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Convergence and its Critics: What are the Preconditions to the Separation of Ownership and Control?

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Abstract

Recent commentary has argued that deep and liquid securities markets and a dispersed shareholder base are unlikely to develop in civil law countries and transitional economies for a variety of reasons, including (1) the absence of adequate legal protections for minority shareholder, (2) the inability of dispersed shareholders to hold control or pay an equivalent control premium to that which a prospective controlling shareholder will pay and (3) the political vulnerability of dispersed shareholder ownership in left-leaning "social democracies." Nonetheless, this article finds that significant movement in the direction of dispersed ownership has occurred and is accelerating across Europe.

To understand how dispersed ownership can arise in the absence of the supposed legal and political preconditions, this article reconsiders the appearance of dispersed ownership in the late 19th and early 20th Century in the U.S. and the U.K. During this era, the private benefits of control were high, and minority legal protections in the U.S. were notoriously lacking, as the famous Robber Barron of the age bribed judges and legislators and effectively employed regulatory arbitrage to escape regulation. Nonetheless, strong self-regulatory institutions (most notably, the New York Stock Exchange) and private bonding mechanisms by which leading underwriters pledged their reputational capital by placing directors on the board of sponsored firms enabled the equity market to expand and dispersed ownership to arise. In contrast, in the U.K., the London Stock Exchange for a variety of path-dependent reasons played a far more passive role and did not become an effective self-regulator until much later in the 20th Century. Yet, dispersed ownership also arose, although at a slower pace. The lesser role for private self-regulation in the U.K. may have been the consequence of its lesser need for self-regulation as a functional substitute for formal law, given both earlier legislation in the U.K. and lesser exposure to judicial corruption and regulatory arbitrage.

Based on these examples, this article argues that "functional convergence" will dominate "formal convergence" and that the principal mechanism of functional convergence may be private self-regulation. However, rather than reject the "law matters" hypothesis, this article suggests that one of the principal advantages of common law legal systems is their decentralized character, which encourages self-regulatory initiatives, whereas civil law systems may monopolize all law-making initiatives. Further, this article proposes that legal reforms, while important, are likely to follow, rather than precede, market changes -- as happened in both the U.S. and the U.K. Once however a constituency for liquid and transparent securities market is thus created, it will predictably seek and secure legislation that fills in the enforcement gap that self-regulation leaves. Both in the U.S., the U.K. and Europe today, the growth of securities markets has been largely divorced from politics.

What then are the preconditions for the separation of ownership and control? The key answer is that public shareholders be able to retain control, protected from the threat of stealth raiders who can assemble controlling blocks without paying a control premium. In both the U.S. and the U.K., these protections were first developed through private (or semi-private) ordering and then formalized in legislation.

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by John C. Coffee, Jr[*].

Introduction

Contemporary assessments of corporate governance and structure today typically begin at the same point and then diverge. Each opens by noting that Berle and Means were myopic.[1] When in 1932 they announced the separation of ownership and control, Berle and Means did not recognize that they were describing a largely Anglo-Saxon phenomenon, which did not characterize the corporate governance systems of the most of the rest of the world. Next, the commentator typically points out that, like parallel universes, two rival systems of corporate governance exist today: (1) a Dispersed Ownership Model, characterized by strong and liquid securities markets, high disclosure standards, high market transparency, and in which the market for corporate control is the ultimate disciplining mechanism, and (2) a Concentrated Ownership Model, characterized by controlling blockholders, weak securities markets, low transparency and disclosure standards and possibly a central monitoring role for large banks.[2]

Thus framed, the debate then usually turns to the prospective persistency of this binary

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1 A. Berle and G. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

2 The seminal work of La Porta, Lopez-de-Silanos, Sheifler and Vishny (hereinafter "LLS&V") has established the existence of these rival systems, that they seem to have evolved along distinctive legal trajectories, and that correlate with significant differences in the legal protections provided to minority shareholders. See La Porta, Lopez-de-Silanos, and Sheifler, Corporate Ownership Around the World, 54 J. Fin. 471 (1999).

division of the corporate universe. Here again, there are two standard positions. One obvious position -- hereinafter called the “Strong Convergence Thesis” -- predicts that competition will force convergence. Thus, as markets globalize and corporations having very different governance systems are compelled to compete head to head (both in, labor and capital markets), a Darwinian struggle becomes inevitable, out of which the most efficient form should emerge dominant.[3] The rival and newer position -- hereinafter called the “Path Dependency Thesis” -- postulates instead that institutions evolve along path dependent trajectories, which are heavily shaped by initial starting points and pre-existing conditions.[4] In short, history matters, because it constrains the way in which institutions can change, and efficiency does not necessarily triumph.

These two polar positions do not, however, exhaust the field. In prior work, I have sought to distinguish “functional convergence” from “formal convergence” and argued that even when formal convergence (meaning convergence to common legal rules and practices) is blocked by political, legal or institutional barriers, functional convergence may yet arrive through a process of migration and substitution.[5] Thus, for example, a corporation whose home country has weak

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3 For representative statements of this position, see H. Hansmann and R. Kraakman, The End of History for Corporate Law, Yale Law School Law and Economics Working Paper No. 235 (January 2000); see also F. Easterbrook and D. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) at 4-15.

4 See Bebchuk and Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127 (1999); see also Licht, The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems (Working Paper 2000).

5 See Coffee, The Future As History: The Prospects for Global Convergence in Corporate Governance and Its Significance, 93 Nw. U. L. Rev. 641 (1999); see also Gilson, “Globalizing Corporate Governance: Convergence of Form or Function” (Working Paper February 2000).

securities markets may cross-list on a stronger, foreign securities market (for example, in the U.S. or the U.K.) and thereby credibly bond its promise to shareholders to fully disclose material information. Many European firms appear to be migrating in this fashion today. Alternatively, the development of a pan-European securities market, possibly with listing and disclosure requirements more demanding than those of existing European markets, could conceivably provide the framework for the adoption of protections for minority shareholders that were essentially similar to those enjoyed today in common law countries. More importantly, the key idea here is that of functional substitutes that provide alternative means to the same end. In this piece, I will expand that concept to suggest that self-regulation is often the principal functional substitute to mandatory legal regulation and that we have historically observed its appearance, not as a lesser alternative to formal legal rules, but often as a precursor to such rules that arises precisely because the formal legal system cannot adopt or enforce adequate standards to support the business activity that self-regulation encourages.

The immediate relevance of this thesis stems from the possibility that self-regulation may be able to mitigate problems that otherwise seem to pose insurmountable obstacles to the appearance and growth of strong securities markets. Both on empirical and theoretical grounds, recent commentators have argued that liquid securities markets and dispersed ownership cannot develop in an environment characterized by concentrated ownership. Three basic arguments have been raised: First, the provocative new scholarship of La Porta, Lopez-de-Silanes, Shleifer, and Vishny ("LLS&V") has demonstrated that a strong, statistically significant association exists between liquid securities markets and certain specified legal protections for minority shareholders.[6] Although it may overread the evidence to say that common law legal systems necessarily provide better or stronger legal protections for minority shareholders than do civil law systems, they certainly provide different legal protections, and dispersed ownership seems to have arisen only in their distinctive legal environment. Hence, if European securities markets are populated chiefly by insider-dominated firms and if insiders have little incentive to give additional protections to minority shareholders (which protections would come largely at the controlling shareholders' expense), then the conclusion seemingly follows that the existing structure of concentrated ownership should be stable (except to the extent that some firms migrate to U.S. or U.K. markets or achieve dispersed ownership through cross-border mergers).

Second, Professor Mark Roe has advanced the "political" thesis that strong securities markets are inconsistent with the European political tradition of social democracy.[7] In essence, he argues that concentrated ownership and low transparency are part of a defensive stance assumed by investors in these left-leaning countries, where the government characteristically favors employees over shareholders and might expropriate corporate assets (to a greater degree, anyway) if fuller transparency were required.

Third and finally, Professor Lucian Bebchuk, also a proponent of the path dependency perspective, has advanced a persuasive "rent protection" model of shareholder ownership, which

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6 See La Porta, Lopez-de-Silanos, Sheifler and Vishny, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997); La Porta, Lopez-de-Silanos, Sheifler and Vishny, Law and Finance, 106 J. Pol. Econ. 1113 (1998). For the latest and fullest statement of their position, see LaPorta, Lopez-de-Silanos, Sheifler and Vishny, Investors Protection and Corporate Governance (Working Paper 2000).

7 See Roe, Political Preconditions to Separating Ownership from Corporate Control, Columbia Law Center for Law and Economic Studies Working Paper No. 155 (January, 2000).

posits that, when the private benefits of control are high, concentrated ownership will dominate dispersed ownership.[8] The core concept in this model is that the entrepreneurs taking a firm public will not sell a majority of the firm's voting rights to dispersed shareholders in the public market, but will instead either retain control or sell a control block to a new incoming controlling shareholder, because dispersed shareholders cannot hold, or enjoy the benefits of, control and thus cannot pay an equivalent control premium. Some empirical evidence corroborates this theory, finding that in concentrated securities markets, IPOs seldom distribute more than a minority of the firm's voting shares to the market, with the controlling blockholder generally retaining control and selling it only as a control block to an incoming control purchaser.[9]

This article will seek to reply to each of these arguments, not to refute them, but to suggest that the manner in which dispersed ownership has evolved in the past can repeat itself in the near future. Part I begins by surveying the latest evidence on convergence, which shows increasing signs of fission within the world of concentrated ownership. Despite the asserted barriers, securities markets are growing across Europe at an extraordinary rate, entrepreneurs in civil law countries are making use of initial public offerings (or IPOs") at a rate equivalent to that in the common law world, and the market for corporate control has become truly international. Something is destabilizing the old equilibrium.

Part II will then examine the claim that securities markets require a strong legal foundation

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8 See Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control, NBER Working Paper 7203 (July, 1999).

9 See Holmen and Hogfeldt, A Law and Finance Analysis of Initial Public Offerings, Working Paper (August 4, 2000); see also Berglof and von Thadden, The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries, Working Paper (June, 1999).

that protects the minority shareholder in order to become deep or liquid. It will argue that, although the association between minority protection and liquidity is real, the cause and effect sequence is backwards. Although "law matters," legal developments tend to follow, rather than precede, economic change.[10] Specifically, Part II will examine the early development of the New York Stock Exchange ("NYSE") and the London Stock Exchange ("LSE"). Although securities exchanges have existed since the 17th Century, both these exchanges primarily traded debt securities up until the late 19th Century. Then, in a relatively brief period (which overlapped, but was different for each nation) and at a time when the private benefits of control were unquestionably high, dispersed ownership arose -- largely in the absence of strong minority protections, which came afterwards. Viewed in retrospect, this sequence makes obvious political sense: legal reforms are enacted at the behest of a motivated consistency that is protected (or at least perceives itself to be protected) by the reforms. Hence, the constituency (here, dispersed public shareholders) must first arise before they can become an effective lobbying force and an instrument of legal change.

This historical analysis still leaves open the question of how the separation of ownership and control arises. When and how can the public market in effect compensate the initial owners of the firm for surrendering their control rights by paying these holders a premium equal to, or

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[10] Stuart Banner has made the interesting argument that, over the last three hundred years, most major waves of securities regulation have followed a sustained price collapse on the securities market. See Banner, What Causes New Securities Regulation?: 300 Years of Evidence, 75 Wash. U.L. Q 849, 850 (1997). It is not surprising that "bubbles" produce victims and hence a political demand for reform. But perhaps the deeper meaning of this finding is that the reform of securities regulation has not been associated with any broader political movement. Thus, this evidence is in tension with Professor Roe's claim that there are "political preconditions" to the growth of securities markets. See Roe, supra note 7.

greater than, that which another party seeking control would pay? In both the U.S. and the U.K., this question historically translated into a closely related question: when can the public market retain control and prevent its usurpation by persons who seek to seize control without paying a control premium? Part II will suggest that private ordering can sometimes enable the public market to hold control in a manner that protects public shareholders from subsequent control seekers who wish to "steal" the control premium without compensating them. When these conditions are realized, (and possibly only then), dispersed ownership can arise and persist. Finally, Part II will suggest that recent legal reforms in Europe (most notably the 13th Company Law Directive) may have now satisfied these preconditions.

Based on this analysis, this article will suggest that the political thesis that social democracy and strong securities markets cannot co-exist rests on a doubtful foundation. Others have also challenged this very ambitious claim,[11] noting that the English example supplies a strong counterexample of social democracy co-existing with strong securities markets. This article will advance a more general objection: namely, that financial institutions -- including the much used example of German universal banks -- do not naturally desire to perform the monitoring and oversight role accorded to them by the theorists of concentrated ownership. Only to the extent that such institutions are state controlled (directly or indirectly) and pressured to play such an activists role, or are locked into holding such illiquid blocks by restrictive tax legislation, do financial institutions accept the monitoring duties that the European system of concentrated

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11 See Chelfin, Putting Britain on the Roe Map: The Emergencies of the Berke-Means Corporation in the United Kingdom, (Working Paper 2000).

ownership historically assigned them. Otherwise, as I have elsewhere argued,[12] institutions prefer liquidity to control. Across Europe today, financial institutions appear on the verge of liberation -- and seem delighted at the prospect of being able to liquidate their controlling blocks.

Part I. The Evidence on Convergence

Some accounts of the ongoing transition in corporate governance and structure tend to refer dismissively to the evidence on convergence as "anecdotal," implying that convergence may be only a transient or apparent trend. But the evidence is by now much stronger and involves quantitative as well as qualitative data. For the sake of convenience, the most salient evidence can be conveniently grouped under the following four categories. Although the transition is far from complete, the customary binary division of the corporate universe into separate worlds of diffuse ownership and concentrated ownership is now clearly out of date.

(a) Formal Legal Change. This is the area where those adopting a "path dependent" perspective have suggested that change would be the slowest and most marginal, because formal legal change generally requires legislative action and can be blocked by political interest groups or strongly motivated minorities (who may have little concern with overall efficiency). Still even here, significant change is evident.

The clearest evidence relates to the transition economies. Employing a methodology that uses cross-country formalized legal indicators to measure statistically the degree of legal change, Katharina Pistor constructed a data base covering twenty-four transition economies (i.e., most of the formerly socialist states in Europe and Eurasia) that tracked the development of shareholder

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12 See Coffee, Liquidity Versus Control: The Institutional Investor As Corporate Monitor, 1991 Colum. L. Rev. 1227 (1991).

and creditor rights from 1990 through 1994.[13] She concluded:

> "Despite substantial differences in the initial conditions across countries, there is a strong tendency towards convergence of formal legal rules as the result of extensive legal reforms."[14]

She notes, however, that "law reform has been primarily responsive to economic change rather than initiating or leading it."[15] As discussed later, this same pattern appears to be evident in the development of diffused securities markets in both the U.S. and the U.K.

The direction of these changes has been uniformly in the "Anglo-Saxon" direction: "By 1998, legal changes had been introduced that raised the level of investor protection in most transition economies above the level of the civil law systems and brought them within close range of the average for common law countries ...."[16] In overview, this transition seems to have largely involved the outright transplantation of common law legal rules for civil law rules, with the total package of legal reforms being usually designed by foreign legal advisors (often supplied by the United States). Still, because these reforms have been legislatively adopted, this wholesale transplantation seems to indicate that, at least under the pressures faced by transition economies, law makers have not felt obliged to maintain continuity with their traditional legal system. Radical legal change is sometimes possible.

A possible response to this evidence of sharp discontinuity in the law of transitional

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[13] Pistor, <u>Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies</u>, EBRD Working Paper No. 49/2000

[14] Id. at p. 2.

[15] Id.

[16] Id. at p. 13.

economies is that mass privatization programs in these countries imposed a diffused, "Anglo-Saxon" structure of share ownership on these countries and so required a corresponding movement to Anglo-Saxon (or common law) systems of corporate governance and securities regulation. From this perspective, one might argue that no similar rate of legal change should be predicted for those economies in which an insider-dominated system of concentrated ownership still prevails. In short, if form follows function (that is, if legal rules are determined by the system of corporate governance that preexists those rules), then no similar rapid legal transition should necessarily be expected in the Continental economies in which concentrated ownership is still the norm.

Indeed, casual empiricism would suggest that no similar rate of rapid legal change is in progress in the larger European economies, at least regarding their corporate law rules. Still, one must remember that shifts in legal rules may follow and not precede shifts in the system of corporate governance and the structure of share ownership. As next discussed, significant, but subtler, shifts are discernable in these countries, both in the structure of share ownership, the growth of securities markets, and the emergence of new governance mechanisms, such as, most notably, the takeover.

(b) The Structure of Share Ownership. Considerable evidence exists that the traditional system of concentrated ownership is weakening across Europe. Data compiled by the Conference Board shows a measurable decline in the stakes held in the twenty-five largest corporations by banks and non-financial corporations in both Germany, France and Japan.[17] Traditionally, these

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[17] See Brancato, "Corporations Outside U.S. Become More Subject to Investor Demands," Corporate Governance Advisor, July/August 2000, p.1.

holders were the allies of the founding families and managements that ran the largest European and Japanese companies. Yet, over just a one year period between September 30, 1998 and September 30, 1999, these traditional stakeholders unwound their holdings to the following degree:

Closely Held Ownership in
25 Largest Corporations[18]

	September 30, 1998	September 30, 1999
France	33.5%	30.2%
Germany	24.2%	17.8%
Japan	21.2%	14.0%

Of course, a one year trend may be unrepresentative, and this data does not demonstrate that the shares so unwound necessarily moved into the hands of public investors. Yet, there is also evidence of a substitution effect: that is, the shares are passing into the hands of more activist owners. Thirty-five percent of outstanding shares of the forty largest companies on the Paris Bourse are now held by American and British institutional investors.[19] Over this same period, U.S. institutional investors have dramatically increased their investments in foreign equity. The largest twenty-five U.S. pension fund holders of international equity held $110.8 billion in foreign equities in 1996, $181.1 billion in 1998, and $265.6 billion in September, 1999 -- a nearly 150% increase in only two years.[20] With this heightened ownership comes, of course, a demand for

[18] Id. at 3.

[19] See Tagliabue, "Resisting those Ugly Americans," N.Y. Times, January 9, 2000, Sec. 3, p.1, 10.

[20] Id. at 3.

additional voice.

More importantly, many expect that this rate of change will soon accelerate, at least in some of the largest and most traditional European economies. In Germany, a high capital gains tax locked financial institutions into their elaborate web of cross-shareholdings, because any attempt to liquidate these blocks would have been punitively taxed.[21] Yet, effective January 1, 2002, the capital gains tax on such investments has been eliminated, and some of the largest German financial institutions have already announced plans to reduce the extent of their cross-shareholdings.[22] The apparent eagerness of German financial institutions to divest themselves of long-held blocks and to scale back non-core assets raises the always lurking question about how deeply the German system of concentrated ownership was truly entrenched. Professor Roe and others have suggested that concentrated ownership (and correspondingly weak securities markets) reflect a strong social and political commitment to a cluster of social values that he calls "social democracy."[23] Yet, if a simple change in the corporate tax laws causes the system to collapse by the mutual consent of those locked into this system of cross-shareholdings, the simpler explanation for concentrated ownership may be that German tax laws either caused this system or, more likely, enforced its persistence well after competitive forces would otherwise have

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[21] Simonian, "Germany Unbound: Measures to Redeem the Country's Restrictive Tax Burden Have Delighted Many Businesses," Financial Times, August 10, 2000 p.14.

[22] Id. (noting plan of Allianz and Munich Re to reduce their cross-holdings).

[23] See Roe, supra note 7.

compelled its dismantling.[24]

(c) The Growth of European Stock Markets. Continental stock markets have long been thin and illiquid. For some political theorists, this was actually a virtue of European corporate governance because it protected corporate managements from the "tyranny" of a fickle stock market, preoccupied only with the short-term, and instead permitted long-term, "statesman-like" business planning by corporations in conjunction with their principal banks. Whatever the historical validity of this story, it now seems increasingly dated.

A particularly useful recent study shows that the number of firms listing on European stock changes rose sharply at the end of the 1990's:[25]

Table 3: Evolution of the number of stock exchange listed companies[26]

Network-oriented	1990	1993	1996	1999	% Growth (1990-1999)
Belgium	182	159	136	140	-23.1%
France (excluding Marche libre)	443	726	686	968	118.5%
Germany	548	568	579	1043	90.3%
Italy	257	242	244	247	-3.9%
Netherlands	222	239	217	233	5.0%

24 German scholars have also suggested that the German tax system may be the better explanation for at least the contemporary system of concentrated ownership in Germany. See Kubler, Comment: On Mark J. Roe, German Codetermination and the German Securities Market, 5 Colum. J. Eur. L. 213, 214 (1999).

25 See Van der Elst, "The Equity Markets, Ownership Structures and Control: Towards an International Harmonization?" (Working Paper, Financial Law Institute, Ghent University, Belgium) (April, 2000).

26 Id. at 5.

Spain	429	464	357	718	67.4%
Japan (Tokyo)	1627	1667	1756	1838	13.0%
Market Oriented					
U.K.	1946	1927	2339	2292	17.8%
USA (Nasdaq)	3876	4310	5167	4829	24.6%

Although the pattern is far from uniform, the equity market grew rapidly in the late 1990's in France, Germany and Spain. Elsewhere, the number of listed companies may have declined, possibly because of an international wave of mergers and acquisitions, which is itself a sign of convergence.

Beyond this growth in the number of listed companies, two other statistics reveal even more clearly the suddenly increased role of the equity markets in European economies, which transition again seems to date only from the latter half of the last decade. First, stock market capitalization as a percentage of GDP skyrocketed in several European countries -- indeed, to the point that it now equals or exceeds the same ratios in the U.S. or the U.K. The following selected examples show how long-stable percentages veered suddenly upward at the end of the decade.

Table 6: Evolution of market capitalization as percent of GDP (1990-1999)[27]

Network-oriented	1975	1980	1990	1996	1999
Belgium	15%	8%	33%	44%	84.8%
France	10%	8%	26%	38%	117.9%
Germany	12%	9%	22%	28%	76.7%

[27] Id. at 8.

Italy	5%	6%	14%	21%	71.3%
Netherlands	21%	47%	42%	95%	205.1%
Spain	-----	8%	23%	33%	87%
Switzerland	305	42%	69%	136%	293.1%
Market Oriented					
U.K.	37%	38%	87%	142%	247.5%
U.S.	48%	50%	56%	114%	184.5%

Of course, these percentages are subject to greater fluctuation in countries with small populations or modest GDP's (such as the Netherlands and Switzerland), and much of the market capitalization in these countries may remain in the hands of controlling owners. Nonetheless, the real point is the suddenness of the transition. Essentially, as the European market integrated in the mid-1990's, stock market values soared, both in absolute terms and as a percentage of GDP.

Second, while IPO's once characterized only the U.S. and the U.K. markets, they have become common across Europe. In 1999, Germany saw 168 IPOs; and France, 75; for the decade, France led with 581 IPOs, Germany followed second with 380, and Spain, a close third with 355.[28] The significance of this point bears emphasis, because systems of concentrated ownership were thought to lack the institutions necessary to bring new companies directly into the equity market. Instead, new firms were believed to be dependant on bank and debt financing, not equity finance. Yet, by the end of the decade, several European countries were raising more equity through initial public offerings as a percentage of GDP than were either the U.S. or the

[28] Id. at 9.

U.K.[29]

There is a double-edged significance to these findings. On the one hand, by the end of the last decade, the stock market was raising equity capital for European issuers at levels (and percentages of GDP) which were thought to characterize only market-oriented systems of corporate governance (i.e., the U.S. and the U.K.). But, on the other hand, this sudden surge in the use of equity finance has occurred unaccompanied by any significant increase in the legal protections afforded to minority shareholders. In this sense, both the "path dependence" theorists, who maintain that the stock market cannot grow in "social democracies," and the economists (most notably, LLS&V), who maintain that the availability of equity finance depends on minority protections, appear to have been confounded. Neither the "path dependency" claim nor the assertion that "law matters" can draw unambiguous support from this evidence.

Institutionally, it is also clear that new market institutions and structures are appearing. A race has begun to create the first pan-European stock market. Easdaq, which began trading as a pan-European exchange in November, 1996, has been a modest success, but lists only some 62 issuers as of August, 2000.[30] The German Neuer Markt, which has over 300 listings, appears to have overtaken it in the competition for high-tech listings, but still newer entrants have entered the competition including Tradepoint, an American ECN, which has linked up with the SWX

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[29] Van der Elst finds, that, both the Netherlands and Spain raised significantly more equity capital in IPO's as a percentage of GDP than did the U.S. or the U.K. Id. at 10. Nor is this simply an artifact of small GDP size, as in 1999 Germany raised equity capital equal to 1.02% of its GDP through IPO's, while the U.K. raised only 0.6% and the U.S. 1.23%.

[30] See Karmin, "World Stock Markets: Europe's Easdaq Finds that Success Doesn't Come Easy," Wall Street Journal, August 14, 2000, C-1, at C-14.

Swiss Exchange.[31] Currently, the pending merger between the London and Frankfurt Stock Exchanges, has been disrupted by a hostile takeover bid by the Swedish stock exchange for the London exchange and may yet be further challenged by another rival bid made by the Paris, Amsterdam and Brussels exchanges.[32] Whatever the outcome of this competition, the key point is that the dominant exchange in the near future will clearly be pan-European and supra-national. To this extent again, path dependent theories may not apply well to supra-national institutions.

(d) The Emergence of the Market for Corporate Control. In market-centered economies, the market for corporate control is the ultimate disciplinary mechanism; and the hostile takeover, its final guillotine. In contrast, in concentrated ownership systems of corporate governance, the takeover has historically played only a minor role. But, once again, that pattern appears to be changing and rapidly. In 1986, 86 percent of all takeover involved at least one American party, but in 1999, this percentage fell to only 40 percent.[33] Over the same time span, the percentage of corporate takeovers involving at least one European party rose from 15 percent to 43 percent (and the percentage involving an Asian party rose from approximately 2 percent to nearly 14 percent[34]). If one looks instead to the market value of these transactions, takeovers involving a

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31 Id. More importantly, some 500 fledgling firms are now listed on one or more of these new markets for start up firms. Id.

32 See "Euronet and Reuters Are Said to Consider their Own LSE Bids," Wall Street Journal, September 5, 2000 at p. A-25.

33 Stokes, "The M&A Game's Global Field," National Journal, July 15, 2000 at p. 2290.

34 Id.

European party grew from 11 percent of the world total in 1985 to 47 percent in 1999.[35] Evidence of this sort has led some scholars to describe the last two years as amounting to the "First International Merger Wave."[36]

What is driving this transition? One answer starts from the integration of European currencies into the Euro. One consequence of a single, unified currency has been the growth of a unified European corporate bond market, which tripled in size last year and has thereby ended the dependence of European acquirers on bank financing.[37] Acquirers can now directly access the capital markets, offering either debt, equity, or a package of both. To this extent, the growth of the takeover market has been concomitant with the declining role of the universal bank.

For the future, the adoption of the 13th Company Law Directive by the European Union is the clearest signal that this trend will continue.[38] In part, it requires all EU members states to legislate (over a four year time period) to bar anti-takeover defensive measures after a takeover has been announced. Even if compliance with this directive is uneven (as seems likely), the more important point is that the legitimacy of the takeover as a mechanism of corporate governance has been accepted. Indeed, the passivity of a German labor government in the face of a hostile takeover bid by a British acquirer (Vodafone) for a German target (Mannesmann) in 1999 already

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35 See Black, <u>The First International Merger Wave (and the Fifth and Last U.S. Wave)</u>, 54 U. Miami L. Rev. __ (forthcoming in 2000). (p. 4 of draft version).

36 Id.

37 See Stokes, supra note 33, at 2291.

38 See "EU Passes Takeover Directive," Financial Times, June 20, 2000 at p. 28; see also "Financial Times Survey -- International Mergers and Acquisitions: The weak will become prey," Financial Times, June 30, 2000 at p. 4.

demonstrated this change in attitude (at least for Germany). Only in a few countries (most notably, the Netherlands and France) does real opposition seem to remain, and even then the objection is more to the foreign character of the bidder, not the use of the takeover device, itself. Finally, a common international business culture has at least begun to develop around the use of the takeover. A wave of international mergers between law firms (chiefly between U.S. and British firms and British and Germany firms) has reportedly been driven by the perceived need to effect cross-border acquisitions.

(e) A Preliminary Evaluation. Why now? The integration of Europe has been in progress for several decades, and the emergence of the transitional economies in the wake of the collapse of the Soviet Union is itself over a decade old. Why have stock markets suddenly surged, takeovers become accepted, and IPOs crested? Both a psychological and a political account seem necessary. Overused as the concept is, a paradigm shift seems in progress.

At the political level, one possible story is that regulators came to sense that economic growth depended on the encouragement of venture capital and high-tech startup firms. Bank financing for such ventures is generally unavailable and also unattractive to the entrepreneurs. In this light, the success of the Neuer Markt (and other incubator stock markets) was necessary if Europe was not to fall rapidly behind the U.S. From this perspective, policy planners saw at least some transition to a market centered economy as central to economic growth. Yet, even if this story sounds plausible, regulators have done relatively little to drive the foregoing transition.

Thus, the more plausible explanation is that economic changes have produced regulatory changes, rather than the reverse. The 13th Company Law Directive (known popularly as the "Takeovers Directive") may be a leading case in point; it has come in the wake of a de facto acceptance (at least throughout much of Europe) of the hostile takeover. Similarly, there is evidence that insider trading prohibitions have recently been widely adopted around the world -- in the wake of greater depth and diffusion in securities markets.[39] Mass privatization first deepened securities markets across Europe and thereby created a constituency that came to desire fairer rules.

Such a sequence seems predictable. Legal changes may have to await the appearance of a constituency to lobby for them. Mass privatization came overnight to the Czech Republic, and its securities market soon crashed, at least in part because of the absence of investor protections. Only then, several years later, were statutory reforms adopted to protect minority shareholders. Pistor has generalized that the same responsive reaction of law to economic change has characterized the adoption of common law reforms by transitional economies.[40]

Thus, with the growth in European securities markets, a constituency for reform (or at least enhancement) of European securities regulation may soon coalesce. What would its objectives be? Once a truly pan-European securities market comes into existence, the next logical step would be the responsive creation of a European SEC to enforce a harmonized system of securities regulation. But such a step requires, first, the unequivocal emergence of pan-European securities market that is supra-national in character and, then, public dissatisfaction with its performance. The history of both the U.S.'s and the U.K.'s system of securities regulation, as next discussed, suggests that such a reform program may only succeed once it is scandal driven.

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[39] See Laura Beny, "A Comparative Investigation of Agency and Market Theories of Insider Trading," Harvard Law School Discussion Paper No. 264 (Sept. 1999).

[40] See text and notes supra at notes 13 to 15.

Both the pan-European market and the requisite scandals have not arrived.

(f) The Status of the Insider Dominated Firm. While takeovers have come to Europe and securities markets have deepened and securities regulation may toughen, all this should not obscure the still unchanged status of the insider dominated firm. Even if ownership concentration has broadened marginally, the average free float of German listed companies has been estimated at only 32 percent, and 89 percent of all listed companies have a single shareholder controlling more than 25 percent of its equity.[41] Although many of these holders seem prepared to sell once the German capital gains tax is eliminated on January 1, 2002, the critical question becomes to whom they will sell: to a single purchaser of its controlling block or to the market generally through a secondary offering.

Those who believe that path dependent forces will limit corporate convergence and preclude the appearance of "Anglo-Saxon" style dispersed ownership make the powerful argument that blockholders will continue to find it more profitable to sell control to new controlling purchaser than to break up the controlling block through a secondary offering.[42] Indeed, precisely this pattern of controlling blocks remaining intact after an initial public offering has long been observed in Scandinavia.[43] But, as next discussed, that pattern can change and did so change in both the U.S. and the U.K.

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41 See Financial Times Survey -- International Mergers and Acquisitions, supra note 38.

42 Bebchuk, "A Rent Protection Theory of Corporate Ownership and Control," NBER Working Paper No. 7203 (July 1999).

43 See Martin Holmen and Peter Hogfeldt, "A Law and Finance Analysis of Initial Public Offerings," (Working Paper 2000).

Part II: When Does Separation of Ownership and Control Arise?: A Historical Perspective

Most of the participants in the recent debate over corporate convergence have implicitly agreed on one (and possibly only one) theme: deep, liquid securities markets arise only under special conditions. LLS&V have emphasized the legal backdrop: dispersed ownership is possible in their view only when the legal system provides adequate protection for minority shareholders. While stressing a path dependency perspective, Professor Bebchuk has formulated a model that essentially states the reverse side of this coin: when the private benefits of control are high, dispersed share ownership will be a transient state, and controlling blockholders will eventually re-appear.[44] In such an environment, leaving control "up for grabs" would, he argues, only attract attempts by rivals to seize control and extract the private benefits of control. Hence, the firm's initial owner will not find it in his or her financial interest to sell a potentially controlling block of shares to the market, but will instead sell only to another incoming controlling blockholder.

These two positions do not conflict. Because the private benefits of control are likely to be highest when the law fails to accord minority shareholders "adequate" legal protections, the positions of LLS&V and Bebchuk basically dovetail. Finally, Professor Roe's view that the separation of ownership and control does not arise, except under certain political preconditions, also implies that the evolution of deep and liquid securities markets is an exceptional event. In common, all these theories suggest that liquid securities market should not naturally evolve -- absent the prior satisfaction of special legal and/or political preconditions.

Yet, modern history seemingly supplies two counter-examples. Beginning in the last quarter of the 19th Century and culminating no later than the 1930's, the largest private businesses

[44] Bebchuk, supra note 42.

in both the United States and the United Kingdom were converted into publicly owned corporations.[45] In this process, control generally passed from families to the market.

More importantly, although both the timing and dynamics differed notably between these two countries, one common denominator was shared: neither country provided strong legal protections for minority shareholders during this period. Moreover, at least during the late 19th Century in the United States, the private benefits of control appeared very high indeed -- indeed to the point, that the exploitation of minority shareholders resembled that which has occurred in Russia and other transitional economies over the last decade. Finally, although one can reasonably debate the timing of this transition, dispersed ownership persisted and grew in both countries during periods in which the local political environment arguably satisfied Professor Roe's definition of "social democracy:" namely, the U.S. during the New Deal and the United Kingdom during the labor governments of the 1940s and 1970s.

How then did these markets evolve? As next discussed, their experiences have less in common than their shared legal institutions or common cultural heritage might suggest. Instead, by very different means, both countries made it possible for corporate control to be held by the market -- with the result that a company's initial owners could find it as profitable to sell control to the market as to an incoming controlling shareholder.

A. The U.S. Experience. The growth of public securities markets in the United States in

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[45] There is some dispute about when the separation of ownership and control truly arrived in the U.K. Professor Cheffins reviews the alternative views, one of which dates the transition as of the1920's and the other as of mid-century. See Cheffins, Does Law Matter?: The Separation of Ownership and Control in the U.K. (Working Paper 2000). For present purposes, the arrival of broad public ownership, which came earlier, is the immediate focus.

the 19th Century was driven by the enormous financing requirements of its railroads. The financial infrastructure that their insatiable demands for capital created was later utilized, with only modest adjustments, to serve the similar financial needs of the steel, auto, and telephone industries in the early 20th Century. Because the greater geographic distances to be connected in the United States implied that the capital costs were necessarily higher than in Europe, financing the railroad industry in the U.S. necessarily required the infusion of foreign capital. An estimated 40% of this capital came from Europe,[46] most of it funneled through London, which had already developed an expertise in international finance.[47] This constantly increasing demand for capital and the reliance on foreign investors in turn produced two basic innovations that appeared in late 19th Century America in order to maximize the reputational capital underlying major stock issuances: (1) a corporate governance system in which investment bankers, originally protecting foreign investors, took seats on the issuer's board both to monitor management and to protect public investors from predatory raiders seeking to acquire control by stealth; and (2) the growth of self-regulation through stock exchange rules.

(i) The Role of Investment Bankers. The financial infrastructure that arose in second half of the 19th Century in the United States was designed to satisfy relatively sophisticated investors in countries that were at the time more financially developed. The first generation of the new American investment bankers were in essence bond salesman to Europe: August Belmont was

[46] See L. Englebourg and S. Bushkoff, THE MAN WHO FOUND THE MONEY: John Stewart Kennedy and the Financing of the Western Railroads (1996) and Chandler, SCALE AND SCOPE (1990).

[47] See R. Michie, THE CITY OF LONDON: Continuity and Change, 1850-1990 (1992) at 72-79, 109-111.

widely known as the Rothschild's agent in the United States, and even J.P. Morgan, himself, was the American representative of an Anglo-American investment bank founded by his father with British investment bankers.[48] These firms grew to dominance based on their ability to recruit foreign capital.[49]

As elsewhere, the financial institutions that arose in the United States were primarily engaged in the marketing of debt securities. Expanding into equity securities was essentially equivalent to an established merchant adding an additional product line; both the merchant and the investment banker carried its reputational capital with it into the new business. This extension into equity securities probably occurred earlier in the U.S. because of the highly leveraged status of U.S. railroads. Inevitably, there are limits on the degree of leverage that any business firm can tolerate, and the greater capital needs of U.S. railroads thus implied that public equity issuances were necessary. In consequence, public equity markets developed earlier in the United States than elsewhere, even though the overall U.S. securities market was substantially smaller than the English market.

Formal corporate governance in these early railroad corporations did little to protect

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48 See V. Carosso, THE MORGANS: Private International Bankers, 1854-1913 (1987). On August Belmont's role as the American agent of the Rothschilds; see V. Carosso, INVESTMENT BANKING IN AMERICA (1970) at pp. 9-10.

49 For example, it is noteworthy that, as late as World War I, 18% of the stock of U.S. Steel, a firm founded by J.P. Morgan & Co., was still owned by foreign investors. See R. Michie, THE LONDON AND NEW YORK STOCK EXCHANGES, 1850-1914 (1987) at p. 56. It seems likely that higher percentages of stock in the largest U.S. corporations would have been held by foreign investors as of the end of the 19th Century and that their investment decisions would have been coordinated, on at least strongly influenced, by their American investment bankers.

minority shareholders. Not only did control groups quickly form, but in some cases the objective of these blockholders was primarily to manipulate the stock price of their corporation. The story of the epic battle for control of the Erie Railroad -- the "Scarlet Lady of Wall Street" -- between Commodore Vanderbilt, on one side, and Jay Gould and Daniel Drew, the leading stock manipulators of the era, on the other, has been told many times,[50] but it deserves a further reconsideration in light of the recent debates over comparative corporate governance. At the high point of the "Erie War" in the late 1860's, the Gould/Drew faction, which controlled the board, essentially prevented Commodore Vanderbilt from buying control of Erie in the open market by selling convertible bonds at heavily discounted prices to their allies, who would convert the bonds into stock in order to dilute Vanderbilt's voting power. Although not as elegant a takeover defense as the "poison pill" of the late 20th Century, this tactic worked very effectively. Even though Vanderbilt secured judicial injunctions against this tactic (possibly by bribing judges), they were ignored by the Erie control group, who secured rival injunctions from the judges that they bribed. Ultimately, Gould bribed sufficient members of the New York State Legislature to obtain passage of legislation that legitimized his tactics.

What was the lesson here? Essentially, the Erie control battle illustrated the manner in which regulatory arbitrage, carried to the extreme, could nullify minority legal protections. In the absence of any federal regulatory authority, the contending sides could move from jurisdiction to

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50 For standard accounts, see J. Grodinsky, JAY GOULD 1867-1892 (1957); John Steele Gordon, THE SCARLET WOMAN OF WALL STREET (1988). For a recent and highly relevant review of Gould's manipulative schemes from a corporate law perspective, see E. Rock, Encountering the Scarlet Woman of Wall Street: Speculative Comments at the End of the Century, University of Pennsylvania Law School, Institutes for Law and Economics, Working Paper No. 276 (December 1999).

jurisdiction, seducing courts and legislatures. To be sure, in less epic battles, the parties could not afford the transaction costs of massive corruption, but the real point is that investors were vulnerable less because of the substantive inadequacy of American corporate law itself than because of the lack of enforcement mechanisms and the prospect of corruption. In truth, substantive corporate law in the U.S. during this era was arguably favorable to the minority shareholder. Most state statutes restricted the issuance of "watered' stock, the derivative suit had been recognized by the Supreme Court as a legal mechanism to protect minority shareholders, and the law of fiduciary duties generally required any corporate official who engaged in a self-dealing transaction with his firm to prove its "intrinsic fairness."[51] But, once the investor had committed his capital, he might discover that the corporation had migrated to another, more permissive jurisdiction or that its founders had amended its certificate of incorporation or caused the legislature to amend the law to give them greater freedom to exploit the public investor.[52] Or, a judge would simply be bribed to accept some pretext for clearly predatory misbehavior. Because of these risks, some prominent underwriters (including Kuhn, Loeb) refused until the very end of the Century to underwrite the common stock of industrial corporations.[53]

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51 Later, many of these rules were relaxed. For a review of American corporate law at this late 19th Century stage, see Friedman, A HISTORY OF AMERICAN LAW (2d ed. 1985) at 511 to 525. Harold Marsh has also surveyed the status of the officer and director's fiduciary duty to the corporation during this era and concluded that strong prophylactic rules against self-dealing existed. See Harold Marsh, Jr., Are Directors Trustees? 22 Bus. Law. 35 (1966).

52 Friedman, supra note 51, at 523-25.

53 See V. Carosso, INVESTMENT BANKING IN AMERICA, supra note 47, at 43-44 (noting that Jacob Schiff of Kuhn Loeb and others considered such investments to be of dubious value, principally because of the inadequate disclosures made by these corporations).

Given these legally primitive conditions plus the need to attract capital from foreign investors who clearly could not hope to stay abreast of current developments from across an ocean, investment bankers hoping to interest such investors in the equity securities of U.S. corporations had to find some means by which these corporations and their entrepreneurs could credibly bond their promises. Foreign investors might buy debt and equity securities on the reputational capital of merchant bankers like J.P. Morgan, but this implied in turn that these agents had to develop a governance structure that enabled them to fulfill their representations to their clients that their investments were safe and sound.

One means to the end was developed by J.P. Morgan & Co.: namely, placing a partner of the firm on the client's board. Up until World War I, the American investment banking industry was extremely concentrated, and any flotation of more than $10 million invariably was underwritten by one of six firms, of which the largest was J.P. Morgan & Co.[54] Given their market power and the desires of distant investors for a "hands on" representative protecting their interests, it became common in the United States (but much less so in the U.K.) for the investment banker to place one or more representatives on the issuer's board. During the last two decades of the 19th Century, virtually every major U.S. railroad developed close ties with one or more U.S. investment banking firms, and the practice of partners from investment banks and officers of commercial banks going on the railroad's board became institutionalized.[55]

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54 See also, R. Michie, THE LONDON AND NEW YORK STOCK EXCHANGES, 1850-1914 (1987) at 226-227.

55 See V. Carosso, INVESTMENT BANKING IN AMERICA: A History (1970) at 32-33. It should be noted that one firm (Kuhn Loeb & Co.) characteristically did not place its representatives on the issuer's board. It was seemingly the exception that proved the rule, but it may have limited its clientele to firms that found other

Recent research by financial economists suggests that these practices were both widespread and created value for investors. One survey of just the financial industry has found that during this period J.P. Morgan & Co. held twenty three directorships in just thirteen banks; First National Bank, which worked closely with J.P. Morgan, held fourteen directorships in other banks, and National City Bank held thirty-two such positions in sixteen banks and trust companies.[56] More importantly, Professor Bradford De Long has assembled evidence suggesting that the presence of a J.P. Morgan & Co. representative on an issuer's board of directors added approximately 30 percent to the value's of the firm's common stock equity.[57]

But why? Financial economists have theorized that such a representative enabled bankers to monitor the firm's mangers and investment projects, replacing those managers that were substandard and rejecting unpromising investment projects.[58] Perhaps, this sometimes happened. Still, the problem with this simple "agency cost" story is that investment bankers have generally not been viewed as activists in corporate governance, in part because any agent, including an investment banker, who intervenes aggressively in the principal's business risks losing the client. Perhaps also, these investment bankers on the boards of competing firms sometimes served as a

means by which to bond their commitments to investors.

56 See Ramirez, Did J.P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century, 50 J. Fin. 661, 664-65 (1995).

57 See J. Bradford De Long, "Did J.P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism," in INSIDE THE BUSINESS ENTERPRISE: Historical Perspectives on the Use of Information (Peter Temin (ed.)) (1991), at 205-249.

58 See Delong, supra note 57.

mechanism for price collusion (as reformers in the Progressive Era clearly believed).

Still, an alternative, simpler and non-exclusive hypothesis merits consideration: the fundamental agency problem facing public investors in this era was not that their managers would expropriate wealth, but that incoming controlling shareholders would.[59] Hence, the presence of a major investment banking firm on the corporation's board offered mutual advantages both to the minority investors and to the corporate management by protecting both from the prospect of a stealth attack by a corporate raider seeking to acquire control without paying a control premium. That is, while the presence of the investment banker may have also reduced agency costs or prevented "disasterous" price wars, the greater problem at the end of the 19th Century was the instability of control and the relative inability of public investors to demand and receive a control premium for its transfer. Takeover raids occurred in the 19th Century,[60] but lacked the visibility of the later tender offer wars of the late 20th Century, precisely because the control seeker did not need to publicly offer to purchase a majority of the issuer's shares at a premium, but instead could assemble a controlling block at low cost by buying in the open market secretly. Because the major investment banking firms were positioned close to the market, they were logically in a position to detect such a raid and to finance a counterbid or design appropriate defensive

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59 A single-minded focus on managerial expropriation is probably a legacy of Berle and Means's continuing influence. More recent scholars have argued, however, that investors are more exposed to expropriation by controlling shareholders. See Sheifler and Vishny, <u>A Survey of Corporate Governance</u>, 52 J. Fin. 737 (1997).

60 See W. Werner & S. Smith, WALL STREET (1991). Jay Gould in particular was noted for conducting proxy fights after buying a substantial block of stock. Often, these contests produced a "greenmail" payment to him, or he would short the stock before announcing the end of his proxy contest. See M. Klein, THE LIFE AND LEGEND OF JAY GOULD (1986) at 197-205, 277-280.

measures. More importantly, they also spoke for the foreign investors, who were likely to act collectively based on the advice of their American agent.

This explanation of the investment banker's role as a protector of the public shareholder from attempts by "speculators" to steal a firm's control premium is not merely theoretical, but can be corroborated with actual examples. In the late 1880's, Kidder Peabody in conjunction with Barings, a British merchant bank, took control of the affairs of the Santa Fe railroad, which then was teetering on the brink of insolvency, placing three partners on its board. Kidder Peabody did not, however, hold a large equity stake itself, and so it devised a complicated voting trust strategy explicitly to defeat a perceived control threat from Jay Gould.[61] Indeed, even the redoubtable J.P. Morgan first made his reputation as a railroad financier when as a young man in 1869 he coordinated the efforts of the Albany & Susquehanna Railroad to fight off the attempt of Jay Gould and Jim Fisk to take control of that railroad in a battle popularly known as "the Susquehanna War."[62] After each side obtained rival injunctions and a pitched battle between small armies hired by both sides proved inconclusive, Morgan resolved matters by negotiating a merger of the Albany & Susquehanna Railroad into the larger Delaware & Hudson, thereby putting the target beyond Gould's reach. Morgan then went on the board of the new entity. However, neither Morgan nor other investment bankers in similar battles during this era sought to take personal control of the corporations they defended. Their role was rather that of an agent protecting their investors. "Board membership," as Ron Chernow has generalized, "became a

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[61] See V. Carosso, supra note 55, at 36-37.

[62] V. Carosso, THE MORGANS, supra note 48, at 121-122. For a fuller account, see R. Chernow, THE HOUSE OF MORGAN: An American Banking Dynasty and the Rise of Modern Finance (1990) at 31-32.

warning flag to ... [others] to stay away from a captive company."[63]

As a result, to the extent that public shareholders received protection from predatory raiders seeking to acquire control without paying a premium, public shareholders could afford to pay a higher premium for shares. Correspondingly, the firm's founders benefitted from such a relationship because they now could in effect sell control to the market, rather than having to retain a control block until a majority purchaser appeared. Moreover, to the extent that the initial owners remained active in management, they also gained protection from a subsequent disruptive hostile takeover if the public shareholders could not protect their position.

From a comparative perspective, the most interesting aspect of this hypothesis is that it helps explain why control was not transferred to the market by similar means across Europe. First, financial institutions closely corresponding to the House of Morgan either did not exist outside the United States or simply did not wish to accept the risks inherent in underwriting equity securities. Partly, this was because J.P. Morgan & Co. and its very few peers were highly capitalized, specialized institutions that, from the 1890s on, focused on basically two activities: (1) underwriting very large issuances of securities, and (2) arranging mergers and acquisitions. The leading English merchants banks were unwilling (until later in the 20th Century) to engage in Morgan's high-risk underwriting activities, which typically involved buying the entire issue from the company and then reselling it to the market. Instead, English merchant banks largely left this rule to more marginal players, known as "stock promoters," who also acted only as agents.[64] For

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[63] See Chernow, supra note 62, at 32.

[64] According to some authorities, British merchant banks did not become interested or heavily involved in underwriting domestic new issues until the 1920's. See Kynaston, THE CITY OF LONDON, Volume IV: ILLUSIONS OF GOLD, 1912-1925 (1999), at 135-136.

reasons discussed later, English underwriters tended to be smaller in size and thus less able to take such risks. In addition, they did not develop in an equivalent environment in which their client industries had a constantly expanding need for capital that required ever larger flotations.

Second, investment bankers in the U.K. did not represent the same cohesive and substantial fraction of the public shareholders as did an American investment banker serving as agent for the foreign investors in U.S. securities. Not only did foreign investors represent a smaller proportion of the U.K. equity market, but U.K. investment bankers, being smaller, would typically represent fewer domestic investors as well.

Finally, a third factor that played a role in both the growth of investment banking firms and the rapid appearance of dispersed ownership in the decades just before 1900 was the first great merger wave of 1895 to 1903. Historians believe that the merger wave of 1890 to 1905 was driven in large part by the passage of the Sherman Antitrust Act of 1890. That Act prohibited price-fixing and collusion among competitors, thereby outlawing the cartel-like structure that characterized many American industries. But if cartels of conspiring firms were forbidden, competitors could instead employ mergers to create monopolies -- at least until this was later also prohibited. In any event, the Sherman Act triggered a wave of horizontal mergers among competitors that in the process also dilute existing blockholders and thereby created dispersed ownership. The classic example was the consolidation of some eight competing steel companies into a new firm, U.S. Steel, in 1901; the transaction was engineered by J.P. Morgan and created the largest business corporation in the world. Such a firm was simply of a scale that was then beyond the ambitions of any potential raider, and hence its dispersed ownership was stable.

(ii) <u>The New York Stock Exchange As Guardian of the Public Investor</u>. The active role played by the New York Stock Exchange ("NYSE") in American corporate governance has been noted by others, but its path-dependent history has escaped serious attention. Exchange activism was not the norm elsewhere, and the NYSE's active efforts contrast sharply with the passivity of the London Stock Exchange ("LSE") or that of the European bourses generally. Much of the difference in behavior relates to corresponding differences in their organizational structures. Between 1870 and 1905, the membership of the LSE rose from 1,406 to 5,567.[65] In sharp contrast, the membership of the NYSE stayed constant. While admission to the LSE was "cheap and easy,"[66] entry to the NYSE could only be gained by buying the seat of an existing member. The closed structure of the NYSE had several important consequences: First, seats on the NYSE had significant value, and this encouraged the growth of large, diversified financial services firms (such as J.P. Morgan & Co.), while the typical British brokerage firm remained small in size, with typically only six to seven partners. Second, larger firms both enjoyed greater reputational capital and had a greater interest in protecting their reputational capital. Third, the small size of the NYSE implied logistical constraints on the ability of its membership to trade all securities for which a public market might have been made; necessarily, the NYSE's decision to limit its membership fragmented the U.S. equity market, creating a high quality upper tier and a lower quality tier that traded elsewhere on an over-the-counter basis.

Further encouraging different institutional dynamics was another difference in the two exchanges' organizational rules: NYSE member firms could raise capital from "special partners,"

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[65] See R. Michie, "Different in Name Only?: The London Stock Exchange and Foreign Bourses, c. 1850-1914" in THE DEVELOPMENT OF LONDON AS A FINANCIAL CENTRE (R. Michie, ed., 2000).

[66] Id.

and all partners in a firm were not required to be members of the exchange. In contrast, the LSE required all partners in a firm to be members of the exchange and further prohibited every member from engaging in any other business.[67] The relative freedom enjoyed by NYSE firms in obtaining capital also explains their larger size -- and their greater ability to engage in higher risk underwriting activities.

A final key difference was that throughout the late 19th Century the NYSE had fixed brokerage commissions, while the LSE did not (at least until just before the First World War). Again, this difference reflected the cartel-like organization of the NYSE in comparison to the "open market" character of the LSE. But because fixed commissions raise the cost of trading, this practice made the NYSE an unattractive venue in which to trade low volume stocks. Competitors could and did win the low volume business from the NYSE. In conjunction with the fact that the NYSE's small and fixed number of member firms could not logistically handle the trading in all firms that might wish to list on the NYSE, this circumstance led the NYSE to define its role narrowly and limit itself to a high volume, high quality business. In short, for economic reasons, the NYSE recognized by the mid-19th Century that it made sense for it to pursue a strategy of exclusivity.[68] Accordingly, it would deliberately list and trade only large issuers whose high volume trading could support minimum commissions. Thus, as of 1900, the LSE listed 3,631 different issuers of securities, while the NYSE listed only 1,157.[69] But this was the NYSE's choice, and the product of its decision to reject most listing applications.

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67 R. Michie, THE LONDON AND NEW YORK STOCK EXCHANGES, 1850-1914 (1987) at 256-257.

68 Id. at 272.

69 Id. at 264.

Another factor also reinforced the NYSE's preference for listing only large, high quality issuers: exchanges may be liable for the debts of a member firm that fails; at the least, its members will be exposed to significant losses upon the failure of a trading partner. Repeatedly, in the late 19th Century, financial panics had caused NYSE member firms to fail and had imposed significant liabilities on the failed firm's trading partners. Because the NYSE, being an essentially closed cartel, had far fewer members than the LSE, it also had more to fear from the failure of a member firm. Hence, to minimize the risk of member failure, the NYSE was far more conservative (and risk averse) about the securities that it would list. For example, it refused to list mining or petroleum companies during this period, because such securities were thought to be especially volatile.[70] The rationale here was less a paternalistic concern for the investor than a fear that in a financial panic a brokerage firm holding such securities could fail, resulting in losses borne by all NYSE members. In any event, the consequence was that to be listed on the NYSE, a company had to be at least five times larger than its counterpart on the LSE.[71]

From these differences in the organizational structure of the NYSE and the LSE, very different policies toward self regulation quickly emerged. From well before 1900, the NYSE saw itself as the guardian of the financial quality of the issuers listed on it. Perhaps, it imposed high listing standards for its own self-interested reasons, but it clearly did regularly reject issuer applications, either because the issuer lacked an adequate earnings track record, had insufficient assets, or was in an industry characterized by high risk. More importantly, under the NYSE's prodding, the standard of disclosure for public companies was significantly enhanced, and

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[70] Id. at 198 and 273.

[71] Id. at 272.

probably as a result, some financial historians date the advent of modern financial reporting from 1900, not from 1934.[72] In contrast, the LSE made no similar effort to police its securities market, at least until the period after the First World War.[73]

To sum up, for a variety of "path dependent" reasons, the NYSE organized itself as an exclusive, "high quality" securities market which would list only securities that were suitable for the public investor -- while the LSE did not. In the total absence of legal requirements, the NYSE imposed mandatory disclosure obligations on its listed firms. Correspondingly, the larger size of U.S. brokerage firms, which again was originally attributable to differences in the organizational rules of the NYSE and the LSE, gave U.S. brokers greater ability to underwrite securities and to pledge their reputational capital to their investor customers. These twin developments -- the development of a monitoring capacity by the NYSE and the bonding mechanisms first developed by U.S. underwriters to attract foreign capital -- constitute the twin pillars that supported the development of a liquid equity securities market in the United States. Such a public market arose far quicker in the United States than in the U.K. For example, by 1907, one Wall Street firm already had 22,000 customers,[74] indicating that it was providing services on a mass scale. Yet, the legal framework that today characterizes the U.S. securities markets did not arise until decades later.

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72 See D. Hawkins, "The Development of Modern Financial Reporting Practices Among American Manufacturing Corporations," in MANAGING BIG BUSINESS (R. Tedlow & R. John, Jr., eds., 1986) at 166, 167.

73 See R. Michie, THE LONDON STOCK EXCHANGE: A History (1999) at 115; see also Werner and Smith, supra note 58.

74 Michie, THE LONDON AND NEW YORK STOCK EXCHANGES, 1850-1914 (1987) at 228.

B. The British Experience. In contrast to the high listing standards that the NYSE imposed by the late 1800's, the LSE's basic policy was to list any security that was expected to generate business.[75] Only in "rare cases where something adverse was known about the security or the circumstances surrounding its issuance," would a listing application be denied for reasons other than lack of trading interest.[76] Of course, this attitude reflected the natural attitude of an "open" exchange with broad membership: more listings implied more business, and the failure of an occasional brokerage firm (which were characteristically smaller in size) did not constitute as serious a threat to the LSE as it did to the NYSE -- in part because the LSE had a considerably deeper capital base.[77] Finally, stock issuance were typically arranged in the U.K. by stock promoters, not the largest merchant banks. These promoters often had unsavory reputations and little reputational capital to pledge.[78]

Given the LSE's laissez-faire approach and, indeed, its caveat emptor attitude, it is thus not surprising that a public equity market developed more slowly in the U.K. than in the U.S. But the deeper question is: how did it develop at all? In the absence of high listing standards or

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[75] Michie, THE LONDON STOCK EXCHANGE (1999) at 96.

[76] Id.

[77] Michie, THE LONDON AND NEW YORK STOCK EXCHANGES, 1850-1914 (1987) at 272 (noting that the NYSE's capitalization was one third that of the LSE).

[78] For this common assessment, see W.A. Thomas, THE FINANCE OF BRITISH INDUSTRY (1978) at 23; D. Kynaston, THE CITY OF LONDON, Volume IV: ILLUSIONS OF GOLD 1912-1925 (1999) at 183, 457-58; J. Armstrong, "The Rise and Fall of the Company Promoter and the Financing of British Industry" in CAPITALISM IN A MATURE ECONOMY: Financial Institutions, Capital Exports and British Industry, 1870-1939 (J. Van Helten and Y. Cassis, eds., 1990) at 130-31.

underwriting practices that placed the reputational capital of credible financial intermediaries behind most offerings, why would public investors place trust and confidence in such a market?

Several tentative hypothesis can be advanced. First, less efforts may have been expended on self-regulation in the U.K. because judicial corruption and regulatory arbitrage posed less of a threat. In this light, self-regulation is again an example of a functional substitute which arose at least in part to solve the problem of endemic judicial corruption in the U.S. during the late 19th Century. Again, this is an illustration of "functional convergence." Second, there is some evidence that only wealthy private investors and financial institutions tended to invest in British equities (and chiefly in railroads) until at least the 1920's. Such investors might have relied on other agents or had other means by which to monitor. In any event, the democratization of the British market into a mass market seemingly lagged well behind the U.S. experience. Third, British substantive law did regulate securities offerings to a far greater degree than did U.S. law and from an early point beginning in the 1890's. Thus, although U.S. institutions moved more quickly to adopt self-regulatory standards, British mandatory law regulating disclosure was enacted well in advance of similar developments in the U.S. Different paths were thus followed at different speeds to an approximately equivalent end point. If one looks at the aggregate effect of mandatory law plus self regulation in both countries, the result by the middle of the 20th Century was arguably very similar. What one country did by legislation, the other did by self-regulation. One substituted for the other. That both could have arrived at the same point by different means is an example of what this author has elsewhere called "functional convergence."[79]

This claim that U.K. law did provide significant protections to minority investors will seem

[79] See Coffee, supra note 5, at 649-650.

surprising to many, because the contrasts between U.S. corporate law and British company law as of 1900 would all seem to favor the minority shareholders in the United States over their British counterpart. Basically, the U.K. shareholder had no appraisal right and only an ineffective derivative remedy, and the majority could ratify any conflict of interest transaction.[80] Worse yet, exculpatory provisions were permitted in the corporate charter that could cancel even the duty of loyalty.[81]

Still, a focus limited to substantive corporate law can mislead. The one respect in which Britain did lead the United States was in its statutory regulation of disclosure to investors. A series of stock market scandals in the U.K. in the 1870's had led to two "public enquiries" by Parliament, but had not produced legislation.[82] Then, in 1890, at the very outset of the relevant transitional period for U.K. purposes, Parliament overruled a judicial decision that had narrowly construed the law of fraud by enacting legislation that permitted investors to recover damages if (i) they suffered loss by reason of an untrue statement in a prospectus and (ii) those responsible for its preparation could not prove that they had reasonable grounds to believe that the statement was true.[83] Not until 1933 was U.S. law to reach a similarly pro-investor position when Congress

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80 For a review of U.K. law in this era, see Cheffins, Does Law Matter?: The Separation of Ownership and Control in the United Kingdom (Working Paper July 2000). See, in particular, North-West Transportation Co. v. Beatty, 12 App. Cas. 589 (P.C. 1887) (upholding majority ratification of self-dealing transaction).

81 See P. Davies, GOWER'S PRINCIPLES OF MODERN COMPANY LAW (6TH ed. 1997) at 611-12.

82 See R. Michie, THE CITY OF LONDON, Change and Continuity, 1850-1990 (1992) at pp. 2-3.

83 See Directors' Liability Act 1890, 53 & 54 Vict. Ch. 64 (U.K.) (overruling Derry v. Peak, 14 App. Cas. 337 (H.L. 1889)).

enacted the Securities Act of 1933, whose Section 11 contains a similar standard for prospectuses that was in fact modeled after this 1890 statute. The Companies Act of 1900 supplemented this antifraud standard by specifying what the prospectus offering securities had to disclose.[84] In 1907, the first step toward a mandatory continuing disclosure system was taken with legislation that required publication of an annual balance sheet.[85] Legislation in 1908 addressed (albeit in a limited manner) abuses in the new issue market.[86] Finally, in 1929, legislation obliged the issuer to provide an income statement and related data on current earnings.[87] Rudimentary as these requirements may seem today, they were enacted well ahead of corresponding legislation in the U.S., although they were slightly behind practices at the NYSE. As a generalization then, the U.K. seems to have led the U.S. in the area of securities regulation, but lagged the U.S. in terms of minority protections in its substantive corporate law. Not until amendments to The Companies Act in 1948 were strong restrictions on self-dealing enacted.

The reluctance of the LSE to play any regulatory role in the protection of investors began to change after the First World War.[88] In 1921, it adopted its first regulations governing the rights of members to deal in or quote a security,[89] and during the between-the-wars period, the LSE's Share and Loan Department began to make inquiries before listing a company into the

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[84] Companies Act 1900, 63 & 64 Vict. ch. 48, § 10(1) (U.K.).

[85] Companies Act 1907, 7 Edw., ch. 50, §§ 19, 21 (U.K.).

[86] See Paish, "The London New Issue Market," in THE DEVELOPMENT OF LONDON AS A FINANCIAL CENTRE (R. Michie, ed., 2000), Vol. 4, at 22, 24.

[87] Companies Act 1929, § 123.

[88] See R. Michie, THE LONDON STOCK EXCHANGE, supra note 75, at 115.

[89] See Paish, supra note 86, at 24-25.

company’s operations and the personnel connected with it. By the 1930's, the LSE’s own disclosure requirements for listed companies were more extensive than those set forth in the U.K.’s companies legislation.[90] Still, the LSE did not become a de facto regulator in partnership with the state until after the Second World War.

The willingness of the LSE to assume a greater regulatory role was to considerable extent scandal-driven. Following a speculative boom in new issues in the 1920's, a major scandal shook the LSE in1929, when a flamboyant promoter, Charles Hatry, was found to have fraudulently sold counterfeit shares in established companies, intending to buy them back before dividends were declared.[91] The Hatry scandal produced little, if any, legislation, but forced the LSE to accept some role as a guardian of issuer quality.[92] The LSE became less willing to list what today would be called “penny stocks” or development stage companies. By the 1950's, the LSE’s listing rules had been tightened to require issuers to reveal all material information on an ongoing basis.[93] Still, legislation establishing anything resembling a U.K. counterpart to the SEC did not come until the Financial Services Act of 1986.

If the LSE’s efforts at self-regulation seem in general to have been laxer than those of the NYSE, there is a later chapter in this self-regulatory story in which the U.K.’s efforts clearly outpaced those in the U.S. Takeover bids first began to appear in the U.K. in the early 1950's, and by late 1959, the first voluntary code of conduct had been drawn up, largely at the request of

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90 See Cheffins, supra note 80, at 27-28.

91 See R. Michie, LONDON STOCK EXCHANGE, at 162-63.

92 Id. at 268.

93 See L.C.B. Gower, PRINCIPLES OF MODERN COMPANY LAW (1954) at 437.

the Bank of England, to regulate them.[94] While often ineffective, this voluntary code eventually evolved by the late 1960's into the City Take-over Code and its now well-known Take-over Panel. In 1972, the Code was revised to require an acquirer to make a mandatory bid for all the target's shares once the acquirer crossed a specified threshold of stock ownership (generally 30%).[95] The effect of this provision was to protect the right of the public shareholder to share in any control premium and to discourage stealth raids that sought to acquire control without the payment of such a premium. The U.K.'s mandatory bid has, of course, now been incorporated into the 13th Directive, but the more relevant point is that it encouraged dispersed ownership by effectively allowing the value of control to be held by public shareholders.

Thus, we come full circle: by a variety of means, including a substantial self-regulatory component, both the U.S. and the U.K. developed legal and institutional mechanisms that enabled dispersed ownership to persist. Generally, these mechanisms followed, rather than preceded, economic changes, but they did protect and permit the survival and growth of dispersed ownership. Finally, conspicuously absent from this process was politics. No political party in either country appears to have actively raised the issue of securities market reform (or opposed such reform) as a major issue.

C. "Does Law Matter?" Reconsidered. Opponents of the U.S.'s mandatory disclosure system have long argued that SEC's disclosure requirements were unnecessary and costly because market mechanisms had already developed prior to 1933 to satisfy investors' real demand for

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94 See A. Johnson, THE CITY TAKE-OVER CODE (1980) at 19-20.

95 Id. at 91-92.

information.[96] In the U.S., there is at least some evidence consistent with this story, but in the U.K., there is very little. The LSE did not recognize any obligation to protect investors or screen issuers until well after the First World War, and serious efforts probably did not begin until after the Second World War. Yet, securities markets developed in each country -- in the U.S., in the absence of legislative protections, and in the U.K., in the absence of meaningful self-regulation or any significant private system for the pledging of reputational capital by financial intermediaries.

One possible way to read the U.S. and U.K. evidence is, of course, to reject the "law matters" hypothesis. If one looks only at the U.S. experience, one could plausibly assert that private market mechanisms proved adequate and investor interests were well served without statutory protections. As next discussed, however, this thesis seems increasingly weak, more the product of an ideological antipathy to all regulation than an even-handed approach to the available evidence.

The alternative hypothesis is that law matters, but not in quite the way that the LLS&V model assumes. Self-regulation may best be viewed as a partial functional substitute for formal legal institutions. It arose in the U.S. largely because of constraints on the judicial system (i.e., corruption plus the ability of the antagonists to pit one state's judges against another state's), even though substantive U.S. corporate law was probably relatively protective of minority

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[96] This debate, which goes back to the work of George Stigler and George Benston, in the 1960's, has been revisited by many commentators. See Stigler, Public Regulation of the Securities Markets, 37 J. Bus. 117 (1964); Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Am. Econ. Rev. 132 (1973). But see, Friend & Herman, The S.E.C.: Through a Glass Darkly, 37 J. Bus. 382 (1964). (arguing that Stigler's data demonstrates the positive impact of the federal securities laws); see also Simon, The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues, 79 Am. Econ. Rev. 295, 311-13 (1989).

shareholders. This pattern is consistent with recent developments in transitional economies, where recent econometric studies have found the "rule of law" and the "effectiveness" of legal institutions to be more important variables in determining the depth of capital markets and the structure of share ownership than the specific legal rules on the books.[97]

Although securities markets may be able to arise in the absence of strong legal protections for minority shareholders because of such functional substitutes, they are generally unable to persist or expand in such an environment. Sooner or later, they predictably encounter crises and experience a loss of investor confidence. Conceivably, a strong system of self-regulation (as in the case of the City Take-over Code) may prove adequate to this challenge, but the line between self-regulation and indirect governmental regulation is often difficult to define. More typically, even when a strong private institutional structure exists (as it did in the case of the NYSE), there are still important deficiencies which require legislative intervention in order to provide adequate enforcement. Legislative action is thus likely to follow, rather than precede, the appearance of securities markets because a constituency of public investors must first arise before there will be pressure for legislative reform that intrudes upon the market. In addition, the legislature cannot anticipate problems that it has never seen (much as it cannot legislate with respect to the Internet before the Internet has first appeared).

This assertion that legislative action will generally be necessary because private ordering will encounter inevitable limitations leads one back to a long-standing academic debate over the impact of the passage of the federal securities laws.[98] George Stigler, the first and still the most

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[97] See K. Pistor, M. Raiser, and S. Gelfer, Law and Finance in Transition Economies (EBRD Working Paper 2000).

[98] See sources cited at note 96 supra.

vehement critic of the rationale for the federal securities laws, found that the variance in the relative price performance of new issues of securities declined by almost half after the passage of The Securities Act of 1933.[99] Despite this dramatic change, Professor Stigler interpreted this data to mean only that riskier new issues were being excluded as a result of The Securities Act's passage. Subsequent economists have, however, interpreted this pronounced reduction in price dispersion to mean that greater pricing accuracy resulted.[100] Paralleling Stigler's work, George Benston focused on whether the new disclosure requirements mandated by The Securities Act had any real impact. In particular, he focused on the new obligation imposed by the 1933 Act to disclose sales data. While some firms already disclosed this data (but a substantial fraction did not), his research concluded that disclosure of sales data produced only a small, statistically insignificant decline in the riskiness of firms. Yet, as more recent economists have shown by re-interpreting Bentson's data,[101] there was an overall and significant decline of nearly one-third in the variance of the residuals of NYSE-listed firms.[102] Thus, even if the impact of mandatory disclosure of sales data was uncertain, the total package of new disclosures produced immediate and observable results that are logically interpreted as an increase in pricing accuracy. Collectively, these studies support the conclusion that the federal securities laws increased pricing accuracy and the amount of meaningful information in the market.

At least as important as any enhancement in pricing accuracy effected by the mandatory

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99 See Stigler, supra note 96, at 120-121.

100 See Friend and Herman, supra note 96, at 390-91; see also Merritt Fox, <u>Retaining Mandatory Disclosure: Why Issuer Choice Is Not Investor Empowerment</u>, 85 Va. L. Rev. 1335, 1369-1380 (1999).

101 Fox, supra note 100, at 1385-91.

102 Id. at 1376-1382.

disclosure system enacted by Congress was the system of enforcement and antifraud liability that came with the New Deal legislation. Severe constraints exist on both incentives and ability of a private body (such as a stock exchange) to enforce rules against its member firms and its listed companies. As we have earlier seen, the LSE did not make a serious effort until probably after the Second World War. While more activist as a self-regulator, the NYSE faced resistance from its listed companies when it sought to upgrade disclosure standards. For example, Merritt Fox has found that although the NYSE continually upgraded its listing requirements applicable to newly listed firms, it was unable (or unwilling) to apply these new rules to earlier listed firms (i.e., the great majority of the firms it traded).[103] This is but one example of the enforcement shortfall that is inherent in a self-regulatory system. Such a shortfall is likely for several different reasons: (1) A private body has weak incentives to enforce rules against its own members and clients; (2) Enforcement is too costly for a private body to undertake on a thorough-going basis; and (3) Private bodies necessarily lack the investigative tools and punitive sanctions that the state has at its disposal. Each of these factors is evident in terms of the factors that led to the adoption of the federal securities laws in the 1930's.

When the U.S. Congress enacted the federal securities laws in the early 1930's, it was dissatisfied not only with the level of disclosure in the securities market, but perhaps even more by the perceived pervasiveness of manipulative practices, including both the use of stock pools and short selling "bear raids" that were intended to panic investors and artificially drive down stock prices.[104] Stock pools were temporary joint ventures formed by a group of traders who bought

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[103] Id. at 1376-79.

[104] See Mahoney, The Exchange As Regulator, 83 Va. L. Rev. 1453, 1464-65 (1997). Although Professor Mahoney challenges the accuracy of this perception, the more important point is such perceptions are likely to persist, thereby eroding investor

and sold a stock pursuant to a common plan to drive its price up or down through their collective action. Revisionist scholars have recently doubted their significance,[105] but the contemporaneous sources treat their existence as a well understood fact.[106] Historians have also noted that the market manipulation constituted the one context in which the NYSE seldom, if ever, enforced its own disciplinary rules.[107]

This limited enforcement effort should not be surprising. It is not simply a matter of weak incentives, but also difficulty of proof. Conspiracies by their nature do not reveal themselves to the observer. Only the public enforcer can threaten criminal penalties or truly punitive civil fines, and only public authorities have investigative tools, such as the grand jury, search warrants, and subpoena power, at their disposal. Absent a public regulatory body, victims may be left to enforce their rights through private litigation, and the high costs of enforcement may make it inadvisable for at least the public investor to seek to rely on such remedies.[108] As a

trust and confidence in an entirely private system of self-regulation.

105 Id. at 1470-72.

106 Although Professor Mahoney disparages the Congressional findings that stock pools manipulated securities prices, he ignores the similar findings by economists in the 1930's who studied the operations of pools contemporaneously. See Twentieth Century Fund, STOCK MARKET CONTROL (1934) (surveying actual techniques used by stock pools in the 1930's).

107 See Banner, The Origin of the New York Stock Exchange, 1791-1860, 27 J. Legal Stud. 113, 138-39 (1998); Werner and Smith, WALL STREET, supra note 60, at 32 (1991).

108 This is particularly true in the U.K. where small investors may be deterred by the U.K.'s "loser pays" rule under which the losing side must pay the litigation expenses of the winning side. In the U.S., private enforcement constitutes a greater deterrent threat, principally because of the availability of the class action, which did not develop, however, until the late 1960's.

practical matter, the creation of the SEC gave public investors a public guardian to champion their rights -- in effect, a public subsidy for the prevention of fraud. This may be probably the most important way in which "law matters."

Even if one reaches the opposite conclusion and decides that the U.S. overregulated in the 1930's, while the U.K.'s system of more limited self-regulation was closer to optimal, this conclusion does not truly challenge the "law matters" hypothesis. Overregulation of allegedly phantom culprits -- such as the stock pool manipulator -- could be justifiable, and even necessary, to the extent that it restored the trust and confidence of investors and so preserved dispersed ownership. The critical point is that serious efforts at self-regulation to protect minority investors seem to have characterized only common law countries. Thus, the LLS&V thesis would remain more right than wrong, even if it has arguably overemphasized some particular substantive corporate law provisions.

The foregoing account of the rise of dispersed ownership in the U.S. and the U.K. is also inconsistent with the leading counter-thesis to the LLS&V hypothesis: namely, that politics determines everything, and legal differences simply flow from deeply rooted political values. Put simply, politics played no more than negligible role in the rise of dispersed ownership in either country. Although Professor Roe has provocatively argued that politics constrained the development of powerful financial intermediaries in the U.S.,[109] this hypothesis ignores that unconstrained institutional investors in the U.K. closely resemble their American counterparts, even though no regulatory inhibitions hobbled their growth.[110] Other things being equal, the

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[109] See Mark J. Roe, STRONG MANAGERS, WEAK OWNERS: The Political Roots of American Corporate Finance (1994).

[110] See Black and Coffee, Hail Brittania?: Institutional Investor Behavior Under Limited Regulation, 92 Mich. L. Rev. 1997 (1994).

simpler model is preferable to the more complex. Here, the simpler model is that financial institutions greatly value liquidity and so do not wish to hold large and illiquid equity stakes in business corporations.[111]

Even if politics cannot satisfactorily account for the development of dispersed ownership in the U.S. or the U.K., can it still account for the persistence of concentrated ownership in Europe? Is, as Professor Roe suggests, the "social democratic" character of European democracies the underlying cause of concentrated ownership? This claim rests on the behavioral premise that investors in such countries seek to avoid the culture of transparency that comes with the development of securities markets, because it would arguably subject them to even greater expropriation. The logical flaw in this reasoning is, however, that it ignores that "social democracies" would have an incentive to enhance transparency if they believed that concentrated ownership were an important defense mechanism. Logically, on Roe's behavioral premise, left-leaning governments should favor the development of securities markets in order to gain greater control over the private sector. In principle, one should then observe across Europe private investors opposing the development of securities markets and the left favoring their growth. The reverse is probably closer to the truth (although no strong opposition to the growth of securities markets is apparent across Europe today and broad support seems to exist).

The better historical and political argument for the bank-centered system of corporate governance that dominated Europe until recently is that it maximized state control of the

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[111] The author has argued this thesis at considerable length elsewhere, and will not belabor it further here. See Coffee, supra note 12. Suffice it to say that banks, as institutions with short term liabilities to depositors, have a major problem with making illiquid long-term investments.

economy.[112] Particularly in times of war and social turmoil during the last century, those in power -- whether socialist or fascists -- preferred a bank centered system, because large banks were ultimately more subject to state control than were securities markets. That securities markets have developed slowly across Europe thus may well have a "political" as well as a "legal" explanation, but that political explanation is more that power seeking nationalists could use banks as their agents and that banks, once entrenched, had natural reasons to resist the rise of rivals for their business.

Conclusion

Two conclusions and one implication for the future emerge from a historical examination of the rise of dispersed ownership: First, the role of private institutional structures -- most notably stock exchange rules and bonding mechanisms by which investment bankers pledged their reputational capital -- probably was more important than mandatory legal rules in the early rise of dispersed ownership. The relative role accorded to self-regulation probably depended on the strength or weakness of the formal legal institutions in the particular country. Arguably, self-regulation played a greater role in the U.S. than in the U.K., because judicial corruption and regulatory arbitrage were not significant problems in the U.K. This conclusion does not refute the LLS&V hypothesis that "law matters," but suggests that further inquiry is necessary as to why self-regulation developed and took deeper root in common law countries more than in civil law countries. Possibly, the more decentralized character of common law legal institutions facilitated the rise of both private and semi-private self-regulatory bodies in the U.S. and the U.K., whereas in civil law systems the state retained a relative monopoly over law-making institutions.

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[112] For one version of this thesis, see Rajan and Zingales, The Great Reversals: The Politics of Financial Development in the 20th Century, (U. Chicago Working Paper, June 2000).

Second, the rise of dispersed ownership in both the U.S. and the U.K. was not accompanied by any significant degree of political self-consciousness. In the United States, the Progressive Era reform movement passed national legislation regulating drugs, foodstuffs, and railroads, but left the securities markets for a later day. In the U.K., the legislative reforms that were adopted attracted little public attention or controversy. This is consistent with the broader pattern in which waves of securities regulation pass only in the period immediately following the burst of "bubble" markets.[113] More generally, if dispersed ownership arose principally through private ordering, law may still "matter" (although different legal institutions become central to the extent that they enabled or facilitated such private ordering), but politics matters much less. Indeed, politics seems relatively irrelevant because the rise of equity securities markets was relatively exogenous to ongoing political debates.

Political hostility to the rise of securities markets can be dimly discerned in Europe, but it dates back to the late 19th Century and was most evident at that time in Germany,[114] a country that could not then be called by any stretch of the imagination a "social democracy." In this light, the reliance of German firms on bank finance seems to have been less a matter of choice than of legislative restrictions on the issuance of securities.[115] But legislation restricting securities markets in Europe seems not to have been based not on class conflict, but rather on the moralistic sense that trading on the stock market was "little better than gambling."[116] The closer one looks, the

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113 See Banner, supra note 10.

114 See Michie, Different in Name Only? supra note 65, at 286-87 (finding that "German companies were denied the ease of access to finance via security issues that their British counterparts enjoyed").

115 Id. at 287.

116 Id. at 286.

more tenuous the connection becomes between the rise of the social welfare state and the suppression of securities markets.

If private institutional structures played the pivotal role in the rise of dispersed ownership in the U.S. and the U.K., what does this fact portend for European corporate governance? If, as just observed, politics has not been as central as the private institutional networks that enabled self-regulation and private bonding mechanisms to work, then the central implication for the future is that self-regulation might take hold in Europe and in the transitional economies, even though optimal legislation remains lacking. Indeed, to the extent that the "rule of law" is only tenuously established in some transitional economies (as it was in the U.S. during the Robber Barron era), self-regulation may outperform legal rules, because it can more effectively enforce its commands. Today, the most dynamic forces on the European stage are not the various efforts to secure harmonized corporate and securities law, but rather the quieter changes that are currently underway in the markets, themselves, including (1) the inexorable movement toward a pan-European stock exchange; (2) the increased activity of securities analysts with regard to European corporations with minority public ownership;[117] (3) the accelerating convergence in international accounting standards;[118] and (4) the current international wave of mergers and acquisitions. Even if legislation is ultimately needed to establish stronger minority protections, the U.S. and the U.K. experience suggest that if strong self-regulation can first bring about the appearance of deeper,

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117 On this important theme, see Chang, Khanna and Palepu, Analysts Activity Around the World, Harvard Business School Working Paper (January 23, 2000) (finding analysts able to penetrate and restate earnings of companies with concentrated ownership and non-transparent accounting).

118 See Land and Lang, Empirical Evidence on the Evolution of Global Accounting (Working Paper available on SSRN) (Sept. 2000) (finding strong evidence of such convergence).

more liquid securities markets, such legislation will predictably follow. Indeed, self-regulatory initiatives have begun to play a critical role in the development of European securities markets, particularly in countries where the prevailing legal rules seem weak.[119] Once these forces have created a stronger constituency for open and transparent markets, that constituency will demand and obtain the necessary legislative reform that fills in the inevitable gaps. If this occurs, the past would once again become prologue.

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119 The clearest example is the Neuer Markt, the rapidly growing German stock market for start-up companies, which prides itself on being both the "most regulated market" and the fastest growing. In just over three years, it has grown from 2 to 302 listed companies with a collective market capitalization of $172 billion. See Fuhrmans, "Playing by the Rules: How Neuer Markt Gets Respect," Wall Street Journal, August 21, 2000 at C1. The Neuer Markt has substantially higher listing and disclosure standards than does the Deutsche Borse, its parent. Moreover, German corporate law ranks relatively low on the LLS&V scale of minority protection. The Neuer Markt thus stands as a modern example of what the NYSE did in the late 19th Century: i.e., establish itself as a higher quality market through self-regulatory standards that were more stringent than those established by prevailing law. As it succeeds, such a market pledges its reputational capital to investors that it will continue to uphold these standards.