra* note 32, at 491-98 (1987); see also Kamar, *supra* note 222, at 1924.

<sup>228</sup> This has been the claim of those who wish to substitute state securities regulation for federal regulation. See Romano, *supra* note 215, at 2361.

<sup>229</sup> For recent discussions of the London Stock Exchange's strong competitive position and its recent linkage to the Deutsche Borse, see Meg Carter, *Competition is Hotting Up in the Staid World of the Stock Market*, TIMES (London), July 24, 1998, at 38; Lea Paterson, *Don't Write Off the City Just Yet; News Analysis: London Can Fend Off Attacks on its Financial Leadership*, INDEPENDENT (London), June 24, 1998, at 18.

<sup>230</sup> See *supra* note 108 and accompanying text.

<sup>231</sup> See *supra* notes 149-83 and accompanying text.

Although some synthesis of these "political" and "legal" theories of dispersed ownership is ultimately likely, the two theories diverge sharply in their predictions about the likelihood of corporate convergence. While the "political" theorists argue that the forces of path dependency are unlikely to be overcome, the "legal" hypothesis suggests that a legal regime that protects public shareholders has important long-term competitive advantages and will attract corporate migrants.<sup>232</sup> This Article has sought to reshape this debate by emphasizing that functional convergence can occur (and is arriving) at the level of securities regulation, even while corporate law convergence has been largely frustrated. Some will fear and others will applaud the prospect of "stealth" convergence, but it is already at the doorstep.

This leads to the ultimate normative question: should we welcome or fear convergence? The efficiency implications of convergence are fairly obvious. If, as suggested, the U.S. system of securities regulation not only specifies a marginally higher standard of disclosure,<sup>233</sup> but directly seeks to reduce agency costs and control opportunism, three principal efficiency gains should result from this transition: (1) harmonization of disclosure standards promises substantial savings in transaction costs and increased comparability of issuers, with consequent gains for investors and greater access to capital markets worldwide for issuers;<sup>234</sup> and (2) greater legal controls on the power of insiders and controlling shareholders should reduce agency costs and increase the ability of foreign firms to sell their shares in public markets;<sup>235</sup> and (3) access to the public equity markets should permit issuers to undertake longer-term and higher risk investments, thereby generating economic growth.<sup>236</sup> This prospect of real economic

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<sup>232</sup> Two advantages have been recurrently stressed in this Article: (1) securities markets facilitate investment in longer-run, higher risk projects that advance technological growth and productivity, see sources cited *supra* notes 25, 81; and (2) in a world of consolidating mergers, firms with high stock prices for their public shares are likely to be the survivors.

<sup>233</sup> It seems generally recognized that U.S. disclosure standards are more rigorous than those of any other country with the possible exception of Canada. Even the United Kingdom's standards require less line of business data and do not require discussion of management-identified trends that may affect the firm's future liquidity, capital needs or operating results. See David H. Landau, Note, *SEC Proposals to Facilitate Multinational Securities Offerings: Disclosure Requirements in the United States and United Kingdom*, 19 N.Y.U. J. INT'L. L. & POL. 457, 459-68 (1987).

<sup>234</sup> These points have been made in great detail by a number of authors. See Geiger, *supra* note 200; Joel P. Trachtman, *International Regulation Competition, Externalization and Jurisdiction*, 34 HARV. INT'L L.J. 47, 66-67 (1993); White, *supra* note 200, at 39.

<sup>235</sup> Some respond that reduction in agency costs is an illusory efficiency gain, because dispersed ownership is the source of most agency costs. See Bratton & McCahery, *supra* note 13, at 12-13. This response focuses only on the agency costs of controlling management and ignores the agency costs of preventing non-pro-rata distributions to controlling blockholders. While this issue may well remain theoretically indeterminate, the extraordinary size of control premiums in some European markets, see Zingales, *supra* note 29, suggests that public shareholders lose more from this form of opportunism than from fiduciary misconduct by management.

<sup>236</sup> See Levine & Zervos, *supra* note 25; Rejan & Zingales, *supra* note 81. Others have argued that legal underdevelopment prevents a national economy from being able to credibly commit to controlling

growth means that the gains from this transition will flow not only to shareholders, but their national economies as well.

Beyond these efficiency arguments, there is still an independent normative claim that facilitating dispersed ownership would produce desirable social and political consequences. In the absence of legal protections for the minority shareholders, investors depend on relationships, not law. The result is a system of relationship-based investing that at its worst can be characterized as "crony capitalism." Such relationship-based systems may be necessary in transitional economics where the contracting system remains at an early and primitive stage, but relationship-based systems of governance essentially misallocate capital and result in a highly stratified and hierarchical economic system which discourages entrepreneurs.<sup>237</sup> Concededly, European governance systems have never been characterized by the corruption or legal anarchy endemic to Asia, but they have tended toward a hierarchical and centrally dominated structure that is a barrier to new entrants and entrepreneurship at a time when growth in economic productivity is being driven by such actors and forces. Encouraging equity markets to develop and encouraging dispersed ownership may therefore imply not only efficiency gains but also a more open society, one less dominated by banks and centralized financial intermediaries and one more attractive to entrepreneurship. This "social hypothesis" about the consequences of providing legal protections for minority shareholders is speculative, but it may ultimately prove more important than the efficiency gains.

If the transition to dispersed ownership is desirable, it implies that U.S. securities regulation should not exempt the foreign issuer who actively enters U.S. trading markets from those forms of regulation that seek to reduce agency costs. In addition, it suggests that current U.S. rules may need to be strengthened. Here, U.S. law faces an important transition problem. Traditionally, U.S. securities law has struck a compromise with the foreign issuer that lists on a U.S. exchange or NASDAQ, requiring it to enter the periodic disclosure system of the Exchange Act, but exempting it from the proxy rules and certain other provisions of the Act.<sup>238</sup> In time, this will become an increasingly strained compromise. Why, for example, should Daimler continue to be exempt from U.S. proxy rules when possibly the majority of its beneficial shareholders are U.S. citizens? To be sure, sensible distinctions can be drawn: foreign issuers have also long been exempt from the "short

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opportunism and hence retards economic growth. See Demirguc-Kunt & Maksimovic, *supra* note 7. In this light, migration to foreign securities markets or international securities harmonization can be viewed as a "second-best" but politically feasible solution by which firm growth and national economic prosperity can still be pursued.

<sup>237</sup> For this view (as applied to the Asian financial crisis), see Raghuram G. Rajan & Luigi Zingales, *Which Capitalism? Lessons from the East Asian Crisis*, 11 J. APPLIED CORP. FIN. 40 (1998).

<sup>238</sup> SEC Rule 3a12-3(b) exempts foreign private issuers from Sections 14(a), 14(b), 14(c), 14(f) and 16 of the 1934 Act. See 17 C.F.R. § 240.3a12-3(b) (1998).

swing" profit provisions of section 16(b) of the Exchange Act,<sup>239</sup> and this exemption makes continuing sense because section 16(b) is a prophylactic rule that would be a trap for unwary foreign shareholders, and probably could not be evenly enforced in the case of foreign issuers. In contrast, the proxy rules go to the heart of corporate governance and to the purposes underlying migration to U.S. markets as a form of bonding.

Ultimately, this Article has advanced two claims that are novel only to the academic world: law matters, and trust is efficient. Protecting the expectations of the minority may be the essential prerequisite to an effective securities market. Still, the future as here predicted does not entail the inevitable triumph of the Berle and Means corporation with its dispersed ownership and strong management. The contemporary systems of dispersed and concentrated ownership are like giant tectonic plates, grating against each other. One may push and even override the other, but where they meet the primary prospect is for friction. The best way to minimize that friction is to encourage a global process of self-selection and migration. Those firms seeking to grow in size to a global scale are likely to elect into the "higher" governance standards already largely observed in the United States, and such bonding should minimize the social friction and even unrest that formal convergence could cause.

Ultimately, just as securities regulation has over the last thirty years dominated substantive corporate law in the United States, so too may the law of securities markets effectively overshadow local substantive law on a global basis, at least in the case of the largest public corporations. History may be beginning to repeat itself.

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<sup>239</sup> See *id.*