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The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control

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THE RISE OF DISPERSED OWNERSHIP: The Role of Law in the Separation of Ownership and Control

by John C. Coffee, Jr
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Abstract

Deep and liquid securities markets appear to be an exception to a worldwide pattern in which concentrated ownership dominates dispersed ownership. Recent commentary has argued that a dispersed shareholder base is 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 shareholders, (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.

But can this trend persist in the absence of strong legal protections for minority shareholders and in the presence of high private benefits of control? To understand how dispersed ownership might both arise and persist 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 Centuries in the U.S. and the U.K. and contrasts their experience with those of France and Germany over the same period. 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 Barons of the age bribed judges and legislators and effectively employed regulatory arbitrage to escape even minimal anti-fraud 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.

In contrast to the New York and London Exchanges, the Paris Bourse over this same period made little, if any, effort to develop a self-regulatory structure or to upgrade listing or disclosure standards. Why not? The answer seems closely associated with the fact that it operated as a state-administered monopoly whose stockbrokers were formally considered civil servants and who were legally denied the ability to trade as principals for their own account. Facing no competition and composed of members having little incentive to promote or enhance its reputational capital, the Paris Bourse did not innovate and fell behind the London Stock Exchange. The intrusive role of state regulation, which discouraged private self-regulatory

initiatives, appears to have a factor in its competitive decline. In Germany, the state strongly supported the growth of large private banks but imposed a high stamp tax on securities transactions that quickly chilled the then growing securities market. In addition, because the German central bank offered very liberal rediscounting terms to the principal private banks, German banks were in effect subsidized in their role as providers of capital to German heavy industry, while the securities market was correspondingly denied the ability to extend credit by punitive legislation enacted in 1896. In this respect, concentrated ownership seems less to have evolved naturally than to have been subsidized by the state.

What then are the preconditions for the separation of ownership and control? The U.S. and European experiences in the late 19th Century suggest that the first step is the separation of the market from politics. When, as in late 19th Century France, the government administers the market, the market suffers. Although proponents of the "law matters" hypothesis argue that liquid securities markets cannot develop in the absence of a legal system that protects shareholder rights, the U.S. and U.K. experience are to the contrary and suggest that functional substitutes for close governmental regulation can be developed. This conclusion does not require rejection of the "law matters" hypothesis, because the principal historic advantage that common legal systems gave the embryonic securities markets of the late 19th Century was a decentralized state, in which self-regulation was the norm and close state control the exception. In contrast, in civil law systems of the same era, the state monopolized all law-making initiatives.

The critical achievement of self-regulation in the United States was the development of mechanisms by which control could be held in the public market, rather than simply in the hands of controlling shareholders. During the late 19th Century, this meant protection from predatory raiders who sought to 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. For the future, private ordering may similarly be able to close much of the gap between "advanced" Western legal systems and those of transitional economies, even in the absence of desirable reforms in mandatory law. By no means does this article argue that state regulation of securities markets is undesirable or unnecessary. Market manipulations have characterized all unregulated securities markets and have ultimately elicited regulation. Its more modest claims are that (i) intelligent self regulation by securities exchanges and professional associations in transitional economies can close much of the gap between "advanced" Western markets and those of transitional economies, and (ii) the first necessary step towards dispersed ownership is to enable control to be held in the market by legal rules and/or private ordering mechanisms that protect the public shareholder from stealth acquisitions of control.

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Introduction

Recent scholarship on comparative corporate governance has produced a puzzle. While Berle and Means had assumed that all large public corporations would mature to an end-stage capital structure characterized by the separation of ownership and control,[1] the contemporary empirical evidence is decidedly to the contrary. Instead of convergence toward a single capital structure, the 20th Century saw the polarization of corporate structure between two rival systems of corporate governance:

> (1) A Dispersed Ownership System, characterized by strong securities markets, rigorous disclosure standards, and high market transparency, in which the market for corporate control constitutes the ultimate disciplinary mechanism; and
>
> (2) A Concentrated Ownership System, characterized by controlling blockholders, weak securities markets, high private benefits of control, and low disclosure and market transparency standards, with only a modest role played by the market for corporate control, but with a possibly substitutionary monitoring role played by large banks.[2]

An initial puzzle is whether such a dichotomy can persist in an increasingly competitive global capital market. Arguably, as markets globalize and corporations having very different governance systems are compelled to compete head to head (both in product, labor and capital markets), a

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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, Shleifer 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 Shleifer, Corporate Ownership Around the World, 54 J. Fin. 471 (1999). More recent work in the same vein has shown that the private benefits of control appear to be much higher in French civil law countries than in common law or Scandinavian countries. See Tatiana Nenova, The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis (NBER Working Paper 2000, available on SSRN Electronic Library).

Darwinian struggle becomes likely, out of which in theory the most efficient form should emerge dominant. Indeed, some have predicted that such a competition implies an "end to history" for corporate law.[3] A 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 rival positions do not, however, state the deeper puzzle. That puzzle involves the origins of dispersed ownership. The recent provocative scholarship of LaPorta, Lopez-de-Silanos, Shleifer and Vishny (hereinafter, "LLS&V") has not only shown the existence of two fundamentally different systems of corporate governance, but has placed legal variables at center stage in explaining the persistence of these two systems.[5] LLS&V have boldly argued that civil law legal systems provide inadequate protections to minority shareholders and hence dispersed ownership can arise only in a common law legal environment. To support this conclusion, they have assembled a worldwide data base that shows that the depth and liquidity of equity markets

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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 La Porta, Lopez-de-Silanos, Shleifer and Vishny, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997); La Porta, Lopez-de-Silanos, Shleifer 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, Shleifer and Vishny, Investor Protection and Corporate Governance (Working Paper 2000); see also Nenova, supra note 2.

around the world correlate closely with particular families of legal systems, with common law systems consistently outperforming civil law systems.

In short, law matters. Although this author concurs generally in this "law matters" hypothesis and has elsewhere suggested refinements on it,[6] it remains difficult to accept the legal variables identified by LLS&V as alone defining or measuring the difference between adequate and inadequate legal protection for minority shareholders. Even if the level of stock market development is determined by the quality of shareholder protection, the specific "antidirector rights" identified by LLS&V seem only tangentially related to effective protection of minority shareholders from expropriation at the hands of management and/or large blockholders.[7] In particular, they fail to focus on the vulnerability of dispersed shareholders to a person who quietly assembles a controlling block and thereby seizes de facto control of the corporation, without paying any control premium.[8] The possibility thus surfaces that the legal differences that LLS&V

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6 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).

7 LLS&V develop an index of shareholder protection that focuses on six legal variables: (1) proxy voting by mail; (2) the absence of any requirement that shareholders deposit their shares prior to the general shareholders meeting in order to vote them; (3) cumulative voting; (4) the ability of shareholder to sue their directors or otherwise challenge in court the decisions reached at shareholder meetings; (5) the ability of 10% or less of the shareholders to call an extraordinary shareholders' meeting; and (6) shareholder pre-emptive rights. See sources cited supra at note 5. By no means is it here implied that these rights are unimportant, but only that they supply partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium.

8 Of course, the simplest way to effect such a control acquisition is simply to buy a majority of the stock in the market, possibly over a period as short as a day, without announcing any tender offer. This has sometimes (but rarely) happened even in the U.S. market. See Brascan Ltd. v. Edper Equities, Ltd., 477 F.Supp.

view as critical and as distinguishing common law from civil systems may serve as a proxy for something deeper.

If one doubts that the specific "anti-director" rights identified by LLS&V are the central factors that distinguish common law from civil law systems, then the next question obviously becomes: what else is there? To address this question, this article re-examines the origins of dispersed ownership in the U.S. and the U.K. during the late 19th and early 20th Centuries. It then contrasts their experience with that of the Paris Bourse and the German stock exchanges over the same period. Based on that re-examination, it suggests that the principal variable accounting for the development of dispersed ownership in the U.S. and the U.K. was the earlier separation of the private sector in these countries from the close supervision and control of the central government. In the absence of direct governmental control, strong systems of self-regulation, administered by private bodies (most notably, private stock exchanges), arose to regulate the conduct of the private body's members in their mutual self-interest. In contrast, in France and in Germany, the state intervened constantly in the market and its supporting infrastructure, sometimes to protect it and sometimes to chill it, but with the common consequence of freezing its development.

This proposed interpretation, which deemphasizes the role of formal law, disagrees with some important premises of the LLS&V model. As will be seen, in the late 19th Century, U.S. law was characterized by a high level of judicial corruption, was demonstrably vulnerable to regulatory arbitrage, and wholly lacked any federal law on securities regulation. In short, the private benefits of control were high and realistic minority protections were weak. Thus, from the

773 (S.D.N.Y. 1979). However, both U.S. securities law (in particular the Williams Act, which insists on high transparency in control transactions) and private self-help measures (such as the poison pill) have long discouraged such low visibility "creeping control" acquisitions in the U.S.

perspective of LLS&V, dispersed ownership should not have arisen in the U.S. But it did!

That dispersed ownership was able to arise in this era derived from the ability of private actors to develop functional substitutes for formal law. In earlier work, this author has distinguished "formal convergence" from "functional convergence".[9] Formal convergence requires multiple jurisdictions to adopt common legal rules and practices. Functional convergence, however, recognizes the availability of substitutes; for example, a legal system that faced doctrinal or political obstacles to the adoption of a particular legal rule might fashion a functional substitute that achieved similar results. Essentially, during the late 19th Century, the U.S. developed a functional substitute for strong minority legal protections through a self-regulatory mechanism (i.e., the New York Stock Exchange, which pioneered high disclosure standards) and through other bonding devices engineered by investment bankers. These mechanisms largely closed the legal gap between the weak existing enforcement mechanisms and the necessary preconditions for dispersed ownership. Later, in the 20th Century, the U.K. also developed strong self-regulatory institutions (although its experience blended an originally stronger formal body of law with a decidedly weaker system of self-regulation).

Conspicuously, similar self-regulatory institutions did not develop on the Continent. Why? Although multiple reasons can be given, including the desire of the central government to directly regulate and control the securities market, one important possibility is that the common law is far more hospitable than the civil law to the development of private self-regulatory institutions. Broadly framed, the hypothesis here advanced is that the common law has a decentralized character that encourages private initiatives, whereas the civil law tends to be more

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9 See Coffee, supra note 6, at 657. ("Functional convergence may well trump formal convergence, but the open question ... is how far functional convergence can proceed before it encounters inflexible legal barriers").

hostile to private law-making. In a nutshell, private self-regulatory initiatives were central to both the U.S. and U.K. experience, but were missing in France and Germany over the same period.

More generally, this article will argue that self-regulation is often the principal functional substitute to mandatory legal regulation and historically appears, not as a lesser alternative to formal legal rules, but rather as a precursor to mandatory law. Only once self-regulation enables the business activity so regulated to develop and prosper does a political constituency develop to fill in the inevitable gaps in any self-regulatory system with mandatory law.

The immediate relevance of this thesis is that it suggests one means by which dispersed ownership may yet develop in Europe and in transitional economies. Both on empirical and theoretical grounds, recent commentators have argued that liquid securities markets and dispersed ownership cannot develop in an environment already characterized by concentrated ownership. Three basic arguments have been raised:

First, LLS&V have pointed to the inadequate legal foundation for dispersed ownership in much of the world. Although it may overread the evidence to say that common law legal systems inherently 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 the common law's hospitable 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 would logically follow 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). This analysis, however, overlooks the possibility that self-regulation may be able to close the legal deficit -- at least if strong self-regulatory institutions can develop within the civil law.

Second, Professor Mark Roe has advanced the "political" thesis that strong securities markets are inconsistent with the European political tradition of social democracy.[10] 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 posits that, when the private benefits of control are high, concentrated ownership will dominate dispersed ownership.[11] 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.[12]

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

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

[12] 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

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 that protects the minority shareholder in order to become deep or liquid. Although the association between minority protection and liquidity seems real, it will argue that the cause and effect sequence is backwards. While this article shares with LLS&V the belief that "law matters," it finds that legal developments have tended to follow, rather than precede, economic change.[13] Specifically, Part II will examine the early development of the New York Stock Exchange ("NYSE"), the London Stock Exchange ("LSE"), and the Paris Bourse. Although securities exchanges have existed since the 17th Century, exchanges primarily traded debt securities up until

Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries, Working Paper (June, 1999).

13 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" and eventual crashes 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 10.

the late 19th Century. Then, over a relatively brief period and at a time when the private benefits of control were unquestionably high, dispersed ownership arose in both the U.S. and the U.K. -- largely in the absence of strong legal protections for minority shareholders, which came afterwards. Viewed in retrospect, this sequence makes obvious political sense: legal reforms are enacted at the behest of a motivated constituency that will be protected (or at least perceives itself to be protected) by the proposed 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.

Dispersed ownership did not, however, arrive in Paris, even though its Bourse was the leading international rival to the LSE during the last quarter of the 19th Century. This article will suggest that the key difference between the NYSE and the LSE, on one hand, and Paris, on the other, was the inability of the latter to develop a strong system of self-regulation -- and that this inability was characteristic of French civil law, which disfavors private law-making.

This historical analysis still leaves open the question of how the separation of ownership and control arises. To answer this question, one must ask: When and how can the public market compete with a potential controlling blockholder by paying the initial owners of the firm a premium equal to, or greater than, that which the potential controlling blockholder would pay? In both the U.S. and the U.K., this question historically translated as a practical matter 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 III 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 III 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 challenge the political thesis that social democracy and strong securities markets cannot co-exist. Others have also challenged this very ambitious claim,[14] 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 are pressured to play such an activist 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 ownership historically assigned them. Otherwise, as I have elsewhere argued,[15] 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.

By no means does this article contend that the triumph of dispersed ownership is inevitable. Rather, its more limited thesis is that, even in the absence of formal legal convergence, a functional substitute is possible in the form of strong self-regulation (chiefly through stock exchanges) that could facilitate and hasten the arrival of dispersed ownership.

Part I. The Evidence on Convergence

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

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

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 conventional 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 and creditor rights from 1990 through 1998.[16] 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.”[17]

She notes, however, that “law reform has been primarily responsive to economic change rather

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16 Pistor, Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies, EBRD Working Paper No. 49/2000

17 Id. at p. 2.

than initiating or leading it."[18] 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 ...."[19] 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 historical legal system. Radical legal change is sometimes possible.

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

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[18] Id.

[19] Id. at p. 13.

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 at least marginally 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.[20] Traditionally, these 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[21]

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

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

[21] Id. at 3.

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 the outstanding shares of the forty largest companies on the Paris Bourse are now held by American and British institutional investors.[22] 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.[23] With this heightened ownership comes, of course, a demand for 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.[24] Yet, effective January 1, 2002, the capital gains tax on such investments will be eliminated, and some of the largest German financial institutions have already announced plans to reduce the extent of their cross-

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

[23] Id. at 3.

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

shareholdings.[25] 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."[26] 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 compelled its dismantling.[27]

(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

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

[26] See Roe, supra note 10.

[27] 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).

stock changes rose sharply at the end of the 1990's:[28]

Table 3: Evolution of the number of stock exchange listed companies[29]

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%
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

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28 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).

29 Id. at 5.

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)[30]

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%
Italy	5%	6%	14%	21%	71.3%
Netherlands	21%	47%	42%	95%	205.1%
Spain	-----	8%	23%	33%	87%
Switzerland	30%	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 a few 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 IPOs once characterized only the U.S. and the U.K. markets, they have

30 Id. at 8.

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.[31] 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 dependent 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 U.K.[32]

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

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[31] Id. at 9.

[32] 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%.

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.[33] 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 Swiss Exchange.[34] 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.[35] 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 an International 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 rapidly changing. In 1986, 86 percent of all takeovers involved at least one American party, but in 1999, this percentage fell to only 40 percent.[36] Over the same time

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33 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.

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

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

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

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[37]). If one looks instead to the market value of these transactions, takeovers involving a European party grew from 11 percent of the world total in 1985 to 47 percent in 1999.[38] Evidence of this sort has led some scholars to describe the last two years as amounting to the "First International Merger Wave."[39]

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.[40] 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 impending adoption of the 13th Company Law Directive by the European Union is the clearest signal that this trend will continue. As adopted by the Council of Ministers, it would require all EU members states to legislate (over a four year time period) to bar anti-takeover defensive measures after a takeover has been announced. [41] While further

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37 Id.

38 See Black, The First International Merger Wave (and the Fifth and Last U.S. Wave), 54 U. Miami L. Rev. 799, 801 (2000).

39 Id.

40 See Stokes, supra note 36, at 2291.

41 After much delay, the Council of Ministers adopted the 13th Company Law Directive in June, 2000. 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

negotiations will be necessary before the legislation becomes binding and even if compliance with it is uneven (as seems likely), the more important point is that the legitimacy of the takeover as a mechanism of corporate governance has been now 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 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 German 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

p. 4. However, that was not the end of the story. In December, 2000, the European Parliament approved it, but with controversial amendments that would permit local governments to approve takeover defensive tactics not specifically approved by shareholders. See Shiskin, “Europe Hits Rough Spot on Takeovers,” Wall St. Journal, December 14, 2000 at A-22. The legislation now enters a “conciliation” stage in which the differences between the Council draft and the European Parliament legislation must be negotiated.

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.[42] Mass privatization first deepened securities markets across Europe and thereby created a constituency that came to desire fairer rules. That constituency is now beginning to pressure for legal changes.

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 broadly characterized the adoption of common law reforms by transitional economies.[43]

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

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

[43] See text and notes supra at notes 16 to 19.

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

(f) <u>The Status of the Insider Dominated Firm</u>. 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 declined across Europe, the difference may be only marginal, as 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 their equity.[44] 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 public market 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 purchasers than to break up the controlling block through a secondary offering.[45]

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[44] See Financial Times Survey -- International Mergers and Acquisitions, supra note 41.

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

Indeed, precisely this pattern of controlling blocks remaining intact after an initial public offering has long been observed in Scandinavia.[46] But, as next discussed, that pattern can change and did so change in both the U.S. and the U.K.

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.[47] 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 owners will not find it in their financial interest to sell a potentially controlling block of shares to the market, but will instead sell only to another incoming controlling blockholder, who will pay more because it can enjoy the private benefits of control.

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,

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

[47] Bebchuk, supra note 45

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 in both the United States and the United Kingdom were converted into publicly owned corporations.[48] 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 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

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48 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. The latter view, chiefly espoused by the business historian Alfred Chandler, focuses more on the internal organization of the firm's management. 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.

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 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,[49] most of it funneled through London, which had already developed an expertise in international finance.[50] 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.

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

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

(i) The Role of Investment Bankers. The financial infrastructure that arose in the 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 salesmen to Europe: August Belmont was 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.[51] These firms grew to dominance based on their ability to recruit foreign capital.[52]

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

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51 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.

52 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.

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 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,[53] 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

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[53] 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).

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 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."[54] 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.[55] 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.[56]

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54 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).

55 Friedman, supra note 54 at 523-25.

56 See V. Carosso, INVESTMENT BANKING IN AMERICA, supra note 51, at 43-44 (noting that Jacob Schiff of Kuhn Loeb and others considered such investments

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 this end was pioneered 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.[57] 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.[58]

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to be of dubious value, principally because of the inadequate disclosures made by these corporations).

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

58 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

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.[59] 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.[60]

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

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that proved the rule, but it may have limited its clientele to firms that found other means by which to bond their commitments to investors.

59 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).

60 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.

61 See De Long, supra note 60.

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.[62] 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,[63] 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 measures. More importantly, they also spoke for the foreign investors, who were likely to act collectively based on the advice of their American agent.

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[62] 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 Shleifer and Vishny, A Survey of Corporate Governance, 52 J. Fin. 737 (1997).

[63] 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.

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.[64] 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."[65] 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 warning flag to ... [others] to stay away from a captive company."[66]

As a result, to the extent that public shareholders received protection from predatory

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[64] See V. Carosso, supra note 56, at 36-37.

[65] V. Carosso, THE MORGANS, supra note 51, 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.

[66] See Chernow, supra note 65, at 32.

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 firm's founders remained active in management, they also gained protection from a subsequent disruptive hostile takeover by Robber Baron, which would typically have been a coercive partial bid made without a premium.

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 merchant 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.[67] For 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

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67 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.

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. Interestingly, the greater scale of this consolidation movement in the United States in contrast to the United Kingdom again shows the significance of legal variables. 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.[68] 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

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[68] Both Alfred D. Chandler, Jr. and Leslie Hannah, each a noted business historian, have argued that differing policies toward cartels in the U.S. and Britain help explain the different scale of the turn-of-the century merger wave in both nations. See A. Chandler, SCALE AND SCOPE: The Dynamics of Industrial Capitalism (1990) at 288-320; L. Hannah, “Mergers, Cartels and Concentration: Legal Factors in the U.S. and European Experience” in LAW AND FORMATION OF THE BIG ENTERPRISES IN THE NINETEENTH AND EARLY TWENTIETH CENTURIES (N. Horn and J. Kocka, eds.) (1979) at 306-315. See also T. Freyer, REGULATING BIG BUSINESS: Antitrust in Great Britain and America, 1880-1990 (1992).

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. A transaction on such a scale inherently created dispersed ownership, even if each of the corporate participants previously had concentrated ownership, and it also produced a new firm with so heightened a capitalization that the new entity was simply beyond the ambitions of any potential raider, thus making dispersed ownership stable.

In contrast to U.S. courts, British courts appear to have been significantly less aggressive in restricting cartels or prohibiting horizontal price-fixing agreements during this period. Hence, there was a weaker incentive to merge, and larger scale business entities emerged more slowly, while family capitalism survived longer in the U.K.[69] For immediate purposes, however, the relevant point is that the lesser the incentive to merge, the lesser the prospect that dispersed ownership would emerge as the result of corporate amalgamations. Hence, we encounter an additional reason why dispersed ownership arrived earlier in the U.S., and it has little to do with the relative legal rights of minority shareholders.

(ii) The New York Stock Exchange As Guardian of the Public Investor. 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. Three points merit special emphasis at outset: First, 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. Second, the NYSE did not possess a de facto monopoly

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69 See T. Freyer, "Legal Restraints on Economic Coordination: Antitrust in Great Britain and Americas, 1990-1920," in COORDINATION AND INFORMATION: Historical Perspectives on the Organization of Enterprise (N. Lamoureaux and D. Raff eds.) (1995) at 183-202; see also sources cited supra at note 68.

position in the trading equity securities as of the late 19th Century. Predominant as it may have been in debt securities, it ranked well behind other exchanges in the trading of equity securities throughout the late 19th Century. Prior to 1900, "the Boston Stock Exchange was the principal market for industrial securities,"[70] and two Boston investment banking firms -- Kidder, Peabody and Lee, Higginson -- were the dominant underwriters of equities securities.[71] Third, that the NYSE uniquely became an activist on corporate governance issues and ultimately the champion of the public investor seems directly attributable to its organizational structure and its competitive position.

This last point comes most clearly into focus when we compare the NYSE with the LSE. Between 1850 and 1905, the membership of the LSE rose from 1864 to 5,567.[72] In sharp contrast, the membership of the NYSE stayed constant between 1879 and 1914 at 1060.[73] While admission to the LSE was "cheap and easy,"[74] entry to the NYSE could only be gained by buying

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70 See V. Carosso, supra note 56, at 44.

71 Id. The Boston Stock Exchange's early predominance came from its natural leadership position in the underwriting of the New England textile mills; also, some early railroad underwritings -- such as that of the Atichison, Topeka & Santa Fe -- were effected exclusively in New England, with the railroad's stock then being listed only on the Boston Stock Exchange. Id. at 34.

72 See R. Michie, THE LONDON AND NEW YORK STOCK EXCHANGES, 1850 -1914 (1978) at 252. One reason that admission to the LSE was open was that the stockholders of the LSE were distinct from the LSE's member brokers, and they profited from the admission fees paid by new brokers. Thus, the LSE's owners wished to maximize admission fees, while its brokers might have preferred to maximize brokerage commissions.

73 Id. at 253. The only increase between 1868 and 1914 came in 1879 when the NYSE added 40 seats. Id.

74 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).

the seat of an existing member. The closed structure of the NYSE gave its members very different incentives, particularly regarding regulation, from those of members of an "open" exchange, such as the LSE. First, the NYSE's restrictions on membership 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, having paid more to join the NYSE and holding a transferable asset with a substantial market value, a NYSE member had a greater reason to favor self-regulation that protected the value of its seat; also, larger firms probably enjoyed greater reputational capital and thus had a greater interest in protecting it. 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 larger and better capitalized firms on the NYSE was another difference in the two exchanges' organizational rules: NYSE member firms could raise capital from outsiders -- known as "special partners" -- 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.[75] The relative freedom enjoyed by NYSE firms in obtaining outside capital resulted not only in larger size, but also in a greater ability to engage in higher risk underwriting activities.

Another key difference between the two exchanges was their position on the question of competitive versus fixed brokerage commissions. Throughout the late 19th Century, the NYSE

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

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. Because fixed commissions raised the cost of trading, this practice drove trading in lower volume and lower price stocks off the NYSE. Competitors could and did win the low volume business from the NYSE. But this business that migrated elsewhere consisted disproportionately of lower priced and higher risk stocks. In consequence, the NYSE quickly made a virtue of this inevitability, arguing that the low-priced or low volume stocks that migrated to other trading venues were unsuitable for the public customer. In combination 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, fixed price commissions 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.[76] 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.[77] This difference was largely the NYSE's choice, and the product of its decision to reject most listing applications.

A final factor that reinforced the NYSE's preference for listing only large, high quality issuers was its fear that listing high volatility stocks would invite predictable insolvencies among its members. Such insolvencies could expose the broker's trading partners to similar failure.

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[76] Id. at 272.

[77] Id. at 264.

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 any 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.[78] The rationale here was less a paternalistic concern for the investor than the fear that mining and petroleum stocks typically experienced volatile price movements (based on discoveries or rumors of discoveries), and a broker holding such stocks was exposed to greater risk in a financial panic. The consequence was that to be listed on the NYSE, a company as of 1900 had to be at least five times larger than its counterpart on the LSE.[79]

From these differences in the organizational structure of the NYSE and the LSE, very different approaches 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. In so doing, the NYSE was also able to distinguish itself from its American competitors and present an image to investors as the most reputable exchange. Indeed, under the NYSE's prodding, the standard of disclosure for public companies was significantly enhanced, and some financial historians date the advent of modern

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78 Id. at 198 and 273.

79 Id. at 272.

financial reporting from 1900, not from 1933 when the federal securities laws were first adopted.[80] In contrast, the LSE made no similar effort to police its securities market, at least until the period after the First World War.[81] The LSE's more laissez-faire approach probably reflects the fact that it faced less competition and that its stockholders profited directly from the admission of additional brokers and issuers.

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 develop and pledge their reputational capital to their investor customers. These two 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,[82] indicating that it was providing services on a mass scale. Yet, the legal framework that today characterizes the U.S. securities

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[80] 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.

[81] See R. Michie, THE LONDON STOCK EXCHANGE: A History (1999) at 115; see also Werner and Smith, supra note 63.

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

markets did not arise until decades later.

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.[83] 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.[84] 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.[85] 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.[86]

Given the LSE's laissez-faire approach and, indeed, its caveat emptor attitude, it is thus not surprising that the public equity market developed more slowly in the U.K. than in the U.S. Exactly when dispersed ownership arrived in the U.K. is debatable. In 1936, the median

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83 Michie, THE LONDON STOCK EXCHANGE, supra note 81, at 96.

84 Id.

85 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).

86 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.

proportions of the voting share held by the twenty largest shareholders in the eighty-two largest nonfinancial U.K. corporations was approximately 40% (whereas the same ownership level for U.S. corporations was then 28%).[87] Moreover, in 40% of U.K. companies, the twenty largest shareholders held a collective absolute majority.[88] Thus, although share ownership may have been dispersed, the separation of ownership and control had not yet truly occurred. A parallel study in 1977 found that the largest twenty shareholders then held between 20% to 29% of the voting stock.[89] Although such a block might still carry control, it is doubtful that the twenty largest shareholders were by this point truly a cohesive group, as institutional investors were now heavily represented in the top twenty. Hence, sometime between the late 1930's and the mid-1970's, ownership and control probably separated in most U.K. companies.

The deeper question is not when did dispersed ownership arrive, but why did it occur. In the absence of high listing standards or underwriting practices that placed the reputational capital of credible financial intermediaries behind most offerings, why did public investors place trust and confidence in the U.K. 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

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[87] See P. Sargent Florence, THE LOGIC OF BRITISH AND AMERICAN INDUSTRY (rev. ed. 1961) at 189.

[88] Id.

[89] See John Scott, CAPITALIST PROPERTY AND FINANCIAL POWER: A Comparative Study of Britain, the United States and Japan (1986) at 95. For a review of this literature, see Black and Coffee, Hail Britannia?: Institutional Investor Behavior Under Limited Regulation, 92 Mich. L. Rev. 1997, 2029-33 (1994).

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 level of shareholder protection was arguably very similar in the U.S. and the U.K. up until the passage of the federal securities laws in the U.S. in the mid-1930's. 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."[90]

This claim that U.K. law did provide significant protections to minority investors may seem 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 action remedy. Worse, the shareholder's rights were subject to the ability of a majority

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[90] See Coffee, supra note 6, at 649-650.

of the shareholders to ratify any conflict of interest transaction and thereby place it beyond judicial review.[91] Worse yet, exculpatory provisions were permitted in the corporate charter that could cancel even the duty of loyalty.[92]

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.[93] 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.[94] Not until 1933 was U.S. law to reach a similarly pro-investor position when Congress 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.[95] In

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91 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).

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

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

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

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

1907, the first step toward a mandatory continuing disclosure system was taken with legislation that required publication of an annual balance sheet.[96] Legislation in 1908 addressed (albeit in a limited manner) abuses in the new issue market.[97] Finally, in 1929, legislation obliged the issuer to provide an income statement and related data on current earnings.[98] 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.[99] In 1921, it adopted its first regulations governing the rights of members to deal in or quote a security,[100] and during the between-the-wars period, the LSE's Share and Loan Department began to make inquiries before listing a company into the 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.[101] Still, the LSE did not become a de facto regulator in partnership

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

97 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.

98 Companies Act 1929, § 123.

99 See R. Michie, THE LONDON STOCK EXCHANGE, supra note 81, at 115.

100 See Paish, supra note 97, at 24-25.

101 See Cheffins, supra note 91, at 27-28.

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.[102] The Hatry scandal produced little, if any, legislation, but forced the LSE to accept some role as a guardian of issuer quality.[103] 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.[104] 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 the Bank of England, to regulate them.[105] 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

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[102] See R. Michie, THE LONDON STOCK EXCHANGE, supra note 81, at 162-63.

[103] Id. at 268.

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

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

target's shares once the acquirer crossed a specified threshold of stock ownership (generally 30%).[106] 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 facilitate the 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. A Civil Law Contrast: The French Experience. While both the NYSE and the LSE were and remain private bodies, the Paris Bourse has historically been a state chartered monopoly, run under very close governmental supervision.[107] Far older than either the LSE or the NYSE, it traces its origins back to 1141, when Louis VII granted a charter to the Guild of Moneychangers,

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106 Id. at 91-92.

107 See, e.g., Norman S. Poser, INTERNATIONAL SECURITIES REGULATION (1991) at 381-86; see also, Thierry Shoed , THE FRENCH STOCK EXCHANGE (1995). For a contemporaneous account of the Bourse during the early 20th Century, see W. Parker, THE PARIS BOURSE AND FRENCH FINANCE (1919).

giving them the sole right to operate on the Great Bridge of Paris.[108] For most of its existence, it fought to preserve this monopoly status, which status was formally reconfirmed by Napoleon, who in 1807 gave the exclusive right to the Bourse's stockbrokers (known as "agents de change" or "agents") to effect transaction in listed securities.[109] A securities transaction off the Bourse was made unlawful, and only an "agent de change" was permitted to transact business on the Bourse.[110] In effect, the Bourse was a publicly administered monopoly, and its "agents de change" had the status of civil servants, who were formally appointed to office by the Minister of Finance after first passing a civil service-like exam.[111] This insulated, monopoly-like status of the Bourse persisted until late 1980's, when both global competitive pressures (including London's "Big Bang") and a series of scandals forced a wholesale restructuring of the French securities market.[112]

Nonetheless, as of the late 19th Century, the Paris Bourse was the one potential international rival to the London Stock Exchange, and it actively traded American railroad securities and later American industrial stocks (such as U.S. Steel). To an even greater extent

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108 See Margaret G. Myers, PARIS AS A FINANCIAL CENTRE (1936), at 146. For the fullest account of the history of the Paris Bourse, see E. Vidal, THE HISTORY AND METHODS OF THE PARIS BOURSE, 61st Congress, 2d Sess. Document No. 573 (1910).

109 See Poser, supra note 107, at 381. The Paris Bourse was briefly closed during the French Revolution.

110 Id. It should be noted that there were a number of regional exchanges in France and a "curb" exchange, but these did not generally compete with the Bourse with regard to securities listed there.

111 See Myers, supra note 108, at 146; see also L. Goldman, The Modernization of the French Securities Market: Making the SEC Connection, 60 Fordham L. Rev. 227, 231 n. 28 (1992).

112 For a brief overview of this process, see L. Goldman, supra note 111.

than London, its market focused on foreign securities, chiefly governmental and railroad bonds.[113] In its competition with the London Stock Exchange, however, the Bourse was subject to an immense, self-imposed handicap: the Bourse's "agents de change" were permitted to act as commission brokers only and never to function as a dealer or principal.[114] To be sure, the London Stock Exchange, itself, also did not permit a member firm to be both a broker and a jobber (that is, a "dealer" in the U.S. parlance), but it did permit and encourage jobbers to function, and it thereby gained its liquidity from them.

By barring any financial intermediaries from its trading floor who could take positions in stocks in the absence of equilibrating customers' orders, the Paris Bourse thus effectively denied itself liquidity. Partly for this reason, a shadow market, known as the Coulisse, arose to fill this void, but, even though it occasionally threatened the Bourse during this era, it principally served as a market for unlisted securities. Indeed, when in the 1890's the brokers on the Coulisse began to challenge seriously the Bourse's monopoly, the Bourse secured legislation that effectively immunized it from competition.

The Bourse's status as a protected monopoly was by no means unique; rather, it was the standard French pattern. Elsewhere, in the U.S., U.K. and Germany, exchanges competed, and

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113 Myers presents data showing that between 1869 and 1908, foreign securities owned as a percentage of all securities owned in France ranged between 32% (in 1869) and 36% (in 1908), with a decline to 27% between 1880 and 1890 (as a result of France's indemnity obligations arising out of the Franco-Prussian War). See Myers, supra note 108, at 136. Between 1908 and 1913 (or just prior to the outbreak of World War I), new issues of foreign securities in France always exceeded (and sometimes more than tripled) new issuance of French securities in France. Id. at p. 138. Myers attributes the popularity of foreign issues to both their higher interest rates and the greater commissions they paid stockbrokers. Id. at 135-136.

114 See Parker, supra note 107, at 28; Myers, supra note 108, at 146.

the winner became dominant. In France, the Government chose the winner. Similarly, the French Government chose and chartered the dominant investment banking house of the era. Perhaps, the most important French financial innovation of the 19th Century was its creation in 1852 of the World's first major corporate investment bank -- Sociète Generale de Credit Mobilier, which became the template for a series of successor institutions.[115] Designed as an investment bank to promote industrialization, it both advanced promotional loans and underwrote the securities of its clients, and it proved to be an engine of French economic growth for its brief, fifteen year existence. But, in both the rise and fall of Credit Mobilier, the French Government was deeply implicated. Originally, it was founded under the patronage of Napoleon III, who saw it as a state-controlled rival to the House of Rothschild. But, because it came to rival and infringe the monopoly status of the Bank of France, Credit Mobilier had envious rivals from its outset (including, of course, the formidable House of Rothschild). Its failure in 1867 came not from a normal financial collapse, but rather from a liquidity crisis occasioned by the Government's refusal, prodded by the Bank of France, to allow Credit Mobilier to issue additional debentures.[116] In short, no institution, however important, truly escaped the Government's control.

Similarly, the Bourse was also administered, according to a contemporaneous observer, as a unique "monopoly which operates under the strict and comprehensive control of the French

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[115] On the rise, fall and significance of Credit Mobilier, see Rondo Cameron, FRANCE AND THE ECONOMIC DEVELOPMENT OF EUROPE. 1800-1914 (2d ed. 1961) at 96-119. The principal innovation in the design of Credit Mobilier was its capital structure. Most banks obtain most of their capital from depositors, and having short-term liabilities can only safely make short term loans. Credit Mobilier attempt to obtain long-term capital by issuing debentures, but never received full governmental permission for the debenture issuances it originally planned.

[116] Id. at 128-132.

Government."[117] Specifically, French law fixed both the commission rates on securities transactions and the number of agents de change.[118] In sharp contrast to both the London Stock Exchange, where the number of seats was unlimited, and the New York Stock Exchange, where the number of seats was limited, but seats could be freely sold, seats on the Bourse were both fixed in number and not freely tradeable; rather, seats were usually handed down from father to son. If there was no male heir, the Minister of Finance would typically accept a nomination made in the will of the deceased agent de change (or submitted by his executer),[119] but the process of transfer still required that the proposed transferee be an eligible individual, who could have no interest in any commercial enterprise and who had to pass a qualifying exam, before the proposed transferee could be voted upon by the membership and then have his name passed on to the Ministry of Finance.[120] As a result, because (1) the agents de change could not serve (or profit) as dealers, (2) no real market in seats existed, and (3) agents de change were jointly and severally liable for the business debts of their fellow agents,[121] French stockbrokers remained small and undercapitalized. As much civil servants as economic entrepreneurs, the Bourse's agents de change could not develop into securities firms, as could their British and American counterparts. Moreover, limited to a total size of seventy members (each of which "agents" could employ no more than six clerks on the trading floor), the Bourse was also logistically constrained.

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117 Id. at 28.

118 In 1898, the number of "agents de change" was raised from 60 to 70 as a move to crush the competitive efforts of the Coulissiers. See Parker, supra note 107, at 34.

119 Parker, supra note 107, at 28.

120 See Myers, supra note 108, at 146-147.

121 Id.

The important point here is not simply that the Bourse was inefficiently designed or structured, or that it lacked liquidity, but that in a fundamental sense it lacked true owners who had the incentive to improve or change its structure and rules. Denied the ability to profit as dealers or to transfer their seats freely, the stockbrokers of the Bourse had limited incentives to improve the Bourse's operation or regulation. Indeed, knowing the historic French tendency toward centralization and strong governmental regulation, the ideal of self-regulation may have seemed both alien and infeasible to them -- if it were ever considered at all.

In overview, governmental regulation governed all aspects of the Bourse's operation. Even the decision to list securities had to be approved by the Ministry of Finance, and the decision to list a foreign security required the additional approval of the Ministry of Foreign Affairs,[122] whose approval was sometimes withheld.[123] Even more invasive of the Bourse's autonomy was the decision of these Ministries to require the Bourse to list foreign securities, whose listing had initially been rejected by the Bourse.[124] By the end of the Century, as international tensions mounted, a Bourse listing came to be seen by the Ministries as a low-cost tool of French foreign policy.[125] Obviously, there was a cost to such a policy, but it fell instead on investors and the financial infrastructure.

Nor did close governmental regulation result in high public esteem for the Bourse. While the NYSE strove to enhance and protect its reputational capital, the reputation of the Bourse among French citizens was, from the 19th Century on, that of "a place of mystery, or even

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[122] Id. at 147.

[123] See Parker, supra note 107, at 28.

[124] See Cameron, supra note 115, at 311-12.

[125] Id. at 312. ("a costless means of winning friends and influencing governments.").

danger,"[126] which Emile Zola attacked and ridiculed in his popular novels.[127] During the early 20th Century, the "flood of foreign issues into France drew criticism," according to one contemporaneous observer, in part "... because of the poor quality of many of the securities."[128] Neither the banks that issued securities nor the Government exercised "adequate supervision over them,"[129] she reports. Yet, at the same time, the "Bourse was under tighter governmental control than were the markets of any other Western European country."[130]

This combination of tight control and poor reputation presents a puzzle. Why did not the Government or, at least, the Bourse itself, intervene to exclude low quality issuers? One answer is that neither the banks not the Government had much interest in improved regulation.[131] The banks seldom held the securities they underwrote, but sold them to relatively small and often unsophisticated consumers. The Government often had political reasons to list (or reject) foreign securities,[132] and in any event profited handsomely on the taxes to which it subjected such issuances.[133]

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[126] See K. Nunes, L. Vogel, C. Linn, and P. Kostrant, French and SEC Securities Regulation: The Search for Transparency and Openness in Decision Making, 26 Vand. J. Transnat'l L. 217, 219 (1993).

[127] See Emile Zola, L'ARGENT (1891). L'ARGENT involved the experiences of its young hero in a mysterious investment bank that vaguely resembled Credit Mobilier.

[128] See Myers, supra note 108, at 136-137.

[129] Id. at 137.

[130] See Goldman, supra note 111, at 230.

[131] This is the answer given by Myers. See Myers, supra note 108, at 137.

[132] Id. at 136; see also Cameron, supra note 115, at 311-12.

[133] Id. at 137.

This answer still leaves open why the Bourse's own members did not seek to exclude low quality issuers, as the NYSE had done early on and as the LSE eventually did? One hypothesis is that tight governmental supervision plus the limited economic stake of the agents de change suffocated any attempt at proactive self-regulation. As noted earlier, the Bourse's members would not share as fully in the gains from an improved public reputation as would, for example, the NYSE's members, because the Bourse's brokers were more restricted in their ability to profit as owners. But, even beyond this organizational point, there was still deeper problem that is possibly inherent in the civil law. As one observer wrote in 1919 with particular reference to the Bourse:

> "The rigid governmental regulation of the continental bourses is a practice that finds no counterpart in the English-speaking world, where each man is supposed to look out for himself."[134]

To generalize, while common law countries assumed there was a zone of private activity within which individuals were expected to protect their own interests, no such assumption influenced the civil law, which was inherently and pervasively paternalistic. The underlying reasons for this contrast have been most fully explored by the British historian and anthropologist, Alan MacFarlane, who has explained the rapid rise of industrialization in the U.K. as largely based on the fact that England had much earlier and uniquely evolved into a "highly developed and individualistic market society" characterized by "absolute ownership" of private property and high labor mobility.[135] Never truly feudal, England was, from at least the 13th Century on, he finds, a

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[134] See Parker, supra note 107, at 112.

[135] See Alan MacFarlane, THE ORIGINS OF ENGLISH INDIVIDUALISM (1978) at 165. According to MacFarlane, an active market in land ownership plus a high degree of economic mobility allowed citizens having no position in the aristocracy to assemble significant wealth in medieval England, which was far less possible in France during the same era.

land of small property owners in which private contractual relationships were recognized, respected and enforced by the courts. In short, entrepreneurial activity did not need the blessing of the state or sovereign and was generally not within their legitimate concern.

In contrast, in truly feudal societies, power came from the sovereign, and the sovereign -- often aided by a powerful, permanent and centralized bureaucracy -- intervened in and oversaw everything of consequence. Thus, it is symptomatic that the Paris Bourse evolved out of a 12th Century concession by Louis VII to the Guild of Moneychangers.[136] From these feudal origins came a tradition of close government involvement in all matters of economic consequence, which was precisely the opposite of the English tradition. More to the point, the natural consequence of this intrusive governmental regulation of private economic activity was arguably to stifle innovation and, in particular, any effort at self-regulation. To be sure, other reasons also exist for the slow pace of change at the Bourse. Given the Bourse's de facto monopoly status, the Bourse lacked the spur of competition to induce it to innovate (at least prior to the appearance of global competition in the 1980's). Yet, even in the face of competition, self-regulation might still not have developed during the late 19th Century. Observers of the French business scene have long noted that"[i]n French business law, everything is proscribed unless explicitly permitted under the country's legal code."[137] Thus, to the extent that the civil law (especially in France) assumed direct governmental control of business activity, it tended to create static entities unlikely to innovate on their own.

In fairness, an important ambiguity surrounds this proposed explanation for the apparent difference in paternalism between common law and civil law countries. To the extent that the

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136 See text and note supra at note 108.

137 See "La Grande Boum," The Economist, Oct. 1, 1988, at p. 83.

Bourse was a private monopoly, it made economic sense for the Government to regulate the Bourse more closely than one would regulate a private entity in an open and competitive market; nor would one defer lightly to, or encourage, private lawmaking by a monopoly.[138] Potentially, two alternative hypotheses are possible: (1) the civil law inherently discouraged private lawmaking; or (2) having created a private monopoly (perhaps unwisely), French authorities could not defer to it, but instead logically recognized the need to regulate it closely (often, however, with the Government's interest in maximizing tax revenues or achieving foreign policy goals overriding investor interests in the determination of actual policies). Still, even if there was a justification for not permitting the Bourse to become a self-regulating body, this justification does not extend to the persistent preference of the French Government throughout the late 19th Century for protecting the monopoly status of the Bourse. Rather than encourage competition, the French approach was to create a centralized monopoly and then regulate it closely.[139] The bottom line consequence was to preclude private self-regulation.

The suffocating impact of close governmental regulation becomes clearest when we contrast the simultaneous development of the Paris Bourse and the New York Stock Exchange during the 19th Century. From its inception, the New York Stock Exchange "operated a miniature legal system, with its own rules governing securities trading and its own mechanism for resolving

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[138] This thesis is implicit in Vidal's work, although not expressly stated as such. See Vidal, supra note 108, at 8-9.

[139] As discussed infra, Professor Alan MacFarlane argues that this structural tendency towards centralization and hierarchical control was the dominant approach in most countries, with only Holland and later England developing a decentralized society that truly encouraged free markets. See text and notes infra at notes 147 to 152.

trade-related disputes."[140] In so doing the New York Stock Exchange "drew upon a centuries-old Anglo-American tradition of self-regulation by mercantile groups."[141] To be sure, development of this self-regulatory capacity was especially important during the early 19th Century because the American legal system regarded many of the standard contracts that securities dealers entered into with each other as essentially gambling contracts and would not enforce them.[142] This judicial neglect of (or hostility towards) the securities industry may have been the principal factor that initially compelled the U.S. securities industry to rely on self-regulation. Even so, what is most noteworthy here is that the common law system could disapprove of an industry's practices (and in truth view them as but amoral gambling), but still tolerate the industry to function without state intervention or supervision.

In any event, if self-regulation on the NYSE was born of necessity, it quickly developed a momentum of its own. The industry soon found that its use could be expanded to achieve other goals, including that of enhancing the New York Stock Exchange's (and the infant industry's) reputational capital. In contrast, in Europe, when every issue of consequence was regulated by law or needed to be referred to the appropriate Ministry for approval, continental exchanges were not positioned to develop self-regulation as a means of private law-making in their own common interest.

D. The German Experience : Statist Intervention that "Stunted" the Market

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140 See Stuart Banner, ANGLO-AMERICAN SECURITIES REGULATION: Cultural and Political Roots, 1690-1860 (1998) at 271.

141 Id. See also William Jones, An Inquiry Into the History of the Adjudication of Mercantile Disputes in Great Britain and the United States, 25 U. Chi. L. Rev. 445 (1958) (discussing this tradition).

142 See Banner, supra note 140, at 271-72.

If the French experience shows the state creating a securities market as a state monopoly, the German experience reveals the opposite: the state disfavoring the securities market and indeed stunting its potential growth. Both attitudes -- the state as protector and the state as antagonist -- are but opposite sides of the same civil law coin in which the state plays favorites, and regularly intervenes in "private" economic decision-making. This presumption of statist intervention contrasts sharply with the neutrality and indifference shown by common law authorities to the growth of securities markets during the late 19th Century in both the U.S. and the U.K. Ultimately, securities markets appear to have fared better under the common law's regime of benign neglect than under the favoritism or antagonism of France and Germany, respectively.

Historically, the two principal German securities markets trace back to origins well before the founding of the NYSE or the LSE. The Frankfurt exchange was founded in 1585 and the Berlin exchange was established in 1685.[143] But, as with other exchanges of the period, they traded debt securities and commodities almost exclusively and were not serious rivals to the London or Paris exchanges prior to German unification in 1871.[144]

As in the United States, the catalyst for the emergence of investment banking as an industry and for the growth of the equity securities market was the enormous need for capital of the German railroad industry.[145] Until the 1850's, those German railroads that were privately

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143 See GERMAN CAPITAL MARKET LAW (U. Siebel, M. Prinz zu Lowenstein, and R. Finney, eds.) (1995) at 3.

144 1871 is the date of the German Imperial Constitution, which reflected the incorporation of the Southern German states into Imperial Germany. For an overview, see W. Mommsen, IMPERIAL GERMANY 1967-1918: Politics, Culture and Society in an Authoritarian State (1990).

145 See James M. Brophy, CAPITALISM, POLITICS, AND RAILROADS IN PRUSSIA, 1830-1870 (1998) at 87-88.

organized were financed by underwriting syndicates composed of traditional investment banking partnerships. These partnerships were relatively small and, even when organized as syndicates, found it difficult to underwrite securities in the amounts needed by the rapidly expanding railroad industry. Recognizing that they needed to create larger-scale entities to provide long-term financing for their clients, both the banking industry and their clients lobbied the Prussian government to charter banks organized as joint-stock companies, which entities would thus have limited liability.[146]

This goal was, however, repeatedly frustrated by the German crown and its bureaucracy, which feared the creation of large independent banks. The result was a major political collision between, the one hand, the Prussian aristocracy, whose wealth was largely agriculturally based and who feared further industrialization, and an emerging business and commercial middle class that essentially wished "to practice trade free of government wishes and restrictions."[147] This confrontation came to a head in 1856 when, having been rebuffed in their attempts to found joint stocks banks by the government's refusal to issue charters, certain leading German financiers organized "commandite banks."[148] Commandite companies were substitutes for joint stock corporations and basically resembled limited partnerships or modern-day limited liability companies in that "silent" partners provided capital but had de facto limited liability by virtue of the fact that their identity was not disclosed to outsiders.[149] The Prussian Government perceived the unauthorized formation of these banks steps as an act of defiance and drafted a decree

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146 Id. at 89-106.

147 Id. at 87.

148 Id. at 89-99.

149 Id. at 90.

declaring commandite banks unlawful. Cooler heads within the Prussian Government convinced the crown to relent for fear that an economic panic might result from any attempt to close down these banks. Still, the episode illustrates the limited range given to even the business elite to conduct business operations on a significant scale.

Eventually, the middle class won this particular battle over access to corporate charters, but not the larger war. They obtained free incorporation as of right in 1870, and, that same year, Deutsche Bank was founded, and in 1872 Dresdner Bank followed.[150] Formed principally to finance heavy industry, these "credit banks" or "Grossbanken" combined commercial and investment banking; typically, they both purchased a newly capitalized firm's stock, underwrote its debt securities, and made it short to medium term bank loans.[151] Although they were modeled after a French prototype, the Societe General du Credit Mobilier, the Grossbanken were distinctive and indeed constituted an institutional breakthrough in one critical respect: they were entirely private and were formed without the German government's direct backing or support. In contrast, Credit Mobilier was founded under the auspices of Napoleon III and had little distance from the French Government.[152]

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150 James C. Baker, THE GERMAN STOCK MARKET: Its Operations, Problems and Prospects (1970) at 6. The original Grossbanken were Schaaffhausensche Bank and Darmstadter Bank, which date back to the early 1850's, but were created as the result of special political accommodations.

151 For the fullest history of the origins of the German credit banks, see Jacob Riesser, THE GERMAN GREAT BANKS AND THEIR CONCENTRATION, (3rd ed. 1911). This translation of an earlier German work by a Professor at the University of Berlin was prepared for the National Monetary Commission in 1911. See 61st Cong; 2nd Session, Senate Document 40143 (1911).

152 For a review of the founding of Credit Mobilier and its significance, see R.E. Cameron, FRANCE AND THE ECONOMIC DEVELOPMENT OF EUROPE, 1800-1914 (2d ed. 1965).

Politically, the Grossbanken were "the expression of an assertive middle class,"[153] which sought to break free from governmental control. From 1820 onward, "banking freedom" (or "Bankfreiheit") was the rallying cry of the German merchant or commercial middle class,[154] and gradually over a half century, they partially achieved it. In contrast, the same issues never needed to be debated or pursued in the U.S. or the U.K., where the government seldom intervened in economic matters. Still, as of the last quarter of the 19th Century, the German economy had probably advanced further than the French towards recognition of a true private sector in which major financial projects could be undertaken without state approval or supervision. But, the effort to secure a zone of business activity free from state intervention required a constant struggle, because the German state remained committed to active intervention in economic decision-making.

German business history over the remainder of the 19th Century exemplified this pattern of recurrent state intervention. Although the best known of the Grossbanken were founded in the early 1870's primarily to finance railroad and industrial expansion, the German Government succeeded in 1879, after a multi-year struggle, in nationalizing all private railroads.[155] Control over the operation of private railroads had long been a source of friction, and ultimately the state insisted on total control. Although reasonable compensation was paid to stockholders, one cannot easily imagine the British or U.S. governments taking, or even contemplating, similar steps during this era. Later, in the 1890's, the Government also severely tightened its regulation of the

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[153] Brophy, supra note 145, at 87.

[154] Id. at 90.

[155] Id. at 169-170.

securities exchanges in a manner that deeply chilled trading and speculation.[156] The point here is not that the conservative German government of Bismarck was hostile to the interests of business; rather, it assumed, in the manner of many civil law countries, that it was naturally entitled to direct major business policies.

Often, this governmental intervention was benign and supportive of business. The best such example was Bismarck's policy of encouraging the development of the Grossbanken. Unlike his predecessors, Bismarck saw the great banks as natural allies in his policy of spurring the development of heavy industry; he envisioned, it was said, a political alliance of "iron and rye" -- that is, a political marriage between the new industrial magnates and the landed Junker aristocracy. Yet, his policies actually worked to the detriment of the development of securities markets. Essentially, his administration opened the bank window at the German central bank (the Reichsbank) for the Grossbanken by liberalizing the central bank's discount policy to such a degree that the Grossbanken could finance the needs of their client industries largely through debt, thereby diminishing their clients' need to resort to equity financing. The impact of this policy was to give virtually unlimited liquidity to the major German private banks.[157] Secure in the knowledge that they could rediscount their loans to corporate clients with the Reichsbank, the major German private banks could "lend to the hilt," undeterred by the fear of illiquidity. In contrast, British commercial banks, although they also combined commercial and investment banking operations, were acutely aware that they could not finance long-term loans to corporate borrowers based on short-term customer deposits. Nor was the Bank of England willing to

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[156] See text and notes infra at notes 160 to 169.

[157] See Richard Tilly, Germany Banking, 1850-1914: Development Assistance for the Strong, 15 J. European Econ. History 113, 144-45 (1986).

extend similarly liberal discounting rights to its major banks; rather, it frequently resorted to credit rationing.[158]

This difference in the behavior of the central banks in Germany and the U.K. over the last decades of the 19th Century is critical to an understanding of the thin character of the German equity capital market (and the highly leveraged balance sheets of major German corporations). Had the German government not intervened to encourage liberal lending by its major banks, it seems likely that the growth of German securities markets would have paralleled that of the British market and produced a slow evolution toward dispersed ownership. After all, the Grossbanken largely controlled the securities exchanges and profited from securities underwritings. Yet, if the central bank in Germany would in effect underwrite loans to major German corporations while the central bank in England would not do the same for its banks, it should be no surprise that heavy industry was financed by debt to a much greater extent in Germany than in the U.K. and that German corporations had less need to raise equity capital in their securities markets. Finally, because the United States in this era did not even have a central bank,[159] there was no possibility that it could encourage its commercial banks to be similarly generous in order to finance industrialization in the United States.

Beyond simply encouraging risky, promotional lending that made equity financing less necessary or attractive, the German Government took far more aggressive steps in the 1890's that effectively stunted the development of its then growing securities markets. Ironically, the precipitating cause of this tightened regulation were a series of speculative bubbles and

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158 Id. at 145.

159 Andrew Jackson's veto of the Second Bank of the United States resulted in the United States being without a central bank to provide bank liquidity throughout the remainder of the 19th Century.

manipulations that occurred in the German commodities markets, not the securities market. In 1888, speculators cornered the coffee market on the Hamburg exchange; in 1889, a dramatic market break occurred in sugar prices; and, in 1891 on the Berlin exchange, another large price drop in grain prices took place.[160] All these price drops injured middle class investors, who had begun to invest in these markets in the decades after 1870. Because the German exchanges traded both commodities and securities, reformers began to lobby generally for reform of exchange trading, based on a popular sense that price manipulation was pervasive and that ordinary investors needed to be paternalistically protected. After a three year study by a government commission, the Stock Exchange Law of 1896 was enacted to curb these abuses. All told, the process seemed to anticipate the same legislative response that later occurred in the United States, following the Crash of 1929, and culminated in the enactment of the federal securities laws in the early 1930's. The difference was that the German legislation effectively eclipsed its market.[161]

Even prior to the 1896 law, the Imperial Stamp Act of 1894 doubled the tax rate on securities transfers, and this tax rate was further raised in 1900 so as to triple the pre-1894 rate.[162] Not only did this chill securities trading, it moved trading off the stock exchanges. This occurred because the major German banks found that they could avoid the tax by internalizing their execution of customer orders. That is, if a German bank bought 10,000 shares and sold 8,000 shares of the same stock, it could net these orders, and pay tax only on the 2,000 share balance.

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160 See Baker, supra note 150, at 7.

161 For this conclusion that the German markets were "stunted" by this legislation, see M. Roe, Some Differences in Corporate Structure in Germany, Japan and the United States, 102 Yale L.J. 1927, 1970 n. 142 (1993).

162 See Riesser, supra note 151, at 618.

The consequence was to permit the major banks to take business away from the smaller brokers and banks that had a smaller order flow and could not avoid the tax in this fashion.[163] German shareholders quickly learned that they could substantially avoid the tax by leaving their stock in the hands of their bank. The result was to lock in place an already developing system of concentrated ownership under which German banks would vote the customers' shares as the customers might direct at the annual shareholder meeting, but not disclose their identity. In truth, such a system is not significantly different from the practice of "street name" ownership in the United States, under which brokers hold securities registered in their names for their customers -- except that in Germany this system was enforced by a punitive tax on stock transfer. Even more important, to the extent that netting stock transfers were made by banks at the existing market price without orders being entered in the market, such order flow internalization necessarily drained liquidity from the market and reduced its pricing efficiency.[164]

The 1896 law disrupted trading to an even greater extent by barring transactions on credit on many classes of securities and commodities transactions.[165] The statute also required all "speculators" entering into exchange transactions to publicly register; failure to do so could lead speculative contracts to be declared null and void as gambling transactions.[166] But the Act

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163 Id. at 620-621.

164 This was recognized contemporaneously. Writing in the first decade of the 1900s, University of Berlin Professor Jacob Riesser described the banks' response to the tax legislation as equivalent to their "taking over the function of the exchange" and resulting in an impairment "of proper price determination." Id. at 771-72.

165 See Baker, supra note 150, at 63.

166 Id.

literally applied only to trading on an exchange.[167] Hence, although designed to curb speculation, the 1896 Act succeeded primarily in driving trading off the exchanges. The upshot was quickly to turn the traditional exchanges into "disorganized markets."[168]

The impact of the 1896 Act was so Draconian as to quickly produce a demand for its repeal, even within even the trading public that it "protected," and portions of the law were in fact repealed in 1908.[169] But the enhanced transfer tax remained in place, and volume did not return to the German market prior to World War I, whose aftermath in turn triggered a series of economic disasters (including the runaway inflation of the Post-World War I era) that crippled the German securities markets until this last decade.

In this light, the disparity in the size of the German equity market versus those of the U.S. and the U.K. appears to be less the result of differences in the legal rights accorded German versus British or U.S. shareholders than the consequence of a strong statist policy in Germany to achieve industrialization through bank finance. Never supportive of securities exchanges, the state intervened to suppress speculation at the first sign of manipulative abuses. Thus, rather than natural evolution towards concentrated ownership, the German experience -- in contrast to that of the U.S. and the U.K. -- was that of constant state intervention. If this capsule history shows how centralized ownership persisted in Germany amidst great industrial expansion, it also shows that this pattern was state planned and directed and not the result of a "natural" Darwinian competition.

E. A Preliminary Summary. What have we learned from this tour of New York, London,

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[167] Id. at 65.

[168] Id.; see also Riesser, supra note 151, at 620-622, 720-722.

[169] Id at 8.

Paris and Germany? Seemingly, there is a difference between common law and civil law jurisdictions, but it does not appear to lie in different legal technologies. Rather, by the late 19th Century, there was already a private sector in the U.S. and the U.K. into which zone the state did not normally intrude. In contrast, the state intervened incessantly in the development of securities markets in France and Germany, either to protect the Paris Bourse's monopoly in France or to prefer the development of commercial banks in Germany. To be sure, significant differences exist between the French and German experiences. In Germany, private actors emerged and played a greater role, whereas in France the state's monopoly was always zealously protected. But, even in Germany, the state ruled with a heavy hand, and regulated its securities markets into oblivion.

Within the Common Law world, the overriding policy was rather one of benign neglect. Even though the experiences of the NYSE and the LSE diverged, the greater activism of the NYSE seems primarily attributable to non-legal factors, including (i) its greater exposure to competitive pressure in this era, (ii) its different organizational structure, (iii) its dependence upon foreign capital, and (iv) its greater need to develop bonding and monitoring mechanisms, given the greater exposure of investors in the U.S. to the predations of the Robber Barons and the prevalence of judicial corruption. In short, private bodies, having different incentives, responded differently to the problems before them.

Part III. <u>"Does Law Matter?" Reconsidered</u>.

A. <u>Law and the Decentralized Common Law World</u>

If self-regulation appears to have been the principal catalyst for the growth of equity securities markets in the U.S., this finding may seem to undercut the LLS&V thesis that dispersed ownership and liquid markets arise only when minority shareholders are accorded strong legal rights. Indeed, the contrary position has long been popular in the academic "law and economics" literature on securities regulation. Opponents of the U.S.'s mandatory disclosure system have long argued that the SEC's disclosure requirements were unnecessary and wasteful because market mechanisms had already developed prior to 1933 that were sufficient to satisfy investors' real demand for information.[170] This claim needs to be reconsidered, however, in the light of the global comparative experience. Both in the U.S. the U.K., and Germany (but to a lesser extent in the U.K.), political pressures developed from early in the development of equity securities markets that eventually resulted in legislative constraints on the private market. These pressures brought legislation in 1896 in Germany, in the 1930's in the U.S., and at varying stages in the U.K., both early and late. Nor has the market always responded to investor needs with alacrity. In marked contrast to the NYSE, the LSE did not seriously recognize any obligation to protect investors or screen issuers until well after the First World War, and meaningful enforcement efforts probably did not begin until after the Second World War. Yet, securities markets developed in both the U.S. and the U.K. -- in the U.S., in the absence of early legislative protections, and in the U.K., in the absence of meaningful self-regulation until recently.

More importantly, while the relative success of self-regulation in the U.S. may initially seem inconsistent with the "law matters" hypothesis, this is neither a necessary nor a logical conclusion. Stripped to its essentials, the LLS&V hypothesis asserts (or, at least, need assert) only that strong equity markets require strong minority rights. Those minority rights could in

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[170] 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).

principle come from any source (legislative, judicial or self-regulatory), or a combination of sources. More to the point, the process by which strong legal protections are obtained could necessarily begin with self-regulation, which creates nascent rights that later are codified into mandatory law.

This sequential interpretation still leaves open the question of why self-regulation developed in common law countries and not in civil law countries. Here, the principal weakness of the LLS&V thesis is its narrow focus on enforceable legal rights. The LLS&V thesis considers only the differences between common law and civil law, viewing law in effect as only a type of technology. But the greater, more important impact of law may be on the society, itself, and not just on the rights of minority shareholders. When one's focus expands to consider this broader context, differences between the common law and the civil law come into clearer focus. The British historian and anthropologist, Alan MacFarlane, has argued that only two European countries -- England and Holland -- deviated from the pattern of absolutism and increased centralization of authority that characterized post-feudal Europe from the 13th to the 18th Centuries.[171] In both countries, but particularly in England, the absolute authority of the sovereign was constrained by law. In England, in lieu of an absolute monarch, assisted by a vast centralized bureaucracy, there occurred a "devolution of power through a complex of often voluntary and honorary power holders, such as constables and justices of the peace."[172] Ecclesiastical power was also confined, and a tradition of religious tolerance arose that further accelerated the movement towards decentralization and diversity. Finally, in place of the caste-

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171 See A. MacFarlane, THE RIDDLE OF THE MODERN WORLD (2000) at 280-85.

172 Id. at 280.

like social structure of feudal Europe, a class system arose in which power and wealth tended more to depend on personal achievements. In truth, these conditions probably first crystalized in Holland, but it was a smaller country, surrounded by larger, envious rivals (including England) and its prosperity thus proved short-lived.[173]

Law, of course, was not the only force that produced this environment in which the worlds of political power and economic activity were at least partially separated. But law played a major role. While the rest of Europe accepted Roman law during the late Middle Ages, which law in turn enhanced the power of the sovereign, England persisted in the development of the common law that it inherited from its Germanic ancestors.[174] As a result, MacFarlane concludes that:

> "The English judicial system was confused, unprincipled, inefficient and cumbersome. Yet, it somehow protected the citizen against the state better than anywhere else in the world."[175]

Why did English judges prove better able than civil law judges to protect individual rights? Different answers are possible, but the core of any answer probably involves their greater distance from the sovereign and their closer identity with the local community around them.[176] Already decentralized, the English legal system furthered the decentralization of power elsewhere in society and thereby assisted the growth of market economy, in part by referring the inevitable

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173 Id. at 279.

174 Id. at 280.

175 Id. at 205 (acknowledging that Tocqueville first recognized this capacity of the common law system).

176 For a more detailed theory of why English judges and the English system was more independent of centralized control than the civil law system, see Edward Glaeser and Andrei Shleifer, "Legal Origins" (Working Paper, Department of Economics, Harvard University, October 19, 2000).

commercial disputes to persons independent of the sovereign or the bureaucracy under his control.

Decentralization in turn made possible private law-making and the growth of self-regulatory bodies. Ultimately, this development in turn enabled market-based institutions, such as stock exchanges, to adapt and to gain the trust of their customers. Much in the late 19th Century histories of stock exchanges in the U.S. and the U.K. as contrasted with the histories of similar institutions in France and Germany confirms this emphasis on decentralization and the growth of a private sector as the initial precondition. Most obviously, the fact that true stock exchanges first emerged in Amsterdam and later London seems neither accidental nor unrelated to the earlier appearance of a pluralistic society. More to the point, what the emerging business class in Germany most desired during the late 19th Century was what the U.S. and the U.K. business class already had: namely, protection from arbitrary governmental interventions in the private sector. This desire translates easily (and in fact did translate in practice) into a powerful belief in the "rule of law."[177] But if German industries that resisted the government were nationalized (as the private railroads were in 1878-79) and if the French financial industry never escaped close governmental control, the British and American entrepreneur of the same era had no such fears. Nationalization was unthinkable, and close governmental supervision had simply not yet been experienced.

Why did the "rule of law" so protect the U.S. and U.K. business class in this era? It is speculative to jump from doctrinal differences to political differences, but the former clearly exist.

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177 For example, Professor Brophy, writing of the political desires of the late 19th Century German business elite, observes: "The sole principle consistently upheld by businessmen throughout this era was perhaps the belief in law, especially as it affected property relations." Brophy, supra note 145, at 171.

Historians and civil law scholars appear to agree that the civil law inherently tends to codify private law, while the common rarely does so.[178] Codification naturally adopts bright line and prophylactic rules that leave less room for flexibility or innovation. Further, codified civil law usually seeks to eliminate all gaps in the law in order to minimize opportunities for judicial discretion.[179] Again, the natural impact of such comprehensive legislation is to crowd out the possibility for local variation, experimentation, or adjustments to changed circumstances. Finally, in the view of some leading scholars, the civil law is inherently interventionist and "policy-implementing," whereas the common law tends to view its task as "dispute resolving."[180] This more passive, neutral and indeed laissez-faire approach of the common law seems less likely then to crowd out efforts at private law-making and self-regulation.

A more concrete example of the manner in which the common law protected the autonomy of the private sector involves the ease and thoroughness with which it accepted private ordering mechanisms for commercial disputes. In the U.K. and the U.S., commercial disputes seem to have largely migrated from the courts to private arbitration systems by no later than the early 18th Century.[181] An arbitration statute, enacted in the U.K. in 1697, gave formal recognition

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178 For this broad proposition, see Arthur Von Mehren, THE CIVIL LAW SYSTEM (1957) at 3 (noting that the "first" difference between the common law and the civil law was that "in the civil law, large areas of private law are codified").

179 See John Merryman, THE CIVIL LAW TRADITION (1969) at 30 (noting that in common law countries, codes are treated as a form of guidance to the court which can sometimes be ignored when in conflict with basic common law principles).

180 See Mirjan Damaska, THE FACES OF JUSTICE AND STATE AUTHORITY (1968) (viewing civil law as "policy-implementing" in its approach in contrast to "dispute resolving" approach of common law); see also Jones, supra note 141.

181 See Jones, supra note 141, at 458-59. Arbitration procedures appear to have been used in London since 1327. Id. at 455 n. 86; see also, Sayre, Development of Commercial Arbitration Law, 37 Yale L.J. 595, 597-98 (1928). Of course, the

to private arbitration awards and required that they be judicially enforced.[182] Even cases that were brought to court were frequently referred to arbitration, and some early U.S. legislation actually made arbitration compulsory for certain types of disputes.[183] The new financial institutions that arose in the U.S. and the U.K. in the 18th Century were quick to mandate arbitration, in part to keep themselves beyond the oversight of the courts. In 1768, merchants in New York founded the New York Chamber of Commerce and made one of its stated purposes the establishment of an arbitral forum for its members.[184] When the NYSE was founded in 1792, Rule 17 of its Constitution mandated compulsory arbitration off all disputes among its members.[185] Virtually all other exchanges and mercantile associations founded in the U.S. during the 19th Century followed this pattern.[186] Possibly fear of judicial corruption spurred the aggressive American adoption of arbitration in the 19th Century, but the original motivation was more simply that private adjudication could outperform public adjudication, both in terms of speed, cost, and accuracy. While arbitration was not unknown to civil law jurisdictions, the common law tradition gave it a more central role, and Anglo-American exchanges placed it at the center of their constitutional

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search for historical antecedents involving specialized commercial tribunals can take one back to the medieval fair (with its specialized courts) and the common law staple (another specialized court). But as Professor Jones has shown, these institutions had died out by the Tudor period in England. See Jones, supra note 141, at 451-452.

182 Jones, supra note 141, at 455.

183 In 1767, the New York legislature adopted such a compulsory statute for disputes involving merchant's accounts. Id at 460.

184 Id. at 461.

185 Id. at 462.

186 Id. at 462-463 (listing thirteen U.S. exchanges or associations with similar provisions).

framework.

One need not make exaggerated claims for the significance of the doctrinal differences between the civil law and the common law. Clearly, a decentralized and indeed pluralistic society arose in Holland more or less contemporaneously with corresponding developments in England. Hence, it cannot be argued that the civil law system precluded the separation of politics from economics or the emergence of a market-oriented private sector. All that might be plausibly claimed is that the common law did more to encourage the emergence and separation of a private sector and that self-regulation became feasible only once the state had effectively ceded operational control of that sector to private actors.

B. The Sequence of Legal Change

That the common law legal system facilitated self-regulation does not end the story. Self-regulation seems best 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 those in another state), even though substantive U.S. corporate law was probably relatively protective of minority 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.[187]

Although securities markets seem able to arise in the absence of strong legal protections for minority shareholders because of such functional substitutes, they may not be able to expand,

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

persist, or attain their fullest development in such an unregulated environment. Sooner or later, they predictably encounter crises and experience shocks that result in a loss of investor confidence. The recent experience of transitional economies in Eastern and Central Europe has been very consistent with this pattern, with unregulated markets crashing during periods of economic stress.[188] 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, in part because a self-conscious constituency of public investors must first arise before there will be political pressure for legislative reform that intrudes upon the market. In addition, the legislature cannot anticipate problems that it has never seen (much as it could not legislate with respect to the Internet before the Internet 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.[189] Seeking to disprove the need for legislation, George Stigler, the first and still the most vehement critic of the rationale for the federal securities laws, analyzed the impact of the Securities Act of 1933 and found that the variance in the relative price performance of new issues of securities declined by almost half after

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188 See Coffee, Privatization and Corporate Governance: The Lessons of Securities Markets Failures, 25 J. Corp. Law 1 (2000).

189 See sources cited at note 170 supra.

its passage.[190] 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.[191] 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 studies have shown by re-interpreting Bentson's data,[192] there was an overall and significant decline of nearly one-third in the variance of the residuals of NYSE-listed firms.[193] 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.[194]

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

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[190] See Stigler, supra note 170, at 120-121.

[191] See Friend and Herman, supra note 170, at 390-91; see also Merritt Fox, Retaining Mandatory Disclosure: Why Issuer Choice Is Not Investor Empowerment, 85 Va. L. Rev. 1335, 1369-1380 (1999).

[192] Fox, supra note 191, at 1385-91.

[193] Id. at 1376-1382.

[194] As Fox points out, this evidence does not address the costs of this legislation. That is, whether the federal securities laws were cost-effective remains an open question.

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 considerably more aggressive as a self-regulator than the LSE, 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., who collectively constituted the great majority of the firms it traded).[195] This is but one example of the enforcement shortfall that is inherent in any self-regulatory system. Such a shortfall is likely for several different reasons: (1) A private body has weak incentives to enforce rules protecting third parties against its own members and clients; (2) A private body has little ability to enforce its rules against non-members; (3) Enforcement may be too costly for a private body to undertake on a thorough-going basis; and (4) 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 overall level of disclosure in the securities market, but perhaps even more by the pervasiveness that it perceived of manipulative practices, including both the use of stock pools and short selling "bear raids" that were intended to panic investors and artificially

195 See Fox, supra note 191, at 1376-79.

drive down stock prices.[196] Stock pools were temporary joint ventures formed by a group of traders who bought and sold a stock pursuant to a common plan to drive its price up or down through their collective action. Revisionist scholars have recently tended to doubt their significance,[197] but the contemporaneous legal sources treat their existence as a well understood fact.[198] Historians have also noted that the market manipulation constituted the one context in which the NYSE seldom, if ever, enforced its own disciplinary rules.[199]

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. Private regulatory bodies, including the New York Stock Exchange, face particularly severe problems in enforcing their rules against non-members,[200] but non-members are the parties most likely to engage in insider trading or other manipulative

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

197 Id. at 1470-72.

198 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).

199 See Banner, supra note 140, at 278-80; see also 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 63, at 32 (1991).

200 See Banner, supra note 140 at 278-80.

practices. Absent a public regulatory body, victims would predictably be left to enforce their rights through private litigation, and the high costs of enforcement may dissuade at least the small public investor from relying on such remedies.[201] As a 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."

A last justification for why public regulation is needed to supplement self-regulation is that the incentives of stock exchanges to self-regulate may change over time, waxing in one period and then waning in another. What could cause this? One explanation might be that changes in the strength of the competitive pressure that a stock exchange faced could reduce its incentive to regulate. For example, the NYSE faced real competition in the late 19th Century, but much less by the 1920's, by which point it had clearly achieved predominance and established its reputational capital. Alternatively, regulatory arbitrage could arise precisely because of the presence of competitive alternatives. Whether the competition between exchanges for listings will erode investor protections depends on whether the competing exchanges believe that managers, controlling shareholders, or public shareholders make the decision as to where to list the corporation's common stock. Unless the listing decision is perceived by exchanges to be made or controlled by public shareholders (which seems unlikely), then exchanges have the incentive to compete for the favors of managers or controlling shareholders and to relax listing conditions that constrain them

One need not attempt to resolve the long-standing debate over the need for the federal

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[201] 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.

securities laws in this article. Even if one concludes 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 require the rejection of the "law matters" hypothesis. Overregulation of allegedly phantom culprits -- such as the stock pool manipulator -- could still 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 primarily common law countries, and in them the partial success of self-regulation set in motion forces that eventually resulted in the passage of strong mandatory laws. In effect, a path dependent trajectory is thus visible here: self-regulation appears first, but its success over time creates a demand for mandatory law that further protects those who entered the market in reliance on self-regulatory protections. The European evidence is entirely consistent with this asserted pattern, because each of the major European economies, as their market matured, created an administrative agency -- style securities regulator that was more or less modeled after the American SEC between the late 1960's and the 1980's. [202]

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[202] The pattern seems almost uniform. France, traditionally the fourth largest securities market, created the Commission des Operations de Bourse (or "COB") in 1967 and then greatly strengthened its enforcement powers in 1988. See Goldman, supra note 108, at 235-237. The latter step was part of a sweeping deregulation of the French market that removed it from the direct control of the French Treasury. Italy created its Commissione Nazionale per le Societe e la Borse ("Consob"), or National Commission for Companies and the Stock Exchange, in 1974. See P. Del Duca and D. Mortillaro, <u>The Maturation of Italy's Response to European Community Law: Electric and Telecommunication Sector Innovations</u>, 23 Fordham Int'l L.J. 536, 576-77 (2000). In Britain, the Financial Services Act of 1986 ("FSA") created the Securities and Investments Board ("SIB"), which is in essence an SEC-like administrative agency that supervises a host of self-regulatory agencies. See Philip Thorpe, "Regulation of the Futures Market in the United Kingdom," in REGULATING INTERNATIONAL FINANCIAL MARKETS: Issues and Policies (F. Edwards and H. Patrick, eds.) (1992). Only Germany remains a partial exception to this pattern, because it created in 1994 a weaker agency with a only limited oversight powers over the

C. The "Political Theory" of Dispersed Ownership.

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. Yet, in both the U.S. and the U.K., politics appears to have played no more than a negligible role in the rise of dispersed ownership. Although Professor Roe has provocatively argued that politics constrained the development of powerful financial intermediaries in the U.S.,[203] this hypothesis ignores that unconstrained institutional investors in the U.K. closely resemble their American counterparts, even though no regulatory inhibitions hobbled their growth.[204] Other things being equal, the simpler model is preferable to the more complex. Here, the simpler model is that financial institutions greatly value liquidity and hence do not wish to hold large and illiquid equity stakes in business corporations.[205]

Even if political theories cannot satisfactorily account for the development of dispersed ownership in the U.S. or the U.K., can they still account for the persistence of concentrated

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securities exchanges. See GERMAN CAPITAL MARKET LAW, supra note 140, at 8, 13-15 (discussing Federal Supervisory Office for Securities Trading (or "BAW") which was created by the Second Financial Market Protection Act in 1994). Still, German regulation of the stock market traces back at least to 1896. See text and notes supra at notes 160 to 169.

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

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

[205] The author has argued this "liquidity versus control" thesis at considerable length elsewhere, and will not belabor it further here. See Coffee, supra note 15. Suffice it to say that banks, as institutions with short term liabilities to depositors, have a major problem with making illiquid long-term investments.

ownership in Europe? Professor Roe has suggested that the "social democratic" character of European democracies is the underlying cause of concentrated ownership.[206] 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 by the state. A problem with this reasoning, however, is that if concentrated ownership were an important defense mechanism against "social democracy," then "social democracies" should logically seek to encourage ownership dispersion by, for example, enhancing transparency. 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 while the left advocated 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 investor support for them 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 economy.[207] Particularly in times of war and social turmoil during the last century, those in power -- whether socialists 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

[206] See Roe, supra note 10.

[207] 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).

as their agents and that banks, once entrenched, had natural reasons to resist the rise of rivals for their business.

Moreover, the idea that the state should control and manage the economy was not a new idea in continental Europe, but rather a continuation of policies and attitudes that dated back to feudal times. In this light, the real division is not between left and right, but between centralized and de-centralized. Those countries -- most notably the U.K. and the Netherlands -- that were the most decentralized and that divorced economic activity from political control were, not surprisingly, the first to develop true securities markets.

D. Implications

If this article's assessment is correct that strong self-regulation was the principal catalyst for the appearance of an active and liquid market in equity securities and the arrival of dispersed ownership, then very practical implications follow. Even in countries with weak legal protections for minority shareholders, it may be possible for those firms that are prepared to bond themselves, install credible monitoring controls, and meet higher standards of disclosure to sell stock to dispersed public shareholders at prices exceeding that which a controlling shareholder would pay. Similarly, the void created by weak formal law can be at least partially filled by a functional substitute: namely, strong stock exchange rules. These claims do not deny the desirability of stronger formal legal rules or the likelihood that shareholder values will be further maximized by such legal changes. But the thrust of this article is to suggest that a very real payoff can be obtained from private ordering and credible corporate governance.

Speculative as this prediction may sound, there is already persuasive empirical evidence to support it. Remember that the U.S. equity market grew and attracted foreign capital, despite the highly publicized predations of the Robber Barons.[208] Could the same phenomenon occur in contemporary Russia, where legal institutions appear equally weak or weaker? The available evidence suggests that a similar process is already well underway. Professor Bernard Black has found that firm-specific corporate governance practices do greatly affect the market value of publicly traded Russian companies.[209] Using corporate governance rankings prepared in 1999 by one Russian investment bank, he compared these ratings with a "value ratio" of actual market capitalization to theoretical Western market capitalization for these same firms prepared by another investment bank. The value ratios revealed the high discounts that investors applied to these firms, and they showed an enormous variation with some firms trading at only .01% of their theoretical Western market value, while others traded at nearly half their "Western" value. Most importantly, the correlation between the firms' corporate governance rankings and their value ratios was strikingly high and statistically significant.[210] The natural inference from this correlation is that corporate governance matters -- and greatly. Even in a legal regime that provides little predictable enforcement, those firms that installed credible corporate governance provisions could through private ordering achieve a much higher proportion of their potential value in a Western market. Moreover, small changes in governance rankings produced substantial

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208 See text and notes infra at notes 51 to 82.

209 See B. Black, "Does Corporate Governance Matter?: A Crude Test Using Russian Data" (Stanford Law School John M. Olin Program in Law and Economics Working Paper No. 209) (December, 2000).

210 Professor Black found a very robust correlation between the value ratio and the governance ranking that yielded a Pearson r equal to .90. He concluded that corporate governance was the "dominant determinant of the value ratio." Id. at __.

changes in firm value.[211]

The second aspect of the 19th Century American experience that appears to be in the process of being renacted today involves stock exchange self-regulation. A century ago, the NYSE adopted rules that were considerably stricter than prevailing local law. Today, the Neuer Markt in Germany appears to be following its example. Created as an intended European rival to Nasdaq, with the hope that it could provide a market for high-tech, start-up companies, it has grown from 2 to 302 listed companies and an aggregate market capitalization of $172 billion in only three years.[212] Yet, not only does the Neuer Markt have stricter disclosure and listing standards than its own parent, the Deutsche Borse, it actually prides itself on being the "most regulated market in Europe."[213] Such a strategy seems identical to that of the NYSE a century earlier: develop reputational capital by pledging to observe requirements far stricter than those required by local law. The point here is not that law does not "matter," but that at least partial functional substitutes for formal legal requirements are possible.

Conclusion

Three conclusions and one implication for the future emerge from a historical examination of the rise of dispersed ownership:

First, the growth of securities exchanges and the rise of dispersed ownership correlate most closely not with specific legal rules or protections, but with the appearance of a private sector that was largely free from direct governmental interference. More specifically, private

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211 In Professor Black's study, a one-standard deviation change in governance ranking predicted a six-fold increase in firm value. See Black, supra note 209, at __.

212 See Fuhrmans, "Playing By the Rules: How Neuer Markt Gets Respect," Wall Street Journal, August 21, 2000 at C1.

213 Id.

institutions -- most notably, stock exchange rules and bonding mechanisms by which investment bankers pledged their reputational capital -- probably played a greater role than mandatory legal rules in the early rise of dispersed ownership. The common law, however, facilitated the emergence of these private institutions, while the civil law system tended to place them directly under the control of the state. Initially, the relative role accorded to self-regulation seems to have depended on the strength or weakness of the formal legal institutions in the particular country. Thus, active self-regulation was more visible in the U.S. than in the U.K., because judicial corruption and regulatory arbitrage were significant problems in the U.S., but not in the U.K.

This initial conclusion does not refute the LLS&V hypothesis that "law matters," but suggests that the critical role of the common law lay in its facilitation of private law-making and, possibly, in its encouragement of the growth of a private sector that was beyond the sovereign's practical reach. The hypothesis here offered is that 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. Indeed, the active role taken by the French government in intruding so deeply into the affairs of the Paris Bourse that the Ministry of Finance had to approve all new listings and transfers of seats seems a paradigm of the kind of state control that could suffocate the development of self-regulation. Both the NYSE and the LSE proved able during this era to adapt and innovate. Nor was it accidental that both exchanges faced (and ultimately overcame) active competitors in the late 19^{th} Century, while the competitors of the Paris Bourse were legislatively suppressed. To the extent that private monopolies were more characteristic of civil law countries than common law countries, then the French experience seems representative of a more basic reason for the slower growth and evolution of securities markets in civil law countries.

In the last analysis, competition and innovation naturally go hand-in-hand. The bottom line then appears to be that the fundamental precondition for the separation of ownership and control is the recognition -- both legal and political -- of the autonomy of the private sector.

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. Nor was the frustration of ownership dispersion caused by the 1896 legislation in Germany connected to any larger political movement or agenda. 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 in the late 19th Century attracted little public attention or controversy. This is consistent with the broader pattern in which waves of securities regulation pass only in the periods immediately following the burst of "bubble" markets.[214] 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 of the era.

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,[215] 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 state imposed, in large part caused

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[214] See Banner, supra note 13.

[215] See Michie, Different in Name Only? supra note 74 at 286-87 (finding that "German companies were denied the ease of access to finance via security issues that their British counterparts enjoyed").

by legislative restrictions on the issuance of securities.[216] The legislation restricting securities markets in Europe seems to have been less the product of rent-seeking by banks than the moralistic sense of legislators, prodded by scandals, that trading on the stock market was "little better than gambling."[217] Alternatively, the motivation may have been a reasonable perception about the need for consumer protection. But, either way, the closer one looks, the more tenuous the connection becomes between the rise of the social welfare state and the suppression of securities markets.

Third, the cause and effect sequence posited by the LLS&V thesis may in effect read history backwards. They argue that strong markets require strong mandatory rules as a precondition. Although there is little evidence that strong legal rules encouraged the development of either the New York or London Stock Exchanges (and there is at least some evidence that strong legal rules hindered the growth of the Paris Bourse), the reverse does seem to be true: strong markets do create a demand for stronger legal rules. Both in the U.S. and the U.K., as liquid securities markets developed and dispersed ownership became prevalent, a new political constituency developed that desired legal rules capable of filling in the inevitable enforcement gaps that self-regulation left. Both the federal securities laws passed in the 1930's in the U.S. and the Company Act amendments adopted in the late 1940's in the U.K. were a response to this demand (and both were passed by essentially "social democratic" administrations seeking to protect public securities markets). Eventually, as markets have matured across Europe, similar

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216 Id. at 287. See also text and notes supra at notes160 to 169.

217 Id. at 184. This interpretation is, of course, consistent with Professor Banner's thesis that securities legislation is adopted only in the wake of scandals. See text and note at note 204 supra.

forces have led to the similar creation of European parallels to the SEC.[218] In each case, law appears to be responding to changes in the market, not consciously leading it.

In this light, 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 the future of corporate governance in Europe and in transitional economies? The "good news" in this article is that self-regulation might take hold in Europe and in the transitional economies, even though optimal legislation remains lacking. The "bad news" is that the mere "transplanting" of U.S. or U.K. law to transitional economies may not accomplish that much if the government still directs, approves, and vetoes major economic decisions in the private sector. To the extent that the "rule of law" is only tenuously established in some transitional economies (as it was only precariously in force in the U.S. during the Robber Baron era), the optimist can hope that self-regulation may outperform legal rules, because it can sometimes more effectively enforce its commands. Rather than wait for optimal legislation to be enacted, companies in these countries have the practical ability to adopt governance and contractual reforms that will enable them to access Western financial markets or to distinguish themselves credibly from firms in their own market that remain ready to exploit minority investors. By no means does this imply that stronger legislation protecting minority rights is not desirable, but historically this step has followed and not preceded the initial growth of the equity market.

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

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[218] See text and note at note 202 supra.

corporations with minority public ownership;[219] (3) the accelerating convergence in international accounting standards;[220] and (4) the current international wave of mergers and acquisitions. None of these conclusions deny that remedial legislation is desirable in order to establish stronger minority protections, but the U.S.'s and the U.K.'s experience suggest that if strong self-regulation can first enhance the market -- that is, effecting the growth of deeper, more liquid securities markets -- protective legislation will predictably follow. Indeed, self-regulatory initiatives have already begun to play a critical role in the development of European securities markets, particularly in countries where the prevailing legal rules seem weak.[221]

For the future, the most likely scenario is that, once these forces have created a stronger constituency for open and transparent markets, that constituency will likely demand and obtain the necessary legislative reforms that fill in the inevitable gaps. Although optimistic, such a scenario is consistent with what actually happened in late 19th Century in America and Britain, and with what nearly occurred in Germany of the same era. This usable past furnishes an immediate lesson for the future: the past could again become prologue.

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219 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).

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

221 See text and notes supra at notes 212- 213.